Is Tanzania an emerging economy?

A report for the OECD project ”Emerging Africa”

by

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ACRONYMS

AIDS Acquired Immune-deficiency Syndrome
BFIN Banking and Financial Institutions Act
BOT Bank of Tanzania
BIS Basic Industries Strategy
CG Consultative Group
CIS Commodity Import Scheme
DAC Development Assistance Committee
EAC East African Community
ERP Economic Recovery Programme
ESAF Enhanced Structural Adjustment Facility
ESAP Economic and Social Action Programme
GDP Gross Domestic Product
GOT Government of Tanzania
HIPC Highly Indebted Poor Countries
OGL Open General License
IBRD International Bank for Reconstruction and Development
IFIs International Financial Institutions
ILO International Labour Organisation
IMF International Monetary Fund
LART Loans and Advances Advances Realisation Trust
MDF Multilateral Debt Fund
NBC National Bank of Commerce
NCPI National Consumer Price Index
NESP National Economic Survival Programme
NGOs Non-Governmental Organisation
NPV Net Present Value
OECD Organisation for Economic Development
OPEC Organisation of Petroleum Exporting Countries
PSAP Priority Social Action Fund
PSRC Parastatals Sector Reform Commission
SAP Structural Adjustment Programme
TAC Tanzania Audit Co-operation
TAKWIMU Tanzania Bureau of Statistics
THB Tanzania Housing Bank
TIC Tanzania Investment Centre
TZS Tanzania Shilling
VAT Value Added Tax
WDI World Development Indicators

0. Introduction

0.1. Background

The last few decades have seen dramatic economic improvements in large parts of the Third World, while African economies in general experienced stagnation or decline until the early 1990s. During the last few years, however, there seems to have been a revival in parts of Africa. Many countries have initiated economic reform programmes, and some have seen significant increases in per capita incomes for the first time since the early 1970s. At the same time as these changes are underway, there has been a decline in aid flows from the developed countries. This partly reflects a decline in external political interest in Africa following the demise of the cold war as well as economic problems in donor countries, but it also may reflect an increasing concern about the effectiveness of aid in its traditional forms. Private resource flows to the third world accelerated dramatically during the 1990s, but so far they have largely bypassed Africa. At this juncture there is a need for a reconsideration of the aid relationships in this new environment, and to investigate what the new situation in Africa implies for future aid to the continent.

OECD's study of "Emerging Africa" sets out to contribute to such an understanding. The OECD describes the rationale for the study as follows:

> "It is widely recognised that poverty alleviation cannot be achieved without economic take-off in least developed countries. Historical experience shows that, starting from very poor conditions, take-off can occur if the right policies are implemented (Berthelemy, Varoudakis, 1998). However, this is not a uniform process. Undoubtedly, there will be leaders and followers, as suggested by East Asia's experience of economic take-off, which was initially led by a few economies - Japan, Korea and the Chinese Taipei. In order to maximise the chances of success of the OECD Development Co-operation strategy (DAC, 1996), it is proposed to identify those countries which have the best success likelihood in the short and medium terms, i.e., those countries which are on the right track in the process of economic and political reforms. These strong reformers would deserve special attention because they would be the countries in which development assistance would have the best chances to have a positive impact on economic growth (Burnside, Dollar, 1997). Moreover, giving more support to strong reformers, and being able to achieve positive outcomes in these countries, would create positive incentives for other countries to implement more reforms. It is therefore expected that the initial success of current strong reformers would create a snowball effect at the regional level and eventually stimulate the take-off of a significant number of African countries around 2015.
>
> The very fact of a strong resumption of growth in several sub-Saharan African countries that has been observed in recent years suggests that such a betting on the

> success of the current reformers can be won. However, targeting countries according to merit will not by itself provide sufficient incentives to African governments, unless the bilateral donors co-ordinate their efforts in this respect. Most donors agree that aid should be targeted to countries, which deserve it more. It is also widely accepted that the prerequisites are a sound macro-economic policy record, perseverance in carrying out economic reform, as well as improved governance and political opening. Even though it is inevitable that each bilateral donor decides its own geographical focus for development assistance, some harmonisation of policies vis-a-vis the deserving recipients could usefully be attempted.
>
> This project aims at helping donors to identify and monitor the countries in which the DAC strategy could be implemented first. Such an exercise requires looking at macro-economic stability, economic liberalisation and opening to trade and investment, as well as governance, with a view to assess the performances of various African countries considered as more or less "emerging" with respect to these criteria. The expected initial outcome is an analysis of the current achievements and of the policy reform challenges faced by "emerging" African countries.
>
> Recent research has demonstrated quite convincingly that the growth shortfall of Africa can, to a large extent, be attributed to economic policy failures and to a week institutional environment that fails to support the operation of market mechanisms (Sachs, Warner, 1997). Implementation of better policies would certainly have contributed to a stronger growth performance. Therefore, the main thrust of the analysis will be on assessing the contribution of economic policies to the observed take off in emerging countries, as well as on the possible obstacles to further economic policy reform which is needed to ensure sustained growth in the medium run."

This study aims to answer these questions for the case of Tanzania. The other countries selected are Côte d'Ivoire, Congo D.R., Ghana, Uganda, and Mali. It is hoped that it will be possible to draw some more general conclusions by comparing the results of these country studies. It is noted by the OECD that

> "All of the countries selected (with the exception of Congo) had a successful growth performance over the last few years and a reasonably satisfactory record of economic and political reform. However, African countries have a distinctive record of reversal of economic policy reforms. This raised doubts about the sustainability of reform programs and has considerably reduced their credibility. As a consequence, many of economic policy reforms that have been reasonably effective elsewhere (especially trade reform), have failed to provide the expected results in the case of Africa. Therefore, the project will be specifically focussed on this topic. It will address issues of appropriate timing of policy reforms (macroeconomic stabilisation on the one hand and various microeconomic reforms on the other) and will take explicitly into account the social and political factors that can ensure sustainability of reform."

0.2. Growth determinants

There are many factors that determine economic growth, and as a starting point for our discussion we will briefly review the major factors that determine income growth in African economies.

Factor accumulation and technological progress

Accumulation of physical and human capital, efficiency in resource allocation, and ability to acquire and apply modern technology are basic determinants of growth in any economy. The policy question, which is relevant here, is how the environment should be organised to facilitate the accumulation of production factors and their efficient allocation as well as the introduction of better technologies. The consensus view today is that economic policies at the micro level should aim to develop and sustain efficient markets, while macro policy must be geared to guarantee macroeconomic stability.

I*nstitutions and transaction costs*

An effective economic system requires an efficient set of institutions that can sustain low economic transaction costs. In African economies uncertainty is high, which hinders transactions and reduces the scope for specialisation. Uncertain ownership conditions incline people to avoid long term contracts and to use little fixed capital.

A central question, then, is what is required for growth-supporting institutions to develop. A government, which is primarily concerned with its own survival, is unlikely to set up institutions and rules that are good for economic growth. With special interest politics at centre stage, there is bound to be static inefficiency due to distortions, investors are going to be cautious, and resources are going to be wasted in rent-seeking activities.

Governance and politics

It is becoming more and more apparent that the influence of politics on economics in African economies is of strategic importance to growth prospects. Many policy interventions undertaken have been discretionary, which has paved the way for the high level of corruption and rent seeking in Africa (Bigsten, 1993). Many interventions were well intended, but the elite has also used the system to allocate rents as a means of securing their power positions (Bigsten and Moene, 1996).

A notion that appears in the analysis of the Asian success stories is "shared growth", suggesting that the mass of the population must see the benefits of growth if they are to participate actively. And it is not only the general citizen who must be included, but the ruling elite must also allow competing elites to progress and allow new competitors to come in. The desire for total control has stifled initiatives in African countries. For shared growth to come about, there is need for a bureaucracy of high quality, which is sufficiently independent of pressure groups. Such an institutional set-up is not easily created. It is not enough to instil the relevant skills in civil servants. If they are then put into institutions where outside interference determines outcomes, they become frustrated and cynical. To avoid this result, the norms and behaviour in the society at large have to change. An open debate can contribute to this.

Some cross-country evidence

Several cross-country studies of determinants of growth in Africa have been undertaken in recent years. Easterly and Levine (1997) point to the importance of ethnic fragmentation and the poor quality of infrastructure in the explanation of poor African growth performance. Sachs and Warner (1997) emphasise the role of closed trade policy and geographical factors as main determents of poor growth. When Rodrik (1998) goes on to look at the variation of growth within Africa he finds that the amount of ethnic fragmentation or openness are not significant. Instead it is fundamentals such as human capital, fiscal policy, and demography and convergence factors that explain intra-country variation.

A summing-up

Growth-determining factors are investment in physical and human capital, efficiency of resource allocation, and technical progress. Changes in these factors do in turn depend on the character of the policy environment (appropriate prices and macroeconomic stability), on institutions and on governance. Thus, variables to consider are the investment rate; accumulation of skills through education; relative prices such as the exchange rate; macroeconomic stability in terms of budget balance, external balance and monetary stability; institutional structures; and the quality of governance.

0.3. Criteria of an emerging economy

The concept of "emergence" is not easily defined. At one level you might argue that any country that is experiencing positive per capita income growth is emerging, but this seems too limited. We suggest for the purpose of this study to define an economy as "emerging" if we find that it is in a process of sustainable per capita income growth. We specify a set of criteria or indicators that one need to consider when deciding whether the growth is sustainable. It is not possible to say whether all criteria need to be met or exactly to what extent they need to be met, but we believe that they can serve as an organising devise for our discussion and that we on the basis of our evaluation of the pattern of growth along those line will be able to have a considered opinion on whether the country's growth is sufficiently stable to be characterised as long-term sustainable.

The criteria we have chosen reflect our reading of the literature partly summarised above, and the indicators can roughly be grouped into five categories:

A: Macroeconomic criteria

1) *Macroeconomic stability*. Sound fiscal and monetary policies have been found to essential prerequisites for successful development. See Chapter II.1.

2) *International competitiveness.* One important indicator of whether a country has taken off is whether it has become internationally competitive in areas outside traditional commodity exports, for example in manufacturing. For an economy to be on a path of self-sustained growth it should gradually improve its external competitive position. This requires liberalisation of the trade regime, for example a shift from quantitative restrictions on imports to tariffs, and those have to be harmonised and set at a lower level. It may be, as suggested by Wood (1994), that Africa does not have its comparative advantages in labour intensive manufacturing production, but that they are rather to be found in production that uses intensively the abundant natural resources. If so the degree of success is not what is happening in the manufacturing sector, but the more general question whether the competitiveness of the economy in general is improving. One would in the Wood case expect improvements with regard to land intensive exports. See Chapters II.2 and III.1.

B: Microeconomic criteria

3) *Competitive domestic markets.* Experience also shows that liberalised domestic markets are essential for efficient resource allocation and thus sustained economic growth. See Chapter III.1.

4) *A stable financial system.* One basic institution in an enabling economic infrastructure is the financial system. This needs to be stable, diversified, and transparent. See Chapter III.2.

C: Human resources and infrastructure

5) *Human capital for competitive production.* Human capital development is crucial if growth is to be sustained. We therefore need to consider what is happening with regard to various forms of education. See Chapter III.3

6) *An effective physical infrastructure.* An well-functioning transportation network is essential for economic growth, but there are also other types of infrastructure to consider. See Chapter III.3.

D: Governance and Politics

7) *Unbiased institutions*. Growth requires a set of functioning public institutions such as courts. The rule of law is essential for the development of a market economy. The experiences of a vast range of countries show that an efficient private sector is necessary for sustained economic growth. For this to be realized there must not be undue interference from agents in the public sector in the private sector, that is an efficient private and public sector demarcation. See Chapter IV.1.

8) G*ood governance.* Growth requires good governance. It is by now obvious that also private sector development requires a supporting institutional infrastructure. The government needs to be both non-corrupt and competent. See Chapter IV.2.

9) *A broad-based development pattern.* Poverty reduction is an important or the most important goal of development. However, there is also evidence that a sustainable pattern of development requires that a sufficiently broad spectrum of the population is able to share in the growth. Broad-based growth and poverty reduction also has an instrumental value. See Chapter I.

10) *Political maturity.* What types of policies that are in the end implemented and sustained will eventually depend on the political process. Therefore it may well be that the major growth constraints are to be found in the political sphere. If there is a distorted or even violent political process growth may slow down or come to a halt. See Chapters I and V.

E: Self-reliance

11) *Limited aid dependence.* The achievement of self-sustaining growth also requires that the country increasingly can grow from its own resources, that is a reduction of aid dependence. See Chapter V.

12) *Controlled level of foreign debt*. A too high level of indebtedness puts a lot of pressure on the budget, and constrains the government. Large debts also signal to private investors that there is a risk of higher taxation in the future or various types of policy reversals. See Chapter II.3.

13) *Domestic saving as the major source of investment finance.* An important indicator of whether the growth process is long-term sustainable is the share of investment that is financed by domestic resources. In an integrated world economy one could maybe argue that the sources of investment resources are unimportant as long as investors find that there exist profitable investment opportunities. Still, African countries are not fully integrated in the global capital market, and, moreover, there are few if any examples of countries that have managed to finance rapid growth over an extended period of time on the basis of foreign investment only. See Chapter I.

On the basis of this set of criteria we will try to determine whether Tanzania is on a path of self-sustaining economic growth.

0.4. Outline of the study

The structure of analysis is as follows. In Part I we review the growth record and political developments. Then in Part II we consider in turn the impact of macroeconomic policies including exchange rate and debt policy. In Part III we investigate structural policies. We look at price and trade reforms, the functioning of the financial system, and investments in infrastructure and social overhead capital. Part IV is devoted to the issue of governance, while Part V provides policy conclusions. We will also consider the role of politics and other social constraints.

Part I: An overview of long-run economic performance and political developments

I.1. Introduction

In this Part we first provide an overview of growth and political developments in Tanzania from independence to the present time (Sections I.2-I.5). This will provide a background to the subsequent more detailed chapters, focussing on the recent reform period. In Section I.6 we discuss welfare changes, while Section I.7 considers issues relating to aid and aid dependence. Section I.8 looks at the position of Tanzania in the region, while Section I.9 concludes the chapter.

To organise our discussion we have divided the economic history of post-independence Tanzania into four periods. The first period dates from independence to the Arusha Declaration in 1967. We refer to this period as the "Pre-Arusha" period (Section I.2). This period is followed by the "Pre-Crisis" period, which runs from 1968 to the collapse of the coffee boom in 1978 (Section I.3). The "Crisis" period begins with the Uganda War and the second OPEC oil price shock in 1979 and runs until the resignation of President Nyerere in 1985 (Section I.4). Finally, the "Reform" period begins with the adoption of a major IMF adjustment program in 1986 and runs to the present.[1]

Any student of the Tanzanian economy has to acknowledge that the quality of macroeconomic data is low, even by African standards. We discuss this issue in Appendix A, where we also present results of the most recent revisions of the national accounts. These are the best data currently available from the Bureau of Statistics in Tanzania. The growth estimates probably underestimate the variability in growth rates, but we take them as rough indicators of magnitude. In the presentation in this chapter we complement this information with data from World Bank data files.

I.2. The Pre-Arusha period 1961-1967

Following independence in 1961 the government concentrated on the Africanisation of the public sector and measures to stimulate economic growth.[2] There were no dramatic changes in the

[1] The presentation of the economic history draws on Adam et al (1994).

[2] In the First Five-Year Plan (1964-69) the government emphasised two goals, rapid economic growth and self-

economic policies, which had been pursued by the colonial power. Peasant agriculture was encouraged by conventional measures. Industrial development was promoted with a relatively mild import substitution policy and relied on private investors. The economy remained fairly open and was highly dependent on revenue from commodity exports. During the Pre-Arusha period 1961-1967 per capita incomes grew by 2% per year, the highest rate of any period in independent Tanzania (see Table 1.1). Capital formation increased steadily between 1963 and 1967. This was also a period of macroeconomic stability with mostly low inflation and a satisfactory balance of payments.

However, the government was not content and argued that inequalities had increased, that industrial growth and inflow of external resources failed to meet expectations. President Nyerere felt that a new strategy was necessary to speed up development.

Table 1.1: Data for the Pre-Arusha period 1961-1967

	1961	1962	1063	1964	1965	1966	1967
Per capita income growth %	-7.1	4.3	1.2	3.6	-0.2	9.9	1.8
Population growth %	2.8	2.8	2.9	2.9	2.9	3.0	3.0
Urbanisation %	4.8	4.9	5.1	5.2	5.3	5.6	5.9
Terms of trade (1987=100)	130	124	137	142	137	137	126
% of labour force in agriculture	92.4	92.1	91.9	91.7	91.4	91.2	90.9
Monetary growth % *		21.7	25.6	-15.2	31.8	476.7	13.1
Inflation %	7.8	0.6	4.9	2.8	-2.4	9.3	11.5
Gross investment % of GDP	13.7	11.6	10.7	12.0	13.9	15.1	18.9

Sources: Income and investment data from Appendix A. Other data from World Development Indicators 1998.
* Includes money and quasi money.

I.3. The Pre-Crisis period 1968-1978

The Arusha Declaration in 1967 was a watershed in Tanzanian political and economic history. It meant that President Nyerere and the ruling party left the cautious course pursued during the first period after independence and launched the strategy of “African socialism”, where the government was to take control of the commanding heights of the economy. There was a concern that the external dependence was too high, and that it was necessary to create an internally integrated economy. The necessary structural transformation was to be facilitated by increased state control.

By the early 1970s, the Government had consolidated its hold on most parts of formal economic activity. Banking and large portions of the industrial sector had been nationalised, the bulk of

sufficiency in middle- and high-level personnel.

international trade and private retail trade had been confined to state agencies, and market prices had largely been replaced by administered prices. A foreign exchange allocation system was developed in response to the balance of payments crises of 1970-71 and 1974-75, and in 1974 a National Price Commission was established that by the late 1970s was setting prices on some two thousand goods.

By the mid-1970s, most of the rural population had been forced to resettle into "Ujamaa" villages as part of a strategy to promote co-operative agriculture, and monopoly government marketing boards had replaced peasant marketing co-operatives. In 1974 the Government began to implement its Basic Industries Strategy (BIS) of import-substituting industrialisation, but it soon had to postpone it in the balance of payments crisis that accompanied the first oil shock. The external position improved dramatically during the coffee boom 1975-1978, and the Government revived the BIS in a decision that came to dominate the allocation of foreign exchange and the pattern of domestic investment. We see in Table 1.2 that investment were high throughout the 1970s, although there was a slack in 1973 -75. The investment programme was state-led, and a lot of the investments undertaken in the 1970s were donor supported. The end of the pre-crisis period was marked by the break-up of the East African Community in 1977 and the rapid depletion of international reserves following the end of the coffee boom in 1978 and an abortive import liberalisation that same year.

There was disagreement among donors in the 1970s about Tanzania, where several bilateral donors were supportive, while the World Bank and the IMF became more and more critical of policies with regard to agriculture, domestic pricing, the BIS, and the exchange rate (Collier, 1991). Since President Nyerere’s position was strong both domestically and with many bilateral donors, he was able to take a hard line with the IFIs.

During the pre-crisis period per capita incomes grew by 0.7% per year (See Table 1.2). The growth was led by the public administration sector, with sizeable contributions from agriculture and manufacturing. Tanzania's export, dominated by traditional agricultural exports such as coffee and cotton, stagnated. The policy environment in Tanzania was hostile to both traditional and non-traditional exports. The explicit taxation of agriculture was relatively low, but such taxes as existed favoured food crops over export crops. More importantly, the rewards to peasant production for export were undercut during the 1970s by the government monopolisation of marketing, with inefficiencies driving down producer prices, the relocation of rural producers in the "villagisation" drive, the high effective protection of the import-substituting industrial sector, which turned relative prices in favour of urban areas, and the use of trade controls rather than exchange rate adjustment as a means of adjusting to external shocks. The weaknesses of the system had been concealed for a few years by the coffee boom bonanza, but when this ceased the inefficiencies of the economy became apparent.

Table 1.2: Data for the Pre-Crisis period 1968-1978

	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978
Per capita inc. growth %	2.1	-0.7	3.0	0.8	2.3	0.5	-0.5	2.9	2.3	-2.7	-1.9
Population growth %	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.1	3.1	3.1
Urbanisation%	6.1	6.4	6.7	7.4	8.1	8.7	9.4	10.1	11.0	12.0	12.9
Terms of trade	126	126	137	123	128	146	174	142	152	182	152
External debt, Million $			212	284	407	619	900	1170	1380	1700	1970
% labour force in agriculture	90.6	90.3	90.1	89.7	89.3	88.9	88.5	88.1	87.7	87.2	86.7
Inflation %	14.5	15.2	3.5	4.7	7.4	9.9	17.9	23.2	6.6	11.0	6.4
Monetary growth %	17.8	9.2	12.0	18.2	17.7	18.2	22.1	24.4	25.1	20.2	12.6
Gross investment, % of GDP	18.4	16.3	22.9	26.8	23.6	22.6	21.6	20.8	29.0	29.4	33.8

Sources: Income and investment data from Appendix A. Other data from World Development Indicators 1998.

I.4. The Crisis period 1979-1985

The "Crisis" period began in 1979 with a major increase in the fiscal deficit associated with the war in Uganda. During this period the control regime was tightened even more as the government sought to finance the increased spending and to maintain the import-intensive BIS in the face of declining export proceeds.[3] External arrears developed rapidly and after the end of the Uganda war foreign inflows fell dramatically as the government clashed with the donors over macroeconomic policy. The dialogue with the IMF broke down in 1978-79, when President Nyerere vetoed an IMF agreement including a 15% devaluation. The government implemented its own "National Economic Survival Programme" in 1981-82, but reforms were limited and unsuccessful.[4] A second domestic effort, the "Structural Adjustment Programme" went further but did not address the important issues such as exchange rate overvaluation and liberalisation

[3] Bevan et al. (1990) provide an extensive analysis of macroeconomic developments during the crisis period.

[4] A Commodity Import Support scheme was introduced in the late 1970s to increase imports of particularly intermediate goods needed to increase capacity utilisation. It was replaced by the Open General License system in the early 1980s, but this had to be suspended already in 1982 due to lack of funds.

of agricultural marketing Donors who had been attracted by the egalitarian principles set out in the Arusha Declaration, had become more and more critical about the negative effects of Ujamaa on economic efficiency, and by 1983 most of the donors had begun to withdraw their support of the Tanzanian experiment and aid flows declined.

Export performance had deteriorated during the period as domestic inflation increased and the government had compressed imports through direct foreign exchange rationing rather than accommodating inflation through nominal depreciation. The government began to reverse its producer pricing policies in an attempt at export promotion in the early 1980s, but this was more than offset by increases in marketing inefficiencies and overvaluation. In 1984 the Government finally made its first major move towards liberalisation, adopting an own-funds scheme that allowed importers to obtain licenses without declaring the source of their funds. But Tanzania resisted the pressure to devalue. It was President Nyerere's resignation opened the way for a more liberal policy including devaluation and import liberalisation.

Export data for the crisis period must be interpreted with care, since the black market premium on foreign exchange was high and provided strong incentives for smuggling (Kaufmann and O'Connell (1991. The decline in official exports during the crisis period therefore in part reflects a diversion of exports from official to unofficial channels in response to an increasing parallel premium (it increased from 45 percent at the end of 1978 to over 800 percent at the end of 1985). Some estimates put the level of smuggled export at about 50% of official exports (Adam et al, 1994, ch.7).

During the crisis period per capita income fell by 1.5% per year according to official estimates (see Table 1.3), but the estimates are particularly uncertain for this period because the price system was in a disarray and much of economic activities had moved to the parallel economy. Estimates by Bevan et al (1988), based on household budget surveys using black market prices for goods traded in the parallel market, suggest more significant income declines. Manufacturing output collapsed due to lack of imports and agricultural growth declined. Public administration was still growing, although the growth rate had declined to less than four per cent. State control of the "commanding heights" of the economy was a central tenet of the Arusha Declaration, and by the late 1970s Tanzania had constructed a very comprehensive parastatal sector (Bagachwa, Mbelle and van Arkadie, 1992). From roughly 40 entities in 1966, the parastatal sector grew to encompass about 450 entities by the mid-1980s, covering the entire range of economic activities.

In the manufacturing sector the parastatals produced half the output and controlled two thirds of the fixed assets.

Table 1.3: Data for the Crisis period 1979-1985

	1979	1980	1981	1982	1983	1984	1985
Per capita income growth %	0.2	-0.2	-3.7	-2.6	-5.6	0.2	1.4
Population growth %	3.1	3.2	3.2	3.2	3.2	3.2	3.2
Urbanisation %	13.9	14.8	15.4	15.9	16.5	17.0	17.6
Terms of trade	139	142	129	127	128	131	126
External debt Million $	2070	2450	2880	3130	3390	3620	4030
Interest rate spread %	7.5	7.5	8.0	8.0	9.0	9.0	7.8
%labour force in agriculture	86.3	85.6	85.6	85.5	85.4	85.2	85.1
Monetary growth %	46.9	26.9	18.1	19.5	17.8	3.7	30.3
Inflation %	12.2	26.4	22.8	25.4	23.5	30.9	28.7
Gross investment % of GDP	33.6	33.1	28.6	26.0	19.3	20.2	18.7

Sources: Income and investment data from Appendix A. Other data from World Development Indicators 1998.

The crisis period was characterised by hard internal political debates (for an extended discussion, see Bigsten, Mutalemwa, Tsikata, Wangwe, 1999). The political resistance to reforms was strong, since the liberalisation of the economy really represented a U-turn relative to the development strategy that was outlined in the Arusha Declaration. By the mid-1980s, however, the crisis was so acute and the external support so small that the government had to budge. Still, a large group within the ruling party saw the shift to reform as a temporary setback, which meant that there was far from whole-hearted support for the reform packages to come, which probably reduced their effectiveness.

I.5. The Reform period 1986-

The "Reform" period began in 1986 with a maxi-devaluation and the initiation of a standby agreement with the IMF and a structural adjustment programme with the World Bank. The "Economic Recovery Programme" 1986-89 (ERP) presented that year included a broad range of policies aimed at liberalising internal and external trade, unifying the exchange rate, reviving exports, stimulating domestic saving, and restoring fiscal sustainability. Internal opposition was still fierce, and the thrust of the ERP was crisis management rather than a definitive move to a market-oriented economy (Mans, 1994). The programme nonetheless addressed the main immediate concerns of donors and met with substantial support, including renewal of the IMF structural adjustment facility in 1987, 1988 and 1990. In 1989, reforms entered a second phase under the government’s "Economic and Social Action Programme" (ESAP). This continued earlier efforts at trade and exchange rate liberalisation and macroeconomic stabilisation, but was widened to include reforms in the banking system, agricultural marketing, the parastatal sector, government administration, and the civil service, together with a targeting of the social sectors which had deteriorated substantially during the crisis period.

Between 1986 and 1992 the Tanzanian exchange rate was discretionarily adjusted. This lead to a rapid depreciation of the exchange rate. The parallel market premium declined from the peak of 800% in 1985 to 30% in early 1992. In April 1992 the parallel market was integrated into the formal market by the opening up of Bureaux of Exchange. In July 1993 the Bank of Tanzania opened up weekly foreign exchange auctions, which were in place until June 1994 and functioned fairly well. At that time the current inter-bank foreign exchange market was set up. In this market both banks and other authorised dealers are allowed to participate. This meant that the exchange rate became market determined (Wangwe, Semboja, Tibandebage, 1998).

The agreements with the IFIs helped restore donor confidence. They came back in force and there was a second aid boom, which peaked in the early 1990s. This support was probably important to make the transformation possible, but it is hard to know for sure what would have happened without this resource inflow. Tanzania was obviously in a desperate situation and would have had to go down the reform route in any case.

In the later stages of the reform process the government has had to grapple with structural reforms such as the downsizing of the public sector, closing or selling of loss-making public enterprises, and financial sector reforms. These are harder than standard macroeconomic or price reforms, since they confront vested interest in a more direct and obvious way. Many people have lost their jobs and privileges in the government and the parastatals. Even at the end of the 1980s the parastatal sector still contributed nearly 25% of non-agricultural wage employment and generated some 13% of total GDP (Bagachwa, 1992), but since then privatisation and liquidation has reduced this share very significantly.

Around 1993-94 a new crisis with the donors emerged. This concerned the lack of fiscal control and in particular the large scale tax exemptions granted by the Ministry of Finance. Tax revenue fell again and the government reverted to borrowing from the central bank. Much of the fiscal control that had been built up since 1986 seemed to be lost. There was a general feeling among donors that corruption and tax evasion was rampant, and that the government was not committed to dealing with these issues. The donors had pledged substantial balance of payments support, but now they withheld substantial amounts. Disbursements between 1994 and 1998 were in the range of 50% of commitments (Mutalemwe, Noni, Wangwe, 1998, p.10).

The new government, from November 1995, put improvement of donor Tanzania relations high on the agenda and it again increased reform efforts. In 1996 Tanzania entered into a new agreement with the IMF on a three-year ESAF, and the relations with the other donors has improved again. It seems fair to say that the government is back on track in the reform process.

The reforms have managed, in spite of some set-backs along the way, to increase growth again. Per capita incomes have so far grown by 0.6% per year during the reform period. Agricultural growth increased significantly, and the manufacturing sector switched from a decline of 4 percent per annum to positive growth, in spite of the fact that many industries have collapsed in the face of increase import competition. There were strong recoveries in construction, trade, and transport as well. The development of the latter may be considered a necessary ingredient in the recreation of a viable market economy. The lagging sector has been public administration. Drought and floods undermined agricultural production in 1997. Harvest of coffee and cotton, Tanzania's main exports, were particularly badly hit, undermining the country's trade balance. Tanzanian economic growth in 1998 was expected to be only about 3 percent, barely keeping pace with the population growth (2.8%).

The types of reforms that were undertaken in Tanzania have been in the standard Structural Adjustment mould, but since large segments of the government were not committed, the level ownership was initially low and there was a lot of foot-dragging. From the early 1990s the anti-reformers have essentially lost control of the party, but even after this it has been hard to stay on course. There was slippage in the programme again and there seemed to be an increase in corrupt practices, which meant that there was a new crisis in donor relations between 1993 and 1995.

The major problem of the government's lack of competence to manage effectively the economy and the reforms remains. The provision of public services is poor, and corruption is high due to the low levels of salary in government. Still, Tanzania has certainly come a long way since 1985. Few countries have undergone such a dramatic change of the entire social and economic set-up in such a short time as Tanzania. It is hard to foresee any reversals of the reforms at this stage, although the effectiveness of many aspects of the reform process is in doubt. Many reforms are still plans to be implemented, and those that have been implemented are often ineffective.

Table 1.4: Data for the Reform period 1986-

	1986	1987	1988	1989	1990	1991	1992	1993	1994	199
Per capita income growth %	3.4	2.7	1.3	-0.6	3.1	-0.3	-1.3	-4.1	-0.1	0.6
Population growth %	3.2	3.2	3.1	3.1	3.1	3.1	3.1	3.0	3.0	2.9
Urbanisation %	18.2	18.9	19.5	20.2	20.8	21.5	22.2	22.8	23.5	24.2
Terms of trade	141	100	107	103	93	94	85	83		
Current account % of GDP			-11.6	-15.5	-18.1	-17.2	-21.8	-24.5	-25.5	-24.
Export % of GDP			9.8	14.6	13.2	8.5	8.4	15.2	18.5	20.5
Import % of GDP			27.3	30.7	35.5	35.3	36.8	44.0	45.4	42.4
External debt Million $	4610	5490	6010	5850	6410	6540	6620	6800	7260	743
Government Consumption % of GDP			16.8	16.3	17.0	18.4	19.3	19.5	18.1	16.1
Gross investment % of GDP (WB)			18.2	17.0	22.3	25.9	26.5	25.8	24.6	21.7
Gross investment % of GDP official		23.5	17.4	19.3	28.2	28.5	28.9	26.7	26.4	21.2
Domestic saving % of GDP			1.3	1.3	0.3	-0.6	-1.6	-2.8	-2.0	0.0
Interest rate spread	10.0	11.8	12.2	14.0						18.2
% labour force in agriculture	85.0	84.8	84.7	84.5	84.4					
Manufacturing VA in GDP %			8.1	8.1	8.9	9.1	8.5	7.8	7.4	7.3
Inflation %	28.1	26.2	27.1	23.0	30.6	25.2	19.8	22.5	29.3	24.2
Monetary growth %	27.9	32.1	32.6	32.1	41.9	30.1	40.6	39.2	35.3	33.0

Sources: Income and investment data from Appendix A. Other data from World Development Indicators 1998.

I.6. Welfare impacts of the reforms

If we only consider what has happened to per capita incomes in Tanzania, we must conclude that progress has been very modest. If we compare changes in per capita income over our four periods we find that the first period 1961-1967 saw the most rapid increase in per capita incomes at 2.0 per cent per year. The Pre-Crisis period 1968-1978 saw an increase by 0.7 per cent per year, while there was an annual decline by 1.5 per cent per year during the Crisis period 1979-1985. Finally, the Reform period from 1986 onwards has seen per capita incomes grow by an average of 0.6 per cent per year. This means that per capita incomes at present are only about 6 per cent higher than at the time of the Arusha Declaration thirty years ago. During this time the country had to live through a period of severe economic crisis, when the official economy practically collapsed. At least peasant households managed to switched to subsistence activities, which meant that they could protect themselves against the decline to some extent. When the reform process started, the situation in the rural areas improved due for example to improved goods availability and higher prices of exportables following the depreciation of the exchange rate. The improvements then seem to have levelled off. Urban incomes have probably been more volatile over the whole period.

There are still some indications of improvements in welfare over the longer term. We can see in Table 1.5 that life expectancy has increased considerably from independence until the mid-1990s. One should note, however, that there has been a reversal of the trend in the last few years. This is probably due to the AIDS epidemic, which is putting the society under severe pressure. It represents a real threat to the recent progress

There are some indications that income distribution has worsened during the last few years, although comparisons of changes over time are very uncertain. Still, combining that with the low levels of per capita income growth, it is possible that the extent of poverty has increased in spite of positive per capita income growth. It is estimated that about 50 per cent of the population live in poverty, most of them in the rural areas (Mutalemwa, Noni, Wangwe, 1998, p. 34).[5] The adjustment measures may have increased regional disparities because of differences in access to land and changes in terms of trade benefiting particular areas. The consequences of the austerity

[5] Cooksey (1994) and Wangwe (1997) review research on poverty. Both cite the Cornell study, which shows that the extent of poverty is more widespread in rural Tanzania than in urban Tanzania. If the poverty line is set as the income required to be able to consume 2100 calories daily plus a set of other basic needs, then 58% of the rural population is poor but only 29% of the urban.

measures have varied significantly among areas, since some have been able to wield more influence in the budgeting process than others. There has also been created by uneven allocation of development projects. In the urban areas it is mainly the access to employment opportunities that determine the distribution of poverty.[6]

Table 1.5: Life expectancy 1962-1996

	Life expectancy at birth, female (years)	Life expectancy at birth, male (years)	Life expectancy at birth, total (years)
1962	43.3	40.1	41.7
1967	45.7	42.5	44.1
1970	47.1	43.9	45.5
1972	48.1	44.9	46.5
1977	50.7	47.3	49.0
1980	51.8	48.4	50.1
1982	52.6	49.1	50.8
1985	52.5	49.3	50.9
1987	52.5	49.4	50.9
1990	53.2	50.1	51.6
1992	53.6	50.5	52.0
1995	52.3	49.5	50.9
1996	51.8	49.2	50.5

Source: World Development Indicators 1998

To deal with hardships the World Bank initiated the Priority Social Action Programme (PSAP) including projects in health, education, water and agricultural development. What the impact on poverty has been remains unclear. If we look at the provision of social services by the government we note that public expenditure on health has been between 4 and 5 per cent during the reform period. The services are still very strained due to the poor pay to the staff and shortages of, for example, essential drugs in many rural health facilities. Also the education sector has received an allocation of public money at around 4 per cent of GDP during the last decade, which has been too little to preserve the system that was build up before the crisis. Enrolment rates have fallen from 75% in the mid-1980s to 67% in 1995.

The reforms have been able to reverse the negative trend in per capita incomes in Tanzania, and this has certainly had beneficial effects. Still, some groups still have seen very limited gains.

I.7. Aid and aid dependence

In a study of Swedish aid to Tanzania, Adam et al (1994) argues that aid since 1970 can be divided into three distinct phases involving a shift from “an essentially co-operative, arms-length relationship between sovereign partners in the 1970s, to a confrontational relationship between

[6] Urban unemployment was estimated by the UNDP to be 15% in 1996, but this figure is of course highly uncertain.

1980 and 1985, and finally in 1986 to a renewed collaboration but one influenced by the recognition of clear conflicts of interest between donor and recipient and by the overwhelming concentration of bargaining power in the hands of the donors."(p. 70) The first period up to the early 1980s saw a steady increase in aid flows. The second phase lasted from 1980 to 1985 and was characterised by donor disillusionment disengagement. Adam et al (1994) characterise it as a 'war of attrition' between the Tanzanian government and its foreign donors. Foreign aid fell steadily during this period of economic decline. The final and current phase began in 1986 and is associated with the IMF-approved Economic Recovery Program and successors to that. During this phase aid increased again up until 1992, but since then it has declined.

Although the Arusha Declaration emphasised self-reliance, Tanzania became heavily aid dependent. Aid per capita peaked in 1992 at 49.6$ per capita per year. As a percentage of GDP aid culminated in 1990, when it was 29.3%. In the 1970s the donors preferred project aid, but in recent years the emphasis has shifted to programme aid. There has also been increased concern about policy and economic management, meaning that aid has been conditioned on policy reform. Also the sectoral composition of aid has changed. In the 1960s and early 1970s support of agriculture and transport dominated, but during the second half to the 1970s the emphasis shifted to industry and energy sectors, while transport rehabilitation came back as a major recipient in the late 1980s.

The level of aid in Tanzania has been high relative to GDP throughout (see Table I.6). Tanzania remains one of the most aid dependent countries in the world, although the share has fallen towards 15 per cent of GDP. Aid is the dominant source of external transfers for Tanzania, and aid of these magnitudes is certainly of major macroeconomic importance. It has both direct and general equilibrium effects on economic variables, and it also influences the policy environment.

One aspect of aid dependence is whether the recipient country is able to sustain aid financed projects once donors have withdrawn. This is obviously a very basic preconditions for aid projects to be successful. In a study of 12 Swedish aid projects in Tanzania, Catterson and Lindahl (1998) show that the prospects for successful take-over of projects are poor. There is lack of financial sustainability in the supported institutions, which means that once they are let go they either run into trouble or they manage to link up to another donor. Few projects have been effectively converted into fully locally controlled operations. Among the reasons for these poor results the study mentions that projects have been poorly technically suited to the environment, but also that there is a severe lack of financial, organisational and managerial skills on the Tanzanian side. There are also incentive problems such as the demands by the Tanzanian government that donor funds should always be found to finance development budgets. Since projects may get finance from other donors once one withdraws, the incentive to seek a viable own financial strategy is weak. There is also often poor attention to cost effectiveness. Projects that may seem to be viable as long as a donor is around, may after his withdrawal look like white elephants. It thus seems as if the Tanzanian environment still is highly aid dependent and that public sector capacity to cope on the basis of own resources is limited. Tanzania thus does not seem to be on a sustainable self-propelled pattern of development as yet. It is felt that the chances of successful aid support would increase if the changed from being supply driven to becoming demand driven.

Table 1.6: Some measures of aid dependence

	% of central government expenditures	% of GNP	% of gross domestic investment	% of imports of goods and services	Aid per capita (current US$)
1975	35.8	..	..	..	18.6
1976	37.6	..	..	..	16.3
1977	38.1	..	..	..	20.1
1978	35.9	..	..	33.6	24.3
1979	37.9	..	..	48.3	32.7
1980	46.0	..	..	54.3	36.5
1981	44.4	..	..	59.0	36.6
1982	34.4	..	..	53.2	34.5
1983	34.2	..	..	54.4	29.0
1984	39.5	..	..	55.8	26.3
1985	36.5	..	..	43.6	22.2
1986	..	..	..	56.2	30.3
1987	..	..	..	61.9	38.0
1988	..	19.9	103.4	63.1	41.0
1989	..	20.2	111.4	52.8	37.4
1990	..	29.3	122.9	67.2	46.1
1991	..	24.9	86.7	61.4	41.1
1992	..	28.7	102.1	64.6	49.6
1993	..	21.9	80.4	43.4	34.1
1994	..	23.8	92.5	40.4	33.6
1995	..	18.3	81.2	37.8	29.7
1996	..	15.6	84.8	38.4	29.3

Source: World Development Indicators 1998

Given the magnitude of aid received by Tanzania, the dismal growth picture poses an obvious question of aid effectiveness. It is clear on the face of it that aid has not had a strong payoff in terms of growth. Constructing a proper counterfactual is extremely difficult, however. What would have happened if aid had been smaller? Aid has clearly exerted two kinds of influence in Tanzania on the supply of external resources, and the other on policy formation. Disentangling these effects is crucial for assessing the impact of aid on growth in Tanzania. We have not attempted to do this, but we might point to some interesting results from a study by Hansen and Tarp (1999). They provide a critique of the Burnside-Dollar (1997) results about aid effectiveness and show that aid typically has a positive effect on growth, even if the policy environment is poor. Even they have a caveat, though, namely that this at least seems to be the case as long as aid is less than 15 per cent of GDP. Therefore aid levels to Tanzania thus seem to have been above what one might assume that the country could effectively absorb

Mutalemwa, Noni, and Wangwe (1998) provide an extensive discussion of aid management issues. They note, for example, that aid co-ordination is a major problem for Tanzania with over 100 donors with varying requirements. The co-ordination is basically the task of the Ministry of Finance and the Planning Commission, but these institutions lack the capacity to do the job effectively. They are weaker in terms of administrative competence then the donors they deal with. When the latter have been discontent with the performance of "their" projects, they have established their own administrative systems to bypass the inefficient government machinery.

In !987 the government and the donors agreed to set up a formal structure for government-donor co-ordination, and since then there have been regular meetings chaired by the Principal Secretary of the Ministry of Finance, with the backing of the UNDP. Co-ordination has improved somewhat, but it is still weak. Various other government departments hold meeting on a bilateral basis to co-ordinate donor activities in accordance with the overall plan, but it is hard to handle the whole range of donors separately. Government officials are severely overstretched. The Consultative Group Meetings organised by the World Bank and the government has provided a modicum of co-ordination. The CG-meeting was held in Tanzania for the first time in 1997, but the majority of donors opted for a Paris meeting again in 1999. Attempt at inter-donor co-ordination has actually been going under the auspices of the UNDP since the 1970s and in a range of other fora, but donor interests vary and so far it has not been easy to achieve efficient co-ordination. Some do not want to be co-ordinated.

I.8. Tanzania in the region

After a few years in the first half of the 1990s when Africa seemed to have had a breakthrough in terms of democracy and political stability, we have again seen wide spread unrest in the form of civil wars and in the case of the Congo with extensive involvement of neighbouring countries.

Tanzania was severely affected by the flow of refugees from Rwanda, but otherwise it has stayed out of the conflicts. Since independence Tanzania has been a peaceful haven in the region. This may be an important asset in future attempts to attract foreign investment and to establish a good environment for growth. At present there does not seem to be any significant risk that Tanzania will be drawn into existing regional conflicts.

Domestically there is the eternal problem of the relationship with Zanzibar, which in a way pursues its own independent policy. President Nyerere created the union, and it still has support. Still, it seems quite possible, given the complicated relations between the island and the mainland, that the union will eventually be dissolved. This would certainly be done in a peaceful way, and the economic impact on the mainland would be minimal.

It seems more important for Tanzania to increase collaboration with its neighbouring countries. The East African Community (EAC) between Kenya, Uganda and Tanzania broke up in 1977, but in the last few years the three countries have started to rebuild collaboration. Attempts are now made to ensure that all parties benefit in roughly equal measure, to avoid the old critique that it was mainly Kenya that gained from the union. The new community is even introducing an East African passport, which allows holders to travel unhindered within the region. There is a measure of collaboration between the stock-exchanges and a major project is concerned with the improvement of the environment in and around Lake Victoria. Attempts are made to co-ordinate economic policies, particularly in the area of trade. It has been proposed that tariffs in the East African region shall be removed by the year 2000, but this is probably too optimistic to believe that there will be a comprehensive agreement by then. Generally the three countries in the Community have similar comparative advantages, so the initial scope for inter-regional trade may be limited. There is probably room for some exports from Tanzania in food and food products, but when it comes to manufacturing Kenya is still much more diversified, even if some industrial development is underway also in Tanzania. The old conflict may therefore easily resurface. Still, increased trade with the neighbours should be part of the overall strategy of opening-up.

I.9. Concluding remarks

From the late 1970s negotiations with the IMF collapsed, since the demands of the IFIs implied a critique of the fundamentals of the Tanzanian approach, that is socialist economic management. However, the retirement or Nyerere as President in 1985 opened the way for the agreement on the Economic Recovery Programme for 1986-1989 and later on for a new ERP for 1989-1992. Since then Tanzania has managed to bring about considerable improvements in its policy environment, and it has seen positive per capita income growth. Still, in spite of an increase in investment, it has not been enough to accelerate growth very much. At present private investors perceive risks to be high and take a wait and see attitude.

The question is why the growth recovery has not been more substantial in the case of Tanzania. We will dwell on this question throughout the rest of this study, but we may already here say something about the importance of politics. We have noted that there was resistance to reform for a long time. The reform programme was started because the government had no choice, and the commitment to reform was initially very low. Nyerere has never fully supported the reforms, and he has had influence also after his resignation as President. His attitude stands in stark contract to that of President Museveni in Uganda. At least until 1990 a lot of scepticism and resistance remained within the government. The half-hearted backing of the reforms has probably had a cost in terms of the efficiency of the programme.

Another factor that seems important in the case of Tanzania is the size of foreign aid flows, and the extent of donor influence in various parts of the government. This aid dependence has undermined domestic control of the development agenda and of the running of government institutions, and this may have resulted in poor governance. The recent emphasis on partnership between donors and recipients is an indication that also donors are concerned with their impact on the recipient government.

Appendix A: A note on the national accounts of Tanzania

The quality of macroeconomic data in Tanzania has for a long time been a problem for researchers attempting to analyse economic performance. A particular concern was the poor coverage of the informal sector or the "second economy". The Bureau of Statistics has during the 1990s, however, managed to revise national accounts for recent years (1985 onwards) on the basis of among other things quite extensive household surveys. This meant that the level of measured GDP shifted up rather dramatically. As can be seen in Table I.1 the GDP revision varies from a staggering 65% in 1985 to 31% in 1995.

We are mainly concerned to find the estimates of growth rates. We use the old series for the period up to 1985, while we use the new series for estimates from 1986 onwards. This means that we used the best data currently available with Tanzanian authorities. It is noteworthy that the recorded swings in the growth rate are rather limited. This may be due to the fact that the authorities are forced to use crude procedures to impute values on for example subsistence production. The methods use may well underestimate the actual swings. It is certainly also the case that the official price indices poorly reflected the price levels that existed during the control regime, when a substantial share of goods were traded in the black market. Estimates of incomes during the crisis period allowing for this show a much more dramatic decline (Bevan, Bigsten, Collier and Gunning, 1988). The figure that are presented are therefore only to be taken as rough indicators of magnitude, but hopefully they may still reflect some of the changes in growth rates between years.

Other data are also of highly variable quality. For example, trade statistics are also unreliable due to the prevalence of export smuggling and import over-invoicing and weaknesses in customs data collection. The extent of these problems have varied over time, which means that also growth rates are significantly affected. Investment data are crude and are largely based on import data and local cement production. The previous round of national accounts revisions for the period from 1976 onwards have improved the data somewhat. We also must note that these weaknesses also affect the estimates of consumption and saving, since these variables are derived as residuals in the national accounts.

The estimates of national accounts aggregates for individual years may thus be misleading and must be treated with caution. Even averages for longer periods can be misleading, due to the prevalence of changes in the policy environment which at times have had dramatic effects on relative prices.

Table A1: GDP 1960-1997 in Mainland Tanzania (Shs million) & growth rates (%)

Year	Current prices - old series	Current prices - new series	1960 prices	1966 prices	1976 prices	1985 prices	1992 prices - new series	Growth rate -old series	Growth rate - new series	Population growth rate	Per capita income growth rate
1960	3701		3701								
1961	3870		3544					-4.24%		2.81	-7.05
1962	4189		3796					7.11%		2.84	4.27
1963	4547		3951					4.08%		2.87	1.21
1964	5594		4209	5619				6.53%		2.90	3.63
1965	5671			5773				2.74%		2.94	-0.20
1966	6514			6514				12.84%		2.97	9.87
1967	6735			6825				4.77%		3.00	1.77
1968	7182			7174				5.11%		3.02	2.09
1969	7460			7338				2.29%		3.03	-0.74
1970	8215			7779				6.01%		3.03	2.98
1971	8857			8076				3.82%		2.98	0.84
1972	10032			8504				5.30%		2.97	2.33
1973	11490			8800				3.48%		2.97	0.51
1974	14010			9020				2.50%		2.99	-0.49
1975	16988			9553				5.91%		3.03	2.88
1976	22109			10069	21652			5.40%		3.07	2.33
1977	26146				21739			0.40%		3.10	-2.70
1978	29798				22002			1.21%		3.12	-1.91
1979	35141				22739			3.35%		3.14	0.21
1980	37564				23419			2.99%		3.16	-0.17
1981	46557				23301			-0.50%		3.17	-3.67
1982	56247				23439			0.59%		3.18	-2.59
1983	61621				22886			-2.36%		3.19	-5.55
1984	74643				23656			3.36%		3.18	0.18
1985	101684	167768			24742	101684		4.59%		3.18	1.41
1986	135493	227310				108388		6.59%		3.17	3.42
1987	186544	302063				114775	1071541	5.89%		3.16	2.73
1988	330260	468098				121502	1119017	5.86%	4.43%	3.14	1.29
1989	515825	582163				123926	1147745	2.00%	2.57%	3.12	-0.55
1990	671742	760006				132812	1219237	7.17%	6.23%	3.10	3.13
1991	825825	989593				140383	1253132	5.70%	2.78%	3.11	-0.33
1992	1007576	1275976				145669	1275916	3.77%	1.82%	3.08	-1.26
1993	1332813	1607762				151398	1262007	3.93%	-1.09%	3.04	-4.13
1994	1731447	2125325				155940	1298942	3.00%	2.93%	2.99	-0.06
1995	2130554	2796640				163003	1345247	4.53%	3.56%	2.92	0.64
1996		3452590					1401712		4.20%	2.82	1.38
1997		4281600					1448089		3.31%	2.8	0.51
Average 1961-1967								4.84%			1.95%
Average 1968-1978								3.73%			0.74%
Average 1979-1985								1.45%			-1.45%
Average 1986-1997								3.63%			0.57%

Sources: Selected Statistical Series 1951-1994, Revised National Accounts of Tanzania 1987 - 1996 and Bureau of Statistics files. Population growth estimates from World Bank Data 1998.

Table **A2: Gross fixed capital formation in Mainland Tanzania**

	Current prices-old series	Current prices-new series	1966 prices	1976 prices	1985 prices	1992 prices	Investment Share	
1960	596						16.1%	
1961	530						13.7%	
1962	488						11.6%	
1963	485						10.7%	
1964	674		731				12.0%	
1965	789		826				13.9%	
1966	982		982				15.1%	
1967	1271		1210				18.9%	
1968	1318		1284				18.4%	
1969	1217		1155				16.3%	
1970	1878		1656				22.9%	
1971	2373		1981				26.8%	
1972	2364		1687				23.6%	
1973	2600		1725				22.6%	
1974	3032		1779				21.6%	
1975	3540		1638				20.8%	
1976	6404		1957	5159			29.0%	
1977	7695			5720			29.4%	
1978	10082			5710			33.8%	
1979	11804			6400			33.6%	
1980	12433			5615			33.1%	
1981	13315			5806			28.6%	
1982	14622			6052			26.0%	
1983	11903			4042			19.3%	
1984	15060			5891			20.2%	
1985	18966			7268	18966		18.7%	
1986	35345				15638		26.1%	
1987	72152	71059			22438	325548	38.7%	23.5%
1988	119439	81492			28209	250648	36.2%	17.4%
1989	164365	112207			24208	248610	31.9%	19.3%
1990	282285	213984			37393	336639	42.0%	28.2%
1991	250343	282427			29649	376461	30.3%	28.5%
1992	337902	369368			31904	369368	33.5%	28.9%
1993	388426	428546			24695	327090	29.1%	26.7%
1994	469378	561819			24245	331095	27.1%	26.4%
1995	423896	591938			17173	281793	19.9%	21.2%
1996		820597				274353		23.8%
1997								

Sources: Selected Statistical Series 1951-1994, Revised National Accounts 1987-1996, Data from Bureau of Statistics files. The reported current price estimate for 1976 differ from the same estimate in 1976 prices. But we have not been able to determine why.

Part II. Macroeconomic policies to promote stability

II.1. Introduction

Although some economies have been able to push through institutional and structural reforms in a macro-economically unstable environment, the experience of African economies during the past two decades shows that reform sustainability and coherence are more likely, if reforms take place in economies characterised by relatively low inflation and a viable external positions. This part of the study discusses some aspects of macroeconomic stability in Tanzania during the period of market-based reforms. Chapter II.2 analyses the fiscal position and its relation to inflation, Chapter II.3 discusses exchange rate policy and its impact on the pattern of production and trade, and Chapter II.4 deals with the debt issue.

II.2. Public finance

II.2.1. Introduction

As seen in Part I, a legacy of the Nyerere period was a pervasive state sector, extending into virtually all areas of economic activity. Several of the measures of the Economic Recovery Programme (ERP) addressed issues relating to the state sector, its range and areas of activity. Although the earlier reform attempts, notably the 1982-85 structural adjustment programmes, also had addressed these issues, the ERP focused more specifically on the role of the public sector.

The major short-run objective of the ERP was to cut inflation to 20% by moving towards fiscal balance, which was supposed to be achieved by both improved revenue generation and cuts in expenditures. In the longer run, growth was to be restored mainly through liberalisation of the economy, notably the financial sector, and deregulation, in particularly by dismantling parastatal monopolies. Economic reforms in Tanzania have, to a high degree, focused on the proper role of the state. Consequently, an indication of reform success may be given by the extent to which the role of that sector has changed over time, both with respect to fiscal balance and its control of the economic institutions of the economy. The purpose of this chapter is to analyse in some detail fiscal performance and its relation to inflation.

II.2.2. Aggregate fiscal performance

The domestic structural adjustment programmes between 1982 and 1985 attempted several measures to improve fiscal performance: The growth of recurrent expenditures was below that of inflation, mainly because of wage restraints in the public sector, and the elimination of all subsidies to crop parastatals. Revenue collection was around 20 percent of GDP, mainly thanks to some tax increases and novel methods for assessing taxable income. Far-reaching rationalisations of the government's project portfolio were undertaken in 1982/83, when some 156 planned development projects were cancelled (ERP, 1986, p. 10ff). Yet, as Table II.2.1 shows, the fiscal deficit in FY 1986 stood at almost nine percent of GDP. Even though this represented a substantial improvement from the 12 percent deficit recorded in FY 1979, it was still a major imbalance and an important source of inflation and destabilisation in the economy.

The decline of the fiscal deficit envisaged in the ERP did not come about immediately. The deficit continued to grow up to FY 1988, after which it declined substantially and rapidly. However, beginning in FY 1993, the fiscal gap started to grow again and a more sustained improvement was achieved only after the introduction of the cash budget in 1996.

Another aspect of the fiscal deficit concerns its financing. For Tanzania, that receives large amounts of foreign aid, it is no surprise that a substantial fraction of the fiscal gap is covered by balance of payments support. Only a small fraction is financed through foreign borrowing. This is a reflection of Tanzania's low standing in international capital markets: virtually all foreign loans come from IDA and the IMF. Domestic borrowing has fluctuated heavily during the period with no apparent pattern. However, as will be seen later on, there has been a distinct shift of domestic finance, from loans from the Central Bank to Treasury Bills, reflecting both repeated attempts to come to terms with inflation and the development of increasingly sophisticated financial instruments.

Table II.2.1: Summary of Central Government Operations, Percent of GDP

	FY86	FY87	FY88	FY89	FY90	FY91	FY92	FY93	FY94	FY95	FY96	FY97[a]	FY98[b]
Revenue	16.0	17.7	16.3	15.1	14.1	15.7	16.8	12.9	15.0	14.5	14.7	16.0	17.3
Recurrent Expenditures	20.7	20.0	18.2	16.4	15.5	16.0	15.7	19.0	18.4	18.9	17.3	14.8	15.7
Capital Expenditures	4.2	7.0	7.5	3.3	3.3	1.9	3.2	5.1	4.6	7.2	3.2	3.6	3.7
Deficit	8.9	9.3	9.4	4.7	4.7	2.2	2.1	11.1	8.0	11.5	5.8	2.4	2.1
Financing													
External grants		6.5	5.6	4.4	4.1	2.7	3.2	4.6	4.8	4.6	2.8		
Net foreign borrowing[c]	1.7	1.4	2.6	-0.7	0.2	1.0	2.2	2.3	3.0	5.0	-1.3	2.8	4.6
Domestic borrowing	4.7	2.6	2.3	1.7	1.0	-0.5	-3.1	3.7	2.5	3.9	4.9	-0.4	-2.5
Arrears	2.5	-1.2	-1.1	-0.7	-0.6	-1.0	-0.2	0.5	-2.3	-2.0	-0.6	0.0	0.0

Sources: World Bank (1996): *Tanzania. The Challenge of Reforms: Growth, Income and Welfare*, Washington DC: World Bank, Volume II, Table 5.1; World Bank (1997): *Public Expenditure Review*, Volume II, Table 1; IFS on CD-ROM, December, 1998

[a] Estimate

[b] Projection

[c] Includes external grants for FY86, FY97 and FY98

The collection of revenue, most of which is tax revenue, has not been sufficient to meet the demands for expenditures. Attempts to broaden the tax base, including the introduction of a new revenue authority, the Tanzania Revenue Authority, in 1996 and VAT in 1998, have so far had limited success. Revenue generation remains one of the most urgent issues in Tanzanian reforms and has been so since the inception of the ERP in 1986.[1]

Recurrent expenditures show a slowly declining trend, particularly in the 1990s, but it is difficult to cut back on social and economic services, when the system is already under great strain. Still, the government has managed to retrench some 20 percent of its civil service workforce in just a few years under the Civil Service Reform Program, but since most of those retrenched belonged to the lower end of the pay-scale and because most of the savings made are used to increase emoluments for middle-level civil servants, savings on expenditures have been limited. Another factor that has to be taken into consideration is that Tanzania receives substantial amounts of project aid with associated demands for (full or partial) recurrent cost coverage by the government. This means that it is difficult for the government to reconsider its strategy with respect to recurrent expenditures without also devising a viable and compatible strategy for handling foreign aid. The major donors in Tanzania have not insisted on rigid rules for cost-sharing, but have often financed recurrent costs in addition to investments. One consequence of this is that the government's project portfolio is not fitted to what can be generated as tax revenue. Finally, there has been a dramatic increase in domestic debt in the 1990s, which requires servicing.

II.2.3. Revenue

There are three major sources of tax revenue: trade taxes, sales taxes and income taxes (Table II.2.2). Collections from these sources are roughly equal in size. Even though estimates are difficult to come by, it is widely believed that the revenue potential substantially exceeds what is actually collected. Evasion from income taxes seems very common, reflecting the low administrative capacity of the revenue authorities.[2] The poor performance with respect to

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[1] The architects of the ERP (1986, p.16) noted that "revenue collection will continue to be closely monitored, to improve collection efficiency and ensure a rising income for government as the tax base recovers." This suggests that the strategy for increasing revenue at the time was to rely on economic growth rather than on tax reform (cf. Osoro, 1994).

[2] Problems of revenue collection are made even more difficult by the existence of a substantial second economy, and the poorly developed financial system makes income monitoring costly.

revenue collection as well as expenditure control forced the government in 1995 to introduce a cash budgeting system, whereby expenditures are limited by what is actually collected.

The major problems with regard to revenue collection seem to relate to the collection of taxes on imported goods. There are three major problems:

- *Transit trade*. Goods in transit are not eligible for taxation in Tanzania so importers have an incentive to label goods as transit goods even though the final destination is Tanzania. This problem is being addressed by closer monitoring of transit goods (e.g., inspectors follow the goods from the port in Dar es Salaam on the railroad into Zambia). Obviously, this is a costly process.

- *Under-invoicing of imports*. Mpango (1996b) estimates that, in the early 1990's, close to forty percent of tariff revenues were lost via under-invoicing. As long as tariffs are on an ad valorem basis, importers have incentive to misreport, even though the unification of the exchange rate has made such practice less profitable.[3] The problem has been addressed by Pre-Shipment Inspection (PSI), whereby all Tanzanian imports exceeding a certain value (currently US$ 5,000) are valued and cleared in the exporting country. Obviously, this is a costly procedure and evaluations regarding the efficiency of the PSI remain to be seen. The PSI procedures are further complicated by the fact that Tanzanian Customs frequently revalue the goods in Dar es Salaam.

[3] There are also indications of substantial overinvoicing, mainly because (i) there are still barriers to capital movements and (ii) costs for avoiding taxes are low. To our knowledge, there are no studies regarding the relative size of over- and underinvoicing covering the 1990's.

- Table II.2.2: Structure of Central Government Revenue. Percent of Total Revenue

	FY86	FY87	FY88	FY89	FY90	FY91	FY92	FY93	FY94	FY95	FY96[a]	FY97[a]	FY98[a]
Tax revenue	94.4	93.8	91.7	87.9	86.1	88.8	88.4	89.2	90.9	89.9	89,4	90,1	90,0
Income tax	29.6	22.6	23.4	23.1	21.3	24.3	23.1	27.7	24.1	27.8	28,0	29,0	29,0
Payroll taxes	1.0	1.0	0.9	0.8	0.9	0.7	1.0	1.3	1.0	1.6			
Property taxes	0.5	0.3	0.2	0.2	0.2	0.2	0.2	0.3	0.4	0.3			
Consumption taxes	46.7	42.1	39.0	36.3	34.8	35.4	34.8	30.1	30.7	24.7	26,1	26,0	26,0
Trade taxes	13.6	24.5	23.7	22.9	24.4	23.8	22.2	19.3	20.7	22.9	20,0	20,0	20,0
Other	2.9	3.3	4.4	4.5	4.5	4.2	7.0	10.5	13.9	12.6			
Nontax revenue	5.6	6.2	8.3	12.1	13.9	11.2	11.6	10.8	9.1	10.1	10,6	9,9	10,0

Sources: World Bank (1996): *Tanzania. The Challenge of Reforms: Growth, Income and Welfare*, Washington DC: World Bank, Volume II; *Policy Framework Paper* and *Public Expenditure Review* (various); Budget speeches, 1996/97 and 1997/98.

[a] Estimate

- *The "Zanzibar Route"*. Nominally, tariffs at the Mainland and Zanzibar are equal. In practice, tariffs in Zanzibar are much lower, because discretionary exemptions are more frequent in Zanzibar. Even though goods exported to the Mainland via Zanzibar are eligible for tariffs equalling the difference between the rates in the two ports, it is extremely difficult to monitor the amount of Zanzibari exports that are actually transferred to the Mainland. Tanzania has a long coastline and the Customs do not have the resources to pursue efficient monitoring. One indication of increasing smuggling from Zanzibar to the mainland is that in 1991, 87 percent of imports to Zanzibar were re-exported to the mainland. In 1994 that proportion had declined to 18 percent (Kimei and Semboja, 1996).

The efficiency of revenue collection seemed to deteriorate even further during the first half of the 1990s. Apart from the problems identified above, other explanations for the paltry revenue collection record include major tax exemptions (exemptions granted by GOT amounted to 46 percent of all taxes and duties assessed on goods inspected by SGS, a PSI company), the possibility for the Minister of Finance to grant discretionary exemptions, and the large exemptions granted by the Investment Promotion Centre. In fact, the discovery in 1994 of corruption and tax evasion was the major reason why bilateral donors decided to freeze balance of payment support. The main strategy for dealing with the revenue problem, a strategy that is strongly endorsed by the IMF and the donors, was the establishment of the Tanzania Revenue Authority (TRA). This is an independent authority that pays its employees considerably above the regular state salary scales. It is also well provided with other resources needed to do a professional job. The TRA has been in operation since July 1996, and while collections have picked up, some reservations remain regarding the complete abolition of corruption and improper conduct. In any case, it seems reasonable to assume that it takes time to establish efficient routines for the collection of revenue, so even if the TRA eventually manages to tap a larger fraction of the revenue potential, these improvements should not be expected in the near future. A similar argument can be made with regard to the introduction of VAT in 1998.

There have been some changes in the structure of taxes during the period. In particular, consumption taxes have to some extent been replaced by income taxes and, in particular, other taxes. The latter are specific taxes such as the entertainment tax. Consequently, the data suggest that Tanzania is moving from general taxes (such as the consumption tax) to specific taxes, which is likely to be a reflection of the difficulty of collecting taxes. The exchange rate liberalisation that started in earnest in the mid-1980s was expected to increase revenue substantially, but this has not been realised, partly because of tariff reductions being pursued simultaneously.

Moreover, tax collection shows a marked fall in buoyancy in the 1990s. Table II.2.3 shows collection elasticities for the major tax types. Thus for instance, the elasticity of total tax collection is down from 1.59 in the early 1990s to 0.43 in 1997/98, and a similar trend can be seen for most types of taxes. One likely explanation is that while much has been done by the way of reducing corruption and misappropriations in the tax system, discretionary exemptions still play an important role. In addition, new channels for exemption are being introduced with the VAT and from income tax for holders of investment certificates issued by the Investment Promotion Centre (IMF, 1999).

Table II.2.3: Tax Buoyancy, FY 1992-FY1997. Selected taxes.

	92/93-93/94	93/94-94/95	94/95-95/96	95/96-96/97	96/97-97/98
Tax revenue	1.59	1.14	1.28	1.11	0.43
Income tax	0.96	1.50	0.72	1.14	0.65
Payroll tax	0.57	2.90	1.50	1.20	0.97
Sales tax	1.69	0.10	1.16	1.42	0.21
Import tax	1.96	2.54	1.19	1.39	0.56

Source: IMF (1999), Table 7.
Note: Tax buoyancy is the percentage change of collected revenue divided by the percentage change in nominal GDP.

In conclusion, then, it seems fair to say that while Tanzania has come a long way in rationalising and simplifying its tax system, the collection ratio still remain among the lowest in the region.[4]

II.2.4. Expenditure

As can be seen from Table II.2.1 the government has been unable to match expenditures with revenue. There is some improvement from 1996 onwards and the reason is the cash budget, introduced in late 1995 to come to terms with the fiscal deficit. Even if several commentators (see e.g., Policy Framework Papers, Public Expenditure Reviews, and Country Economic Memoranda) identify the major problems as being on the revenue side, it is quite clear that much remains to be done with respect to expenditures as well.

[4] Particularly in view of the recent revisions of the national accounts. The data published in 1997 revealed that official GDP was revised upwards by 68 percent for 1992 and by 263 percent for 1998. Consequently, collection rations were revised downwards—to 9.5 percent in 1992/93 and 11.2 percent in 1997/98 (IMF, 1999, Tables 1 and 6).

Some data on the structure of expenditures are shown in Table II.2.4. The most notable trend is the sudden drop in the item “other”, from over 55 percent of total expenditures in FY91 to approximately one-third in FY95. The reason is a massive revision of Tanzania’s pay structure. Prior to 1995, various forms of allowances often constituted the major part of total reimbursement for higher civil servants. Anecdotal evidence suggests fuel allowances three or four times higher than the salary and meeting and teaching allowances abounded. As part of the public expenditure review process, these were monetised (or abolished), so the salary figures for the late 1990’s better reflect the proportion of expenditures actually flowing to civil servants.[5]

Interest payments have increased substantially in the 1990s consuming in the second half of the 1990s over one-fifth of total expenditures. Foreign interest payments have remained rather stable (and quite low, given the size of Tanzania’s external debt) which is a reflection of relatively generous treatment in the Paris Club. Domestic interest payments have, on the other hand, increased substantially. This is because of two factors. First, prior to the introduction of the cash budget, the government did not allot high priority to payment for domestic supplies, so the debt increased rapidly. Second, the increase of the domestic debt also reflects the relatively (1990s) recent practice of financing the budget deficit via the issuance of Treasury Bills. Also, the introduction of the cash budget meant a strict prioritisation of expenditures, with debt servicing (external and domestic) taking top priority.

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[5] While the salary data in the table—particularly the break between FY95 and FY96—seem to suggest a change of data source there is no indication of this is the available documentation. The increase—in nominal terms—of salaries is due to the monetisation of various benefits and the simultaneous decline of development expenditures is mainly due to unexpected shortfalls in project aid disbursements: according to the 1998 *Public Expenditure Review* (Volume 1, Table 2.2), available resources for non-prioritised activities (i.e., all expenditures except debt service and arrears and salaries) were only 67 percent of what was budgeted and resources for domestic development (i.e., capital expenditures) were only 22 percent of the budgeted amount. This raises of course an issue, which becomes more increasingly important in an economy operating under a cash budget constraint, viz., the predictability of revenue, notably foreign aid.

Table II.2.4: Structure of Central Government Expenditures. Percent of Total Expenditure

	FY86	FY87	FY88	FY89	FY90	FY91	FY92	FY93	FY94	FY95	FY96[a]	FY97[a]	FY98[a]
Recurrent	83.1	74.1	70.7	83.1	82.3	89.1	83.3	78.8	79.9	72.4	80.5	82.9	87.8
Wages and salaries	24.8	19.0	16.2	21.4	21.3	20.0	19.3	19.0	19.9	18.4	29.9	28.1	29.7
Interest payments	8.7	13.7	14.2	15.6	13.2	13.2	12.2	12.9	13.9	22.3	16.2	20.5	21.6
Domestic	6.3	8.8	7.5	6.9	6.7	5.7	5.4	7.5	8.6	9.7	11.0	12.7	13.4
Foreign	2.4	4.9	6.8	8.7	6.5	7.6	6.7	5.4	5.3	12.6	5.2	7.8	8.2
Other[c]	49.7	41.4	40.2	46.1	47.8	55.9	51.9	46.9	46.1	31.7	35.1	34.3	36.5
Capital expenditures	16.9	25.9	29.3	16.9	17.7	10.9	16.7	21.2	20.1	27.6	19.5	17.1	12.2

Sources: World Bank (1996): *Tanzania. The Challenge of Reforms: Growth, Income and Welfare*, Washington DC: World Bank, Volume II; *Policy Framework Paper 1997/98-1999/00* (dated November 25, 1997)*; Public Expenditure Review, 1997*(dated August 11, 1997)

[a] ESAF program

[b] Government projection

[c] Includes “other goods and services” and transfers to parastatals, crop authorities, and others.

The major problem with the expenditure side is that there is an urgent need to increase expenditures on wages and salaries rapidly; and this is obviously difficult, given the revenue collection situation. A recent study (Jahna, 1998) shows that approximately 94 percent of all civil servants earn less than an estimated minimum living wage (some TZS 65,000 or US$ 85, a month). Moreover, remuneration in the private sector (not to mention the donor community) is more attractive. For a representative sample of middle-level positions Jahna estimates that the public sector wage is approximately 35 percent of that in the private sector.

Table II.2.5 shows changes in the structure of recurrent expenditures. Note in particular the increase of the share going to wages and salaries and the decline in the share going to other expenditures. This is, as noted, a reflection of benefits and allowances being monetised and included in the wage bill, and it also reflects the ongoing rationalisation of the civil service pay structure.

Table II.2.5: Structure of Recurrent Expenditure, period average

	FY86-FY89	FY90-FY95	FY96-FY98
Wages and Salaries	26.0	24.3	35.0
Interest Payments	17.0	18.3	23.2
Other	57.0	57.3	41.9

Source: Table II.2.4

The table also reflects the changing priorities of the government imposed by the cash budgeting system. Under this system, debt servicing has the highest priority. In addition the ESAF agreement (1996-99) stipulates clearance of all accumulated debt arrears. Consequently interest payments, as s share of recurrent expenditures, have increase noticeably, mainly at the expense of other expenditures.

The cash budget system deserves special mentioning here. It was introduced as a measure to bring the budget into balance and operates on a monthly basis where expenditures in, say, October cannot exceed revenues plus program aid received in September. Moreover, planned expenditures are classified into priority groups: debt servicing and clearance of arrears, wages and salaries, and other expenditures. While the system has worked well in the sense that the budget is closer to equilibrium than it was before, and in the sense that inflationary tendencies have weakened, its long run impact remains to be seen. In particular, since the category "other expenditures" include maintenance, locally financed investments, generation of counter-part funds for aid-funded investments, and administration, it is likely that these items receive less funding now than what used to be the case. The neglect of maintenance of existing investment projects may affect growth negatively both now (because of e.g., deteriorating roads) and in the future (because of accumulating needs for replacement investments and the impact on human capital accumulation). There may also be a slower rate of project aid disbursement because of failure to generate counter-part funds or an increased dependence on donor finance for recurrent costs which in turn may have a negative impact on local ownership and thus aid performance. It is an open question whether the beneficial effects of a cash budget (in the form of budget balance, lower inflation and improved budget discipline) outweigh the potential costs (in the form of lower investments).[6]

II.2.5. Deficit financing and inflation

The well-established thesis that high inflation is often caused by fiscal excess has two components. First, that part of the fiscal deficit is financed by issuing debt to the central bank, which thereby increases the rate of growth of money. Second, that a change in the rate of growth of money causes a change in inflation. The first link is rather easy to establish and depends often on the availability on financing alternatives, while the latter relies to some extent on the Quantity Equation and thus assumes that the velocity of money and the level of real output are unaffected by the rate of growth of money. In addition, the short data series available and the questionable quality of that data make it difficult to test econometrically the extent to which the rate of growth of money statistically “causes” inflation.

Table II.2.6 shows the financing structure of the deficit during the reform period. There are basically three ways for financing the deficit: foreign grants and loans, domestic non-bank loans, and domestic bank loans. The latter means in Tanzania essentially loans from the central bank. There is no apparent pattern in the financing structure. The domestic share shows a declining trend (apart from 1989/90) from the beginning of the reform period up to 1991/92, after which it increases sharply up to 1995/96 and declines thereafter.

One possible explanation of the pattern is that the share of the budget deficit that is financed from domestic sources is determined (prior to 1996, when the cash budget was introduced) more or less by the availability of foreign finance, i.e., program aid (either directly, or as debt relief). This would account for the declining share of domestic finance in the 1980s, when foreign aid (particularly program aid) was one the rise. Note also the bulk of the domestically

[6] A somewhat more detailed discussion is in Danielson (1999). Adam and Bevan (1998) provide a technical discussion of the cash budget experience in Zambia.

financed debt comes from bank borrowing. This is a reflection of the low degree of sophistication of Tanzania's financial markets.

The next link in the chain is that between changes in the money supply and inflation. It is obviously misleading simply to correlate the rate of growth of money to that of prices, because (i) the demand for money increases with income and (ii) prices may changes without a corresponding change in the money supply, particular in an economy where around seventy percent of the weights in the consumer price index basket consists of domestically produced food.

We have chosen another approach. Assume that the demand for money is stable. We then define the rate of excess money creation (*EMC*) as the difference between the actual rate of money growth and the rate at which the demand for money grows. If the velocity of money is stable, the Quantity Theory suggests that the correlation between *EMC* and the rate of inflation should be close to one.

Using OLS for the period 1980 to 1998 (source: IFS, March, 1999) the result is

$$INF = 22.4 + 0.22EMC, \qquad R^2 = 0.16 \qquad (1)$$

where INF is the rate of change of consumer prices. The slope coefficient has a t-value of close to 4, implying that it is significantly different from zero. The relatively low degree of explanation, as manifested in the R^2-value, together with a small slope coefficient, suggests that while money growth, caused by fiscal deficits, is an important factor in explaining Tanzanian inflation, it is not likely to be the only, or perhaps even the most important, one. This result cannot be used to argue that monetary restraint is unimportant, because other determinants of inflation are likely to be either structural (such as bottle-necks in food production) or exogenous (such as terms of trade), while the rate of growth of the money supply is clearly in the hands of the authorities. Consequently, while it is doubtful to what extent the Bank of Tanzania can control the rate of inflation by using monetary policies, it is clear that such policies have an impact.

Table II.2.5: Financing Structure for Budget Deficit: TZS mn and percent.

	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97
Financing	9,715	18,749	24,727	29,728	48,746	42,461	82,230	73,579	104,515	64,559	13,777	-73,860
Foreign (%)	36.4	75.9	80.0	106.0	75.2	121.9	102.6	40.0	61.2	4.6	-307.7	43.2
Domestic (%)	63.6	24.1	20.0	-6.0	24.8	-21.9	-2.6	60.0	38.8	95.4	407.7	56.8
o/w: bank[a]	79.7	36.7	52.3	250.9	69.1	162.2	510.8	86.3	34.5	90.6	111.7	62.2

Sources: Table II.2.1; BOT, *Economic Bulletin*, Vol. XXVIII; *IFS on CD-ROM*, March, 1999
[a] Percent of domestic financing

II.2.6. Conclusion

The problems of fiscal performance permeate Tanzanian reform efforts. Issues of taxation and expenditure restraint have been at the centre of the debate even since reforms took off in earnest in the mid-1980s. Problems abound on both the revenue and expenditure side. While an ambitious civil service reform program together with the rationalisation of the pay structure that took place in the mid-1990s may pave the way for a more efficient public sector, which is at the same time affordable, the problems on the revenue side seem more acute. A number of measures have been taken to increase revenue and some of these (the introduction of the TRA and the introduction of VAT) offer some hope. Still, the problem of revenue generation is far from solved: Tanzania collects less in taxes than do comparable economies and the culture of corruption, misappropriation of funds, and discretionary behaviour on the part of authorities continue to flourish. Unless these problems can be addressed in a coherent and determined manner, it is not likely that revenues will increase substantially.

In a sense, then, the revenue problem is the central problem in managing Tanzania's reforms, for without higher revenue, it is impossible to escape the cash budget without jeopardising stabilisation and it will also not be possible to carry through some of the costly but necessary reforms that lie ahead. Moreover, many Tanzanians—including the sitting President—perceive a high degree of aid dependence as a major problem, and it will not be possible to reduce that dependence significantly without increasing the amount of resources mobilised domestically. Consequently, the high degree of aid dependence reflects not so much the massive need or the overwhelming support from donors as it reflects a failure of Tanzanian authorities to address properly the issues of revenue mobilisation.

II.3. Exchange rates and exchange rate policy

II.3.1. Introduction

A cornerstone in the Tanzanian policy towards socialism and self-reliance was a reluctance to devalue the currency. Imbalances in the foreign exchange market were fought mainly through exchange controls, and the exchange rate policy was closely linked to the policy on import and export control through various price and non-price means (cf. Ch. III.2).

Consequently, the adjustment program commencing in 1986 focused on devaluation as a means for rectifying the large and growing external imbalance. Still, the trade balance has remained strongly negative, although exports have increased while imports have stagnated in the 1990s (see Table I.4). We note two reasons for the limited success. First, while devaluations have been used frequently during the reform period, the Shilling price of the US dollar changed from 8.3 in 1981, to 51.7 in 1986 and to 670 in mid 1998, persistent inflation has eroded part of the competitiveness gained from nominal exchange rate adjustments. For some years, notably in the latter part of the 1990s, inflation has even been higher than the nominal depreciation of the Shilling and thus caused an appreciation of the real exchange rate. The second argument is that while the adjustment strategy in the latter half of the 1980s addressed short-run macroeconomic issues, less attention was paid to structural problems. It is likely that exports failed to respond swiftly to changes in the nominal exchange rate, partly because of the very nature of Tanzania's export produce. It takes several years for coffee trees to bear fruit and there is a range of bottlenecks in agriculture. Similarly, a large share of imports in Tanzania is "non-competitive" in the meaning that there are no or few domestic substitutes. This, coupled with a slowly responding export sector, slows down the improvements of the trade balance.

The chapter is organised in the following way. In Section II.3.2 we outline how the Tanzanian exchange rate regime has changed over time. In II.3.3 we discuss exchange rate misalignments and how these have affected the allocation of resources. Section II.3.4 relates the exchange rate and associated policies to the outcome in terms of the pattern of trade (and thus points forward to the discussion is the next chapter, on the evolution of the debt). Section II.3.5 concludes.

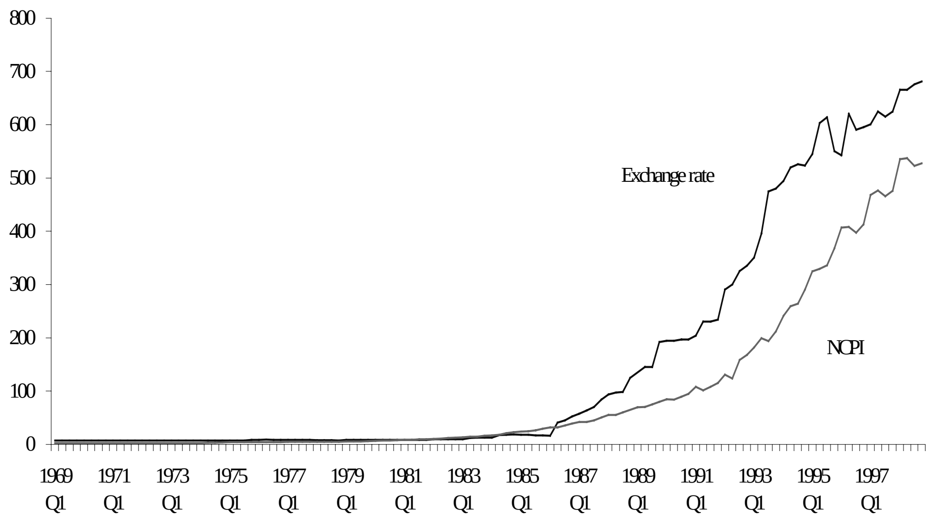
II.3.2. Exchange rate regimes

Tanzania tried for a long time to maintain a fixed exchange rate. The major reason seems to have been a worry about macroeconomic stabilisation objectives, whereby a depreciating currency would have increased inflation. To avoid that outcome, authorities combined from the late 1960s and throughout the 1970s a currency pegged to the US dollar with far-reaching restrictions on the current account.

Massive inflows of foreign aid from the late 1960s and up to the late 1970s contributed to exchange rate stability despite a large current account deficit before grants.[7] However, there are at least three ways in which development assistance may increase the outflow of currency rather than closing a foreign exchange gap. First, some assistance was commodity import support, which increases imports at the same time as it provides the necessary finance. Consequently, from an accounting perspective, the existence of commodity import support does not affect the current account, but weakens the trade balance. Second, the inflow of project aid often has implied increasing imports. Since some project aid has been used for purchases of domestically produced goods and services (including labour), project aid, taken as a whole, has probably contributed to external balance (i.e., project finance is larger than the increase in imports associated with project aid). Third, bilateral export credits and concessional loans have increased payments of interest. To the extent that activities financed by borrowed money have failed to generate additional export earnings, the net outcome is maybe deterioration in the external position. Despite these considerations, it is probably fair to say that the massive inflows of foreign aid discussed in previous chapters helped the Government to maintain the relative stability of the official exchange rate observed up to the beginning of the crisis period in 1980 (cf. Figure II.3.1), and to avoid an even higher black market premium.

[7] However, exchange rate stability did not imply an exchange rate close to equilibrium, but made it possible to avoid a large-scale devaluation despite a very weak link between the level of the exchange rate and the underlying fundamentals.

Figure II.3.1: Exchange rate (TZS/USD) and NCPI, 1969-1998



The Tanzanian authorities were reluctant to devalue during the crisis period despite the fact that foreign aid fell substantially in conjunction with exports. Moreover, the small devaluations that took place during the first half of the 1980s did not alter the fundamentals of the system: foreign exchange was still allocated administratively and within the overall frame of heavy trade restrictions.

The commodity import scheme was finally replaced in 1988 by an open general license (OGL) whereby foreign exchange was allocated on a first-come-first-served basis. While one could remark, as do Raikes and Gibbon (1996, p. 241), that this system was a queue-system and thus the very opposite to the market-based system the World Bank claimed it was, there are two other important points to make about the change of system in this context. First, under the OGL the central bank asked no questions about the origins of the foreign exchange used to import commodities.[8] One of the advantages of the system thus was that illicitly earned foreign exchange could be channelled into the formal system. This, reduced incentives to continue clandestine trade activities. Second, the OGL system implied that the administrative control over the allocation of foreign exchange decreased substantially. In particular, the earlier system for commodity import support favoured parastatals. State-owned companies were not only allocated priority in the handing out of foreign exchange, but there was also little control as to their paying for it. In consequence, parastatals, often operating

[8] Strictly, the abolition of the requirement of declaring the sources of foreign exchange is associated with the "own-funds" system, not the OGL proper (which relates to aid inflows only). However, the two are both part of the gradual liberalization of the exchange rate system.

according to primarily political motives and under soft budget constraints, were heavily subsidised under the commodity import support scheme. This was reduced when the OGL was introduced.

The OGL system worked better than the system it replaced, but not sufficiently well and further liberalisation followed. In the late 1980s a system for full retention of foreign exchange for exporters of non-traditional goods was introduced, followed by first expanding positive lists, then shrinking negative lists for imports under the “own-funds” and OGL schemes. Finally, in 1993, a system for weekly (later semi-daily) auctions for foreign exchange was created. An inter-bank foreign exchange market subsequently replaced this. As of July 1995 the Tanzanian Shilling was effectively determined on a continuous basis by the forces of supply and demand. A small number of restrictions remained—notably the requirement to show relevant documentation (invoices or international travel documentation) to purchase large amounts of foreign exchange, and restrictions on capital account transactions. However, the Mkapa government has expressed its determination to fully liberalise the exchange rate and as the political opposition to such a move is virtually non-existent, and as IFIs endorse the strategy, it is likely that it will be carried out in the near future. In twelve years’ time, then, Tanzania has moved from an exchange rate system characterised by massive trade restrictions—on both imports and exports—coupled with heavily over-valued currency to a system under which the value of the currency is more or less completely determined by market forces. At the same time, the price of foreign currency has increased by a factor of 17. It is quite clear that this change in exchange rate policies has had an impact on the competitiveness of Tanzanian commodities, as well as on macro policies in general. These aspects will be considered below. First, however, we turn to the issue of black market rates.

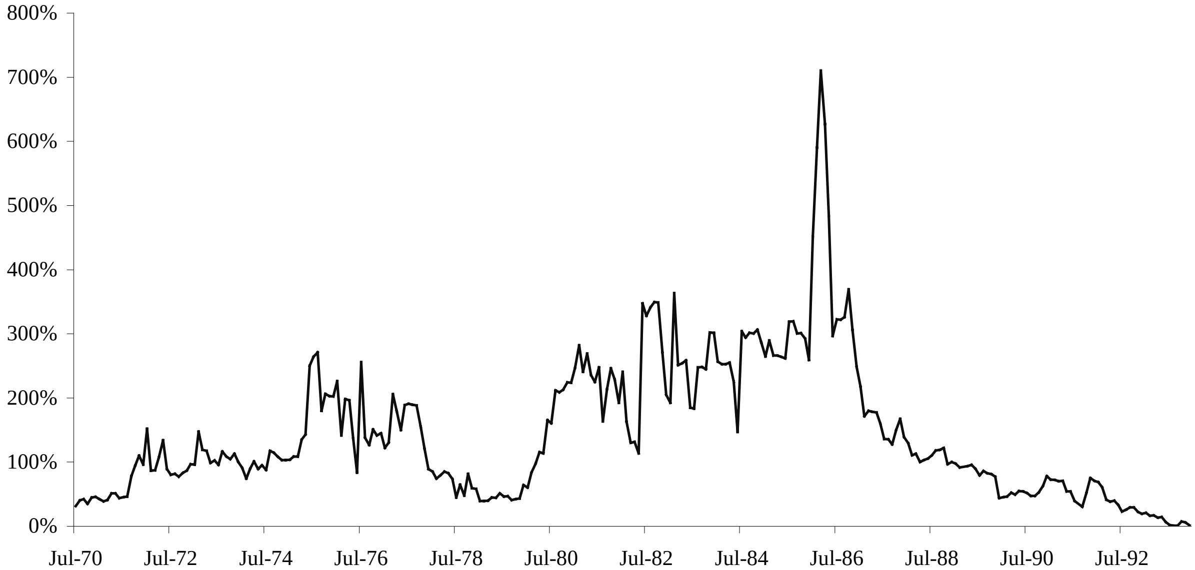
II.3.3 Exchange rate misalignments

The extent to which individuals are willing to pay a higher price than the official for foreign currency depends basically on two factors. First, the amount of over-valuation of the currency and expectations concerning future changes in that over-valuation. Second, the extent to which the use of foreign currency is restricted and the extent to which individuals circumvent those restrictions by smuggling or misrepresentation of export and import invoices. The latter point requires some elaboration. Smuggling increases the demand for foreign currency if the purpose is to avoid tariffs or other restrictions by bringing goods into the economy; it increases the supply of foreign currency if commodities are sold illegally abroad and the proceed brought back to the country. The latter also requires that sellers of foreign currency in the country are required to disclose the source of their foreign exchange earnings (something that was removed when the own-funds system was introduced in the late 1980s). As for misinvoicing trade, it is clear that overinvoicing of exports or underinvoicing of imports is a form of capital flight, most likely as a response to expectations regarding financial instability (Cuddington, 1986; Dornbusch and Tellez Kuenzler, 1993). The opposite, underinvoicing of exports or underinvoicing of import, relate more directly to the trade policies pursued: overinvoicing of exports is usually seen as a way of capturing export subsidies, and underinvoicing of imports as a way to avoid import tariffs.

It is difficult to come up with hard and reliable data in this area. However, by comparing the exports for Tanzania (from Tanzanian data) with imports from Tanzania (using data from the recipient country), discrepancies may be detected. Mpango (1996b) calculates that around 40 percent of Tanzanian imports were misinvoiced in the mid 1980s. Although this assumes that all discrepancies were the result of underinvoicing on the part of Tanzanian importers, rather than overinvoicing on the part of exporters, it suggests that substantial amounts of funds were diverted before the reform process gained momentum.

A less precise, but perhaps more illustrative, way of looking at the problem is by measuring the extent to which there is a black market premium. There are different methods for doing this, ranging from informed guesses to repeated observations in the street, and different methods produce different answers. The most widely used method appears to be to rely on the cost of sending funds, outside the official channels, abroad. This captures both the over-valuation aspect and part of the trade restrictions in use. Here, we rely on data from William Pick's *World Currency Yearbook*, which publishes monthly data on the extent to which Tanzanian individuals are prepared to pay a premium for foreign exchange. Figure II.3.2 plots the relevant data series. According to the source used here, no black market premium existed prior to or after the period in the Figure (i.e., prior to July 1970 and after December 1993). Other sources produce slightly different estimates, particularly with regard to the end date, but the trend derived in the data from different sources is quite similar.

Figure II.3.2
Exchange Rate Premium



There are four major points to make with regard to this figure. First, the increase in the premium in 1974 is likely to be associated to OPEC I and the subsequent recession in Europe, Tanzania's most important export market. The oil crisis hit Tanzania hard, both in terms of declining export proceeds and in terms of a rapidly growing import bill. There was even severe compression of non-oil imports. Second, the increase in the premium in 1979 is the likely result of OPEC II, coupled with the Kagera war. It seems as if Tanzanian authorities had expected donors to carry the cost of that war, an expectation that remained largely unfulfilled. Moreover, 1979 and 1980 marks the start of the crisis period in Tanzania. Several economic reform programs were constructed and discussed, but as it proved impossible to reach an understanding with the IMF (the major issue of conflict was that of devaluation) very little external finance came through to support those programs. The early 1980s was also characterised by severe import compression—mainly due to rapidly shrinking levels of foreign aid. Third, in the mid-1980s the economic crisis had reached dramatic proportions, with an all-time high premium of over 700 percent in March 1986. This suggests that the confidence in the government's ability to handle the situation had dwindled. It is likely, although we lack the necessary data to prove it, that the extreme premium immediately prior to the agreement with the IMF was the result of massive capital flight. Fourth, the devaluations and liberalisation of the trade and exchange rate regime that have been part and parcel of the adjustment program negotiated in 1986 have borne fruit, at least in terms of a falling black market premium. It is important to keep in mind, however, that the falling premium resulted not only from devaluations, which produced a more realistic official exchange rate and liberalisation of the trade regime, but also from the surge in external finance. The second aid boom coincided with the commencement of the IMF-supported structural adjustment program.

II.3.4. Exchange rates and macroeconomic policy

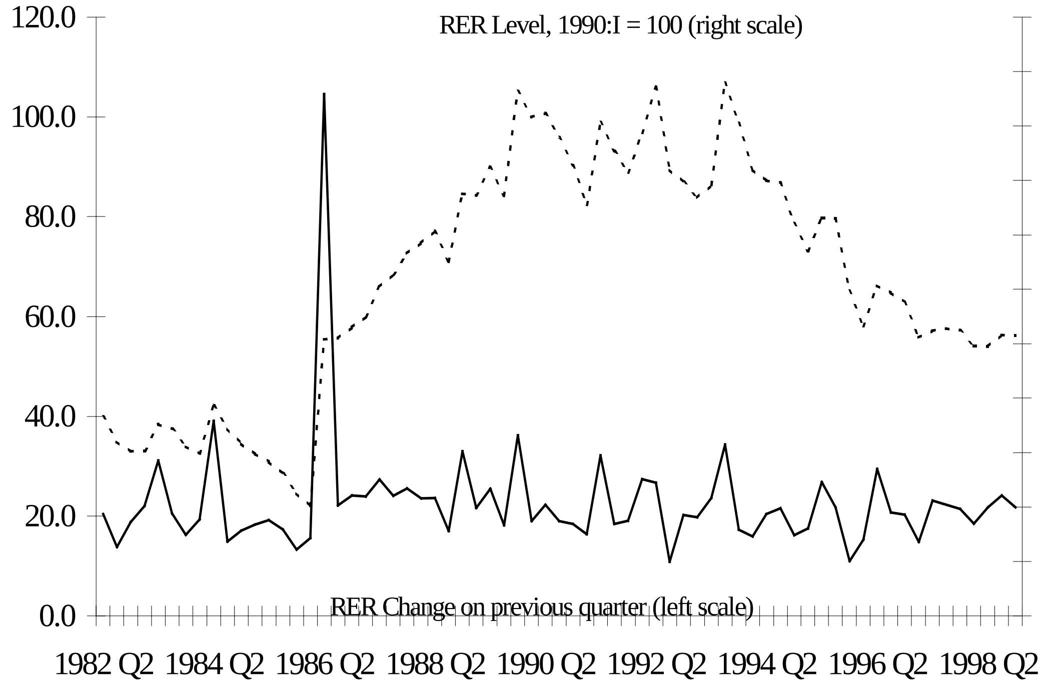
Control of the fiscal deficit is a necessary but by no means sufficient condition for low inflation. There may also be problems with too high a level of private sector demand. To curb that, and to complement the tight fiscal policy manifested in the cash budget, tight monetary policy may be used. In principle, the fight against inflation may take one of two forms: exchange rate stabilisation or monetary restraint (i.e., tight control of the expansion of the money supply). The Bank of Tanzania has chosen the latter approach, even though interventions in the foreign exchange market also take place regularly.

Under a floating exchange rate regime it is assumed that the nominal exchange rate adjusts to inflation differentials with other countries so as to keep the real exchange rate stable. However, Figure II.3.3 shows that the real exchange rate has appreciated from 1994 to 1998, making Tanzanian exports increasingly uncompetitive.

To understand the real appreciation of the currency it is useful to recall that large sectors in the Tanzanian economy are not well integrated in the monetary economy. Agriculture was negatively affected in 1996 and 1997 first by drought and then by heavy rains which destroyed rural infrastructure. The result was increased food prices. At the same time, financial liberalisation and monetary restraint combined to increase real interest rates to positive levels which tended to appreciate the currency.[9] Since the real exchange rate is measured as an aggregate, its rate of change being the difference between the rate of change of the nominal exchange rate and the inflation differential between Tanzania and her trading partners, it appreciated because (a) the nominal exchange rate was relatively stable, mainly because tight monetary policy in combination with financial liberalisation and (b) inflation in

[9] Recall that the Bank of Tanzania's primary objective is price stability; for exchange rate policies the BoT tries to follow the market and only intervenes when the exchange rate apparently displays movement or fluctuations which are not motivated by fundamentals.

Figure II.3.3: Real Exchange Rate, 1982-1998



Tanzania was higher than motivated by the monetary policy stance[10], mainly because of unfortunate weather conditions for several seasons in a row.

The available data do not contradict this interpretation. First, while the purchasing power parity theory suggest a negative relation between changes in the nominal exchange rate and the rate of inflation, Tanzanian data do not confirm this.[11] On the other hand, the correlation between monthly changes in the nominal exchange rate and the rate of *non-food* inflation is negative (but only significant at the 10 per cent level). This result is in accord with theory and with what was said above. The BOT, through monetary policy, is able to control only a small portion of all prices in Tanzania; and consequently, for purposes of stabilisation the rate of change in the non-food NCPI is the relevant object.

In addition, the evidence points to the conclusion that the bank of Tanzania has not been able to pursue a particularly tight monetary policy—at least not prior to 1995. Figure II.3.4 plots two interest rates, the discount rate (the BOT's primary weapon for monetary policy), and the deposit rate for short (3-6 months) deposits, corrected for inflation. As a rough approximation, this may be taken to be two indicators of real interest rates, and thus the prudence of monetary policy. It is clear that for the most part of the period, the real interest

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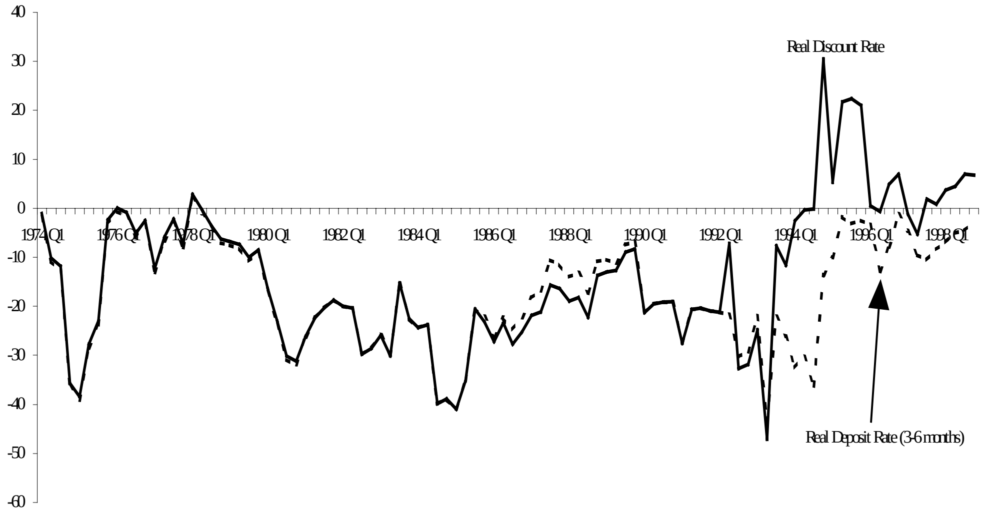
[10] Food currently has a weight of 71 percent in the CPI basket. This is higher than warranted given the average consumer basket in Tanzania. Revision of the CPI basket is underway, pending funding.

[11] Data from BOT (1994), BOT (1997) and BOT (1998). Simple correlation of changes in monthly exchange rates and monthly inflation (from 1994:1 to 1998:5) is close to zero. Regression analysis with changes in monthly nominal exchange rates as the dependent variable and monthly inflation and the monthly discount rate (to reflect the monetary policy stance) provides no significant estimates and an R^2 close to zero.

rate has been negative. Prior to the reform period, or even prior to the early 1990s, the BOT also had a battery of quantitative restrictions at its possession for controlling credit access (cf. Chapter III.2). However, even during the 1990s, interest rates have been negative. There was an increasing discount rate in 1994, but the increase was not sustained. Deposit rates continue to be negative for most of the period, an effect, which largely depend on the lack of competition in financial markets[12].

Figure II.3.4: Real Interest Rates, 1974:I - 1998:IV



II.3.5. Conclusion

For several reasons the Tanzanian authorities attempted for a long time to maintain a fixed exchange rate far away from a realistic level. Now the exchange rate is floating, but the external position is still weak, and it is questionable to what extent monetary policies are really strict enough. In addition, the real exchange rate has appreciated for some time, and it is difficult to see how the authorities will be able to handle this situation without jeopardising the objective of price stability.

[12] Food currently has a weight of 71 percent in the CPI basket. This is higher than warranted given the average consumer basket in Tanzania. Revision of the CPI basket is underway, pending funding.

II.4. Debt and debt policies

II.4.1. Introduction

The analysis in the previous two section suggests that while much progress has been made with regard to fiscal policies as well as the external position, the mismanagement of the economy has left marks which are not easily erased. This is particularly true with regard to the debt situation. The external debt grew rapidly during the 1980s, and the ratio of debt payments, interest and amortisation, in relation to export proceeds has fluctuated between 25 and 40 percent. The debt burden has grown rapidly despite generous treatment of Tanzania in Paris-Club negotiations, which has two implications. First, an increasing share of the debt is multilateral, and consequently not eligible for relief or retirement unless Tanzania becomes part of the HIPC-initiative. Second, most debt relief in the 1980s and 1990s has been devoted to servicing existing multilateral debt, rather than retiring debt. This means that the room to manoeuvre for Tanzania has not increased despite massive inflows of bilateral funds destined to ease the debt burden.

Section II.4.2 discusses the structure and development of the external debt and Section II.4.3 the question of sustainability. The motivation for this is the observation that the rapid increase of the debt stock in the 1980s and the 1990s at least partly can be explained by poor policies. GDP and exports have grown slower that the debt and interest payments, respectively. The question, then, is to what extent current polices can be said to be sustainable in the longer run.

II.4.2 Structure and development of the external debt

Table II.4.1 presents data for the external debt in Tanzania. From the start of the reform period until 1993, there is no clear trend regarding the debt-to-GDP ratio; after 1993 the trend is negative. In just four years, the external debt stock in relation to GDP is almost halved. There are several explanations for this. First, GDP growth increased in the mid-1990s. Second, Paris Club negotiations commenced in 1995 after the temporary stop following the customs scandal (and the freeze of all program support) in 1994. Third, the introduction of the cash budget in 1995 gave debt servicing top priority among government expenditures. As can be seen in the table, debt arrears accumulated up to 1996, after which they fell substantially.

The pattern for the debt-service ratio is rather similar, even though the phasing of servicing precedes the phasing of the debt stock by two or three years. The explanations for this are, first, that bilateral credits have been rescheduled several times; and second, that the 1990s have seen increases in export earnings, both because of increases in export volumes, and because of favourable developments of some export prices.

Tanzania did not pursue any clear and explicit policy on debt prior to the introduction of the cash budget. After 1995, on the other hand, debt policies seem to be guided by two principles. First, as mentioned above, all debt servicing is prioritised (this includes domestic debt servicing). Second, no loans are taken on non-concessional terms. Although this is more a reflection of donor decisions than Tanzania's policies, new bilateral loans are almost non-existent. Consequently, loan inflows are IMF and IDA-credits, which explains the increasing share of multilateral debt in the total debt stock. This means that the average terms on which new loans are contracted, measured by maturity, grace period, interest rate, and grant element, are substantially more generous for Tanzania than for either low-income countries in general or for other sub-Saharan African countries (Danielson, 1997).

In contrast to the situation in some other countries, notably Uganda, Tanzania has not managed to control the development of the domestic debt (see Table II.4.2). There are several reasons for this. First, one strategy in the early 1990s for keeping expenditures down was to defer payment to domestic suppliers; this led to a rapidly accumulating domestic debt. Second, the tightening of the fiscal conditions in the early 1990s led to an increase in the issuance of T-bills. This, too, increased the domestic debt. The bottom line, of course, is the inability to limit government expenditures to available resources. To some extent, the problem is also complicated by the fact that the size of the domestic debt is the subject of some dispute. In any case, the large public or government-guaranteed debt creates a fiscal problem. Consequently, to the extent that Tanzania's fiscal situation is identified as one of the major problems, debt relief emerges as a potential solution.

Table II.4.1: Debt Indicators. Tanzania, 1986-1997

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Total Debt Ratio (% of GNP)	..	..	122	128	161	151	143	156	179	141	114	97
Debt Service Ratio (% of exports)	35.2	39.2	32.0	32.9	32.9	40.3	40.4	26.9	19.0	17.9	18.9	13.0
Concessional Debt (% of total debt)	52.9	49.7	53.1	54.2	53.8	54.5	57.5	59.0	60.1	59.8	60.5	70.9
Multilateral Debt (% of total debt)	26.2	26.8	27.6	29.7	30.9	33.0	34.4	35.6	36.7	37.7	39.1	41.0
Arrears (mn current USD)	531	766	845	1,050	1,215	1,486	1,518	1,815	2,090	2,421	2,532	1,795
Rescheduled debt (mn current USD)	657	59	385	77	185	7	348	58	9	0	33	761

Source: *Global Development Finance, 1999*, Washington DC: World Bank

Table II.4.2: Central Government Debt and Debt Service Payments, 1993/94-1997/98

	1993/94	1994/95	1995/96	1996/97	1997/98[a]
	Millions of Tanzanian Shillings				
Domestic debt	167,532	320613	528,798	702,117	605,726
o/w: T-bills	4,738	41,320	117,572	208,009	114,656
	Debt payments				
Domestic	33,163	67,237	82,161	95,993	103,918
o/w: interest	31,725	57,700	77,696	73,477	50,499
Foreign	59,422	73,331	80,635	91,771	117,093
o/w: interest	19,799	31,961	34,293	37596	44,672
	Memorandum				
Debt service/exp[b]	22.5	26.1	25.3	26.6	25.8
Debt service/GDP[c]	4.6	5.3	4.8	4.6	5.4
Domestic debt/GDP[c]	8.3	12.1	15.6	17.1	17.3

Source: IMF (1999), Table 21.
[a] Estimate
[b] Percent of total government expenditures
[c] Percent of GDP

Finally, what are the prospects for large-scale debt relief? Given the structure of Tanzania's debt, it is unlikely that the debt stock will be substantially reduced without access to the HIPC facility. The country would enjoy multilateral debt relief, at the earliest, in 2002 according to the HIPC rules. While it would seem that Tanzania should qualify for HIPC treatment,[13] the final decision would depend on which projections, particularly for export growth, that are used (OXFAM, 1999). However, it would be overly simplistic to evaluate the debt burden in Tanzania with reference to sustainability criteria only. Exports cover less than half of imports, and given the trend in the 1990s for bilateral ODA, Tanzania's external position is likely to become even more vulnerable. There is currently a discussion going on among donors and the IFIs as to whether it would be possible to interpret the rules liberally and thus to speed up the acceptance of Tanzania as a HIPC country.

A Multilateral Debt Relief Fund was introduced in July 1998 to help the government service its debt obligations to the IFIs. Funds are deposited into a special account and payments are to be made once obligations fall due. The government can then use the budgetary savings to increase spending on social sectors. This type of aid is thus equivalent to budget or balance of payments support. It is as yet too early to evaluate the impact of the fund.

[13] The HIPC sustainability criteria relate to the size of the debt stock and debt servicing (in net present value terms) in relation to exports and budget revenue. On each count, Tanzania would qualify. The thresholds below which the debt is deemed sustainable—with current Tanzanian data in parentheses—are as follows: debt stock as percent of exports 200-250 (406); debt service as percent of exports: 20-25 (35); debt stock as percent of budget revenue: 280 (673) (OXFAM, 1999, Table 1).

II.4.3. Conclusion

This chapter has shown that Tanzania is afflicted by large external and fiscal deficits. Both of these affect the level and composition of debt and, at the same time, the existence of a large debt feeds back into the disequilibria. Transfers in the form of interest and amortisation on the external debt increase the external gap, and given the floating exchange rate regime, the government has, to raise tax revenue to honour such obligations. In the absence of substantial expenditure cuts, this implies an increasing fiscal gap.

It would be possible to take the position, as the international financial institutions have done, that the large debt is a consequence of Tanzania's bad policies in the past, and that honouring these obligations should be the first test as to the commitment of the Tanzanian authorities' to a new era of policy-making. Tanzania has also taken steps in that direction: the introduction of the cash-budget system with the associated prioritisation of debt servicing seems to have pleased most international stakeholders. However, the existence of a large debt can also be acknowledged as a hindrance for rapid growth and therefore as an obstacle for better policies. It should be kept in mind that the country is a young and fragile democracy, and that the reforms steps that the government can take depend very much on how the electorate perceives that the costs are distributed and the perception of the necessity of these reforms.

Most students of Tanzania would agree that the country will not be capable of paying back her external debt. Consequently, large-scale debt relief may have several beneficial consequences: it may show the good will of international institutions; it may decrease political tension and thus increase the support for obviously reform-committed president; and it may help increase growth in the country.[14] From this point of view, the question of Tanzania's possible emergence is not only a question of large-scale policy change, and far-reaching structural reforms, but of concerted international action as well.

The conclusion of this part is that Tanzania is rather far from a situation that can be characterised as "sustainable". Much of this has to do with policy mismanagement and external shocks in the past. However, the economy has come closer in recent years to a situation, which is viable in the longer run. That is to say, while several important policy

[14] It should be noted, however, that unless complete debt retirement is provided instead of normal program aid, the large inflow may imply real exchange appreciation, which may slow growth.

changes have taken place in the 1990s, much more needs to be done in order to eliminate the results of past policy mistakes.

Part III. Structural policies to promote long-run growth

III.1. The structure of production and trade

III.1.1. Introduction

Structural change is one goal of market-oriented reform programmes. The aim is to move resources from nontradables to tradables production and from public to private ownership. While several arguments can be advanced in favoured in such a policy, we focus in this chapter in particular on the external gap. In order to close the external gap permanently, which is a precondition for moving away from aid dependence without jeopardising the stabilisation objectives, it is necessary that the export sector is sufficiently large to be able to cover import needs. In this chapter we study two questions. First, we consider how the reforms have affected the balance between tradables and nontradables. Second, we investigate how the volume and composition of exports and imports have changed during the reform period.

The chapter is organised as follows. Section III.1.2 tries to pin down the changes in the structure of production that have taken place since 1986. In section III.1.3 we examine the composition of exports, and we look at how responsive exports have been to varying reform attempts, including changes in the real exchange rate and the tax system. In addition we provide a few tentative estimates of export elasticity. In section III.1.4 we conduct a similar exercise for imports. Section III.1.5 looks closer at the composition of nontradables production, with particular emphasis on the role of and scope of the government. Section III.1.6 concludes.

III.1.2. Structure of production

At least two aspects of structural change are important when we assess the impact of more than a decade of economic reforms in Tanzania. The first one is changes in the allocation of resources between tradables and nontradables. This is important since only output from the former may contribute to an improved external balance, but also because tradables producers tend to be more productive since they tend to be exposed to international competition. In particular, liberalisation and deregulation associated with reforms may reinforce the tendency created by large-scale devaluations to move resources into the exportables sector. Second, the structure of production in terms of agriculture, industry and services may also be expected to change. Subsistence production may be expected to be monetised.

The data available on these issues varies somewhat between sources. Table III.1.1 shows four estimates for the share of agriculture in GDP.

Table III.1.1: Four Estimates of Agriculture's Share of GNP. Percent

	1988	1989	1990	1991	1992	1993	1994	1995	1996
World Bank	53.1	52.4	48.0	47.2	48.1	48.1	46.3	46.2	47.6
BoT-Monetary[a]	43.4	39.6	36.7	39.9	38.6	37.8	36.5	38.8	40.3
BoT-All[b]	56.1	52.3	47.6	50.1	50.2	49.8	46.5	48.7	50.0
TAKWIMU	48.0	48.0	48.0	48.0	48.0	48.0	49.0	50.0	51.0

Sources: *World Development Indicators, 1998*; Bank of Tanzania *Economic Bulletin,* Vol. XXVIII; *National Accounts of Tanzania,* Revised series, 12th edition

[a] Monetary agriculture as share of monetary GNP

[b] Total (monetary plus subsistence) agriculture as share of total GNP

Even though the differences in level are rather small, it is notable that while both the World Bank and the BoT estimates show a falling share of agriculture in GDP, the TAKWIMU estimate shows an increasing trend. In what follows, we rely on BoT estimates, partly because the negative trend in the share of agriculture displayed in the data is consistent with that observed from other data sources (e.g., PFP and PER data), but also because that data is internally consistent and the source contains some series which are absent in other publications.

The distinction between tradables and nontradables is important when one tries to assess the impact of economic reform programs. The national accounts are not constructed in such a way that it is possible to identify directly tradables and non-tradables, so we have to look for proxies. Our first choice is to aggregate agriculture, mining and industry into tradables, and everything else into nontradables. The main problem with this approach is the inclusion of non-monetary agriculture, since it could be argued that this sector produces mostly for subsistence and thus should be included into nontradables. On the other hand, there is evidence showing that also output classified as subsistence is traded across international borders.

In Table III.1.2 we show three different decompositions of GDP: between monetary and non-monetary GDP; between tradables and nontradables portions of monetary GDP and between tradable and nontradables portions of total GDP, where non-monetary agriculture has been included in tradables. The bottom row shows the real exchange rate. We may note that the real exchange rate has been appreciating, despite substantial nominal devaluations, in two periods: between 1989 and 1991 and from 1993 and onwards.

The main result from the table is that the share of the tradables sector in GDP has not been increasing during the reform period, and one plausible explanation is, of course, that there has not been any systematic real exchange rate depreciation. We also note that the relative size of the non-monetary sector has not changed. In order to investigate these phenomena more closely, we turn to an examination of the sectoral components of GDP.

Table III.1.2: Sectoral Decomposition of GDP. Percent.

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Monetary	71.0	71.2	70.3	72.9	72.7	72.0	72.1	72.5	70.7	71.1	69.8	71.0
Non-monetary	29.0	28.8	29.7	27.1	27.3	28.0	27.9	27.5	29.3	28.9	30.2	29.0
Tradable[a]	41.2	39.8	39.3	38.5	37.4	36.9	37.5	34.4	33.8	36.3	37.0	35.5
Nontradable[b]	58.8	60.2	60.7	61.5	62.6	63.1	62.5	65.6	66.2	63.7	63.0	64.5
Tradable[c]	70.2	68.6	69.0	65.6	64.7	64.9	65.4	61.9	63.1	65.2	67.2	64.5
Nontradable[d]	29.8	31.4	31.0	34.4	35.3	35.1	34.6	38.1	36.9	34.8	32.8	35.5
memo: RER[e]	76.7	95.5	108.7	132.9	100.0	92.4	108.7	124.2	101.8	82.5	74.6	67.4

Sources: Bank of Tanzania, *Economic Bulletin*, Vol. XXVIII, No. 1; *IFS on CD-ROM*, December, 1998.
[a] Percent of monetary GDP. Comprise agriculture; mining and quarrying; and manufacturing.
[b] Percent of monetary GDP. Comprise electricity and water; construction; trade; transport; financial services; and public administration
[c] Percent of total GDP. Includes non-monetary agriculture
[d] Percent of total GDP
[e] Real exchange rate, defined as the nominal exchange rate divided by the nominal consumer price index. Index, 1990 = 100. An increase is a depreciation.

III.1.3. The export sector

Reform measures designed to stimulate and expand the export sector have included liberalisation in the form of abolition of export licenses, removal of the requirement of foreign exchange surrender, and reduction of the role of marketing boards. Prior to the 1990s the BoT and the Board of External Trade (in collaboration with the Customs Department) also set minimum prices for export goods, which exporters were not allowed to under-quote. Approximately sixty percent of Tanzania’s exports were controlled in this way. This was also abolished. These liberalisation measures, coupled with the large nominal devaluations, were expected to have had major effect on the size and structure of exports. It should be noted, however, that the nominal devaluations to a large extent were counteracted by rapid domestic inflation, reducing the real exchange rate depreciation.

We first present some aggregate data for total exports and imports (Table III.1.3). These show first that in the last year of the crisis period, there was a staggering deficit. Since then aggregate exports has more than trebled, while there is no clear trend for imports. In the aggregate the liberalisation measures have had some impact.

Table III.1.3: Trade balance (Million US$)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Export	215	280	289	246	327	382	319	422	478	537	642	742
Imports	1458	1021	929	791	915	875	1341	1298	1321	1294	1355	1133
Trade balance	-1243	-741	-640	-545	-588	-493	-1022	-876	-843	-757	-713	-391

Source: Word Bank: World Development Indicators 1998

Table III.1.4 shows that the structure of the export sector has not changed dramatically. Coffee, cotton and manufactures, which earned almost 60 percent of export revenue in 1991, are important in 1997-98 as well, but now also cashew nuts and minerals contribute substantial shares.

Table II.1.4: Shares of Tanzania Exports by Type of Commodity (Jan-Sept)

Year	1991	1992	1993	1994	1995	1996	1997	1998
Coffee	0.23	0.18	0.23	0.26	0.25	0.20	0.15	0.17
Cotton	0.14	0.27	0.19	0.20	0.14	0.14	0.15	0.09
Sisal	0.00	0.00	0.00	0.01	0.01	0.01	0.01	0.01
Tea	0.06	0.07	0.06	0.08	0.04	0.03	0.04	0.06
Tobacco	0.03	0.05	0.03	0.04	0.04	0.06	0.02	0.03
Cashew nuts	0.03	0.08	0.06	0.05	0.08	0.10	0.07	0.08
Total agriculture	0.49	0.64	0.57	0.65	0.56	0.55	0.44	0.42
Petroleum	0.03	0.02	0.00	0.01	0.02	0.02	0.02	0.01
Minerals	0.10	0.11	0.23	0.17	0.09	0.08	0.11	0.22
Manufacturing	0.25	0.14	0.09	0.05	0.13	0.10	0.23	0.13
Other	0.12	0.10	0.10	0.12	0.21	0.24	0.19	0.22
Total other	0.51	0.36	0.43	0.35	0.44	0.45	0.56	0.58

Source: Financial Times (Tanzania), 3/3-1999

The revenue generated by the major commodities fluctuates rather much: cotton contributes between 9 and 27 per cent of total revenue; manufacturing between 5 and 25 per cent, while coffee revenue is more stable fluctuating between 15 and 25 per cent. Agriculture, which is likely to exhibit rather low supply elasticities, at least in the short run, contributes a falling share of total exports. Still, there has not been any breakthrough in manufacturing exports.

We show in Table III.1.5 price and quantities for the traditional export crops (these are the only ones for which such data are available). While volumes fluctuate substantially, it is equally clear that also prices fluctuate widely without a clearly defined trend. In addition, the correlation coefficient between volumes and unit prices is negative (and significantly different from zero at the five percent test level) for four of the six commodities (tea and sisal are the exceptions). Consequently, a fall in output has been associated with an increase in price and vice versa. While it is difficult to determine the direction of causality, one reasonable hypothesis could be that Tanzania's major export commodities are the same goods that are produced in other African economies, and that the swings in volume are determined primarily by changes in the weather. As this also affects output in other African economies, the result would be that volume increases cause world market prices to fall and vice versa. To the extent that this is a correct interpretation, it suggests that the problem of heavily fluctuating export revenues is a problem associated to the lack of diversification in the export sector.

Table III.1.5: Exports: Prices and Quantities

	1991	1992	1993	1994	1995	1996	1997	1998
				Unit price (USD/ton)				
Coffee	1,623	1,432	1,548	1,995	3,538	2,146	2,299	1,984
Cotton	1,718	1,480	1,313	1,685	1,482	1,688	1,453	1,577
Sisal	540	83.7	575	0	592	589	633	545
Tea	1,500	1,162	2,273	1,740	1,087	1,002	1,213	1,853
Tobacco	1,324	1,822	1,647	1,000	1,612	1,894	2,198	1,876
Raw cashew nuts	905	818	1,149	1,042	825	873	642	824
				Volume ('000 tons)				
Coffee	13.6	13.9	19.6	13.4	12.7	22.1	16.4	18.4
Cotton	13.0	26.3	21.3	21.9	19.3	16.0	25.7	13.2
Sisal	0.7	2.4	0.8	0.0	4.8	2.5	3.0	2.6
Tea	4.1	5.7	7.5	5.2	8.6	6.4	5.7	7.7
Tobacco	1.7	5.4	5.1	5.4	6.2	5.3	1.4	3.0
Raw cashew nuts	11.0	14.3	9.4	2.4	34.4	49.2	55.5	34.0

Source: Bank of Tanzania, *Economic Bulletin*, Vol. XXVIII

For most of the reform period there was little change in the structure of exports, while there was a substantial increase in the share of non-agriculture in the last two years. Whether this trend will continue is too early to say, but if so it would certainly help reduce the volatility of Tanzanian export revenue. Exporters have had to struggle with a multitude of problems, including strict state control of the export sector in the 1980s, high and increasing operating costs for the marketing boards which prevented increases in prices to trickle down to producers, and low supply elasticities for the major agricultural export commodities One problem is that Tanzania's export structure is similar to that of neighbouring countries and that the policies pursued in Tanzania in order to improve the functioning of that sector is similar to those policies in the other countries. Reforming countries are forced to reform rapidly only to retain its relative position with respect to export proceeds from commodity exports.

III.1.4. Imports

While exports were stimulated during reforms mainly by devaluation and the abolition of the requirement to surrender foreign exchange earned, the major impact on imports was through a gradual removal of an elaborate system of import licenses. Prior to the 1990s, the main instrument for regulating imports was a system of licenses coupled with a large "negative list" comprising goods that were not allowed into the country. The first step towards a liberalisation of foreign trade was the introduction of the "own-funds" system according to which the importer was no longer required to reveal the source of foreign exchange. The rationale for this system was two-fold: first, to incorporate part of the large unofficial trade into the formal economy and to make that trade the subject of taxation; second, to lessen the demand from the public on foreign exchange from the Bank of Tanzania, and consequently to lessen the depreciation pressure on the Shilling.

The own-funds system was accompanied by a change from a Commodity Import System to an Open General License scheme (for aid funds), which was considered less administratively cumbersome and which favoured inefficient parastatals to a lesser extent. However, even under the OGL and own-funds systems, importers were required to obtain an import license from the Bank of Tanzania. In 1992, further liberalisation was attempted through the introduction of Bureaux de Change, which acted as yet another window for import financing up to 1996, when their operations were restricted to mere over-the-counter transactions.

In 1993, the import license was replaced by an import declaration form which did not require approval from the Bank of Tanzania (save for items on the shrinking negative list). To combat misinvoicing and frequent smuggling, the form has been complemented by compulsory pre-shipment inspection for all goods, the value of which exceeds USD 5,000. The elaborate system designed to bring an increasing share of total imports into the formal system has been continued,[1] even after the introduction in 1995 of daily inter-bank trade for foreign exchange and thus, effectively, a floating exchange rate regime.

Since one rationale for the large changes of the value of the Shilling that have taken place since 1986 has been to slow the growth of imports, it would have been desirable to have an estimate of the extent of illegal trade. Informed sources provide guesstimates that range from

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[1] For a critical discussion of the functioning of the Tanzania Revenue Authority and the various attempts to combat corruption and smuggling, see Mpango (1996a). Mpango (1996b) provides some quantitative estimates of the degree of misinvoicing during the 1980s.

20 to 50 percent of total imports. The problem is made even more difficult by widespread misconduct among Customs personnel. TRA (1997) list the following problems as being particularly severe with regard to the control of imports and collection of duties:

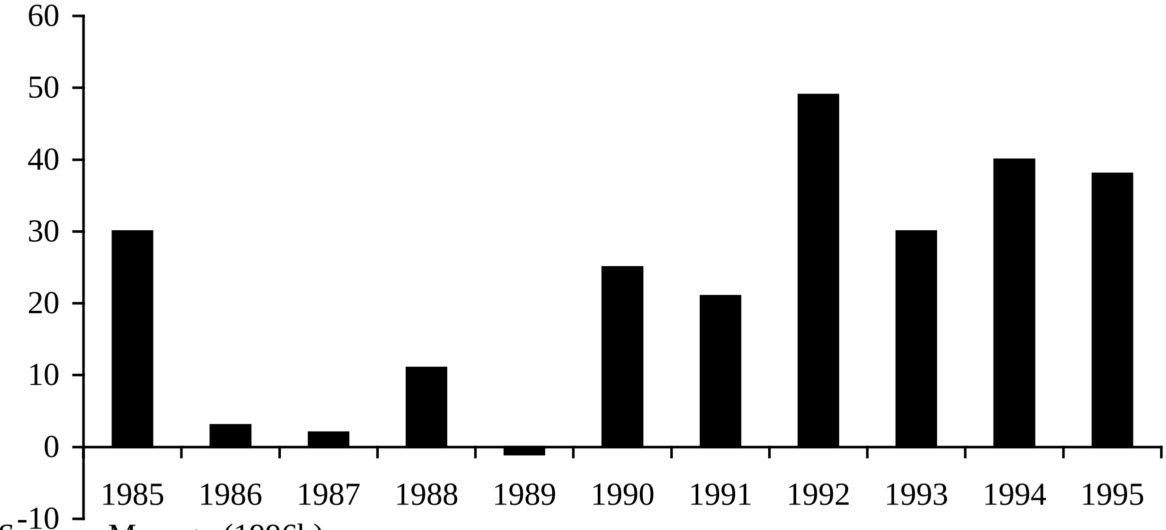
Malpractice by taxpayers:
- Underinvoicing of imports
- Diversion of transit goods
- Routing imports through Zanzibar (where nominal tariffs were lower prior to 1997)
- Smuggling goods into the country
- Abuse of investment certificates

Malpractice by tax officials
- Abuse of exemptions
- Poor accounting
- Use of fake revenue stamps
- Deliberate under-assessment of imported goods
- Deliberately wrong classification of goods
- Application of wrong exchange rates
- Non-registration of taxpayers
- Cumbersome procedures and questionable documentation

Two additional indications of the difficulty of estimating actual protection rates are the amount of import underinvoicing and that the rate of change of imports differs considerably from the rate of growth of tariff revenue. From 1993 and onwards, the rate of growth of the latter exceeded the former. This suggests, particularly since this period was characterised by substantial reductions in nominal tariff rates, that the efficiency of tariff collection increased, following pressure from the donors. Figure III.1.1 and Table III.1.6 provides information.

Even though actual imports are likely to deviate substantially from recorded levels, it is clear that imports has been subject to lower tariffs. The compilation of Tarimo (1996) shows clearly that import duties as well as excise taxes have been lowered, particularly after 1996. Prior to that, import liberalisation was very much concerned with exchange rate liberalisation with the transformation of quantitative restrictions into tariffs. The current structure is such that there are three sets of tariffs, for capital, intermediate and consumer goods respectively. While the rates are supposed to be homogenous, there are still a number of loopholes, particularly with regard to the classification of goods and because donors' imports for own use is exempted.

Figure III.1.1:Import underinvoicing, percent of imports



Source : Mpango (1996b)

Note : Underinvoicing is measured by comparing value of exports to Tanzania in the exporting country to value of imports from that country in Tanzania.

Table III.1.6: Growth of Imports and Import Duties

	90/91	91/92	92/93	93/94	94/95	95/96	96/97
Growth of Imports (%)	67	32.1	39.7	29.5	19.7	2.5	N/A
Growth of Tariff Revenue (%)	55.3	21.6	-18.1	58.8	81.7	32.9	34.5

Source: Mpango (1996a)

One interesting question in this regard is how the liberalisation of the exchange rate regime and the lowering of tariff barriers have affected the structure of imports. Table III.1.7. provides an import counterpart to Table III.1.3 for exports.

Table III.1.7: Structure of Imports. Percent

	1991	1992	1993	1994	1995	1996	1997	1998
Capital goods	43.8	46.3	45.6	48.3	41.3	37.0	29.3	34.8
o/w Machinery	21.5	18.2	14.3	23.5	23.3	17.6	13.7	20.1
Intermediate	18.0	21.1	18.2	25.2	37.0	34.3	39.7	31.2
o/w Oil	8.9	10.6	12.2	9.9	14.7	7.7	19.9	5.1
Consumer Goods	20.0	27.5	31.6	23.7	21.7	28.7	31.0	34.0
o/w Food	0.0	3.5	10.8	9.2	0.9	8.2	3.6	9.0
Other	18.3	5.1	4.6	2.8	0.0	0.0	0.0	0.0
TOTAL[a]	397.1	446.0	314.6	442.5	324.5	376.5	343.3	302.8

Source: Bank of Tanzania, *Economic Bulletin*, Vol. XXVIII

[a] Million USD

The most important trends in the table are that capital goods imports has declined substantially, particularly after 1995; that consumer goods imports shows an upward trend since 1995; and that non-oil intermediate goods imports have increased. There are three possible explanations. The first is that intermediate goods imports have replaced capital goods imports in an attempt to improve capacity utilisation of existing capacity. This would probably be a consequence of donors' increasing recognition that donor-financed projects cannot work efficiently without funds to finance inputs (cf. Doriye et al., 1994 for a similar argument regarding the situation in the mid 1980s). Second, the extent of misclassification of goods may have increased in response to the reduction in the number of tariff rates. Finally, capital goods may be less smuggled than consumer goods. If smuggling has decreased as a result of falling protection, this shows up in the data as increasing consumer goods imports. In any case, the table shows that much of imports may be classified as "necessities", meaning commodities with low price elasticity. Consequently, the devaluation strategy has not succeeded notably in lowering the dollar import bill.

Finally, we should note that domestic manufacturing producers seem on average to have been more hurt by tariff reductions than helped by devaluations. Prior to reforms they operated behind high trade barriers with resulting inefficiencies. Since trade liberalisation was rapid and wide-ranging, the producers had little time to upgrade methods of production. The result was that some types of domestic production, such as clothing and textiles, shoes, leather, sugar and oil were largely replaced by imports (Tarimo, 1996). These problems point to the need to co-ordinate changes of the exchange rate and tariffs.

III.1.5 The non-traded sector

While the financial and public sectors are the focus of later chapters, we here provide some indications of the extent to which the non-traded sector has been the subject of structural change. The sector comprises utilities, constructions, services and the public sector. For the purpose of this chapter, we exclude all discussions of the non-monetary parts of the economy. Table III.1.8 shows how the structure of the sector has changed.

From the start of the 1990s, the share of the nontraded sector in GDP has remained fairly constant, which is maybe not so surprising given the limited change that has been achieved with regard to the real exchange rate. This is equally true for most of the components in the sector, with the possible exception of utilities (where user fees have been introduced) and the public sector, where probably increases in aid-funded education and health account for the increases. The financial sector has been deregulated in the 1990s, but it still accounts for a virtually constant share of GDP. Similarly, the large retrenchments and attempts to rationalise public administration have not reduced the share of the public sector.

Table III.1.8: Structure of Non-Traded GDP. Percent of GDP

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Utilities	0.8	1.3	1.6	1.8	1.6	2.4	1.9	2.2	2.0	1.9
Construction	3.1	2.7	4.2	3.5	3.6	2.8	2.8	2.2	2.1	2.9
Trade	14.8	15.2	16.5	16.1	16.6	15.8	15.5	15.4	14.9	14.3
Transport	3.8	5.2	5.6	5.2	5.4	6.3	6.3	5.9	5.7	5.6
Financial services	6.2	7.5	8.2	6.3	5.8	7.1	7.4	6.2	6.3	6.1
Public sector[ed]	5.9	6.3	6.1	5.6	6.2	7.9	7.9	7.0	6.1	8.7
TOTAL	34.6	38.2	42.2	38.5	39.2	42.3	41.8	38.9	37.1	39.5

Source: Bank of Tanzania, *Economic Bulletin*, Vol. XXVIII
[a] Electricity and water supply
[b] Includes restaurants and hotels
[c] Includes finance and insurance real estate and business services
[d] Includes administration, education and health

III.1.6. Concluding remarks

The drastic nominal devaluations in Tanzania have been fostering inflation, which the Bank of Tanzania has not managed to keep at bay. The result has been that the real exchange rate has not changed as much as one could expect. To bring about structural change, it is important to combine expenditure-switching policies with expenditure reducing polices. Apparently, the latter has failed, and the result has been a non-depreciating real exchange rate and limited structural change. Our major conclusion is therefore much has been accomplished in terms of policy change, particularly if that is measured in terms of the size of devaluations, the number of privatized firms, and the amount of legislative changes in order to create a more competitive environment for producers. There has been some export expansion, but the balance between traded and nontraded sectors has not changed much.

III.2. Financial liberalisation

III.2.1. Introduction

An important element in the development strategy of *dirigiste* economies is a financial system, which allocates cheap credit on generous terms to firms and sectors perceived to be important. Tanzania, before the reforms in 1986, was no exception. Interest rates were kept low and usually negative in real terms and parastatal companies received a share of that credit which reflected neither their creditworthiness, nor their potential role for economic development.

The price to be paid for this strategy was that the growth of some sectors was hampered by lack of credit, a stagnating agriculture characterised by risk-minimising rather than profit-maximising producers, small private savings, and a growing informal financial sector in which individual intermediaries were too small to be able to deal adequately with issues of scale economies and risk pooling and thus charged high real interest rates.

Consequently, the reform programs included a comprehensive program to restructure and redesign the financial sector. The major perceived benefits from reducing or removing some of the constraints of the system included increased private savings, both because increased real interest rates would increase total savings, and because a better system would induce people to put their savings into the formal system; an allocation of financial resources which better reflected the expected growth of firms; an efficient allocation of resources emanating from increased competition among banks and other financial institutes; the development of new financial instruments, both for handling risks in the private sector and for the conduct of monetary policy; and increased investments, both because of a better allocation of credit among firms, and because of the increased possibility of joint ventures (FDI inflows being seen as dependent on, inter alia, the availability of domestic credit).

Apart from the problems associated to regulated interest rates and severe credit rationing, pre-reform Tanzania was also characterised by undue state dominance in the financial sector. In short-term financing, the market was dominated by the state-owned National Bank of Commerce, which, at its height, accounted for close to eighty percent of all deposits in the country. While a few smaller banks also existed, notably the Tanzania Postal Bank, which could compete, with the NBC in terms of reach into the rural areas, all of these were controlled either by the state or the party.

On the long-term side, the problems were similar. Prior to reform, Tanzania had three development banks: the Tanzania Investment Bank, the Tanzania Development Finance Co. Ltd., and the Tanzania Housing Bank (THB). In addition, there were two insurance companies and two pension funds. All of these were controlled or owned by the government and, in addition, since each has a specific mandate, all enjoyed virtual monopoly in its designed area of operation (Kimei, 1994).

In this chapter we attempt to assess the success of the financial reforms so far. We discuss in Section III.2.2 the major institutional and legislative reforms. Section III.2.3 looks at the conventional indicators of financial liberalisation and "monetary maturity" to assess the extent to which reforms has affected these indicators. Section III.2.4 looks at savings and investments in order to assess how financial deepening and liberalisation have affected these variables, and Section III.2.5 concludes.

III.2.2. Institutional and structural reforms

During the first five years of IMF-supported reforms Tanzania did not have any policies designed to change the functioning of the financial market as such. Some policies indirectly affected the workings of that sector, i.e., devaluations and the combating of inflation, but not until 1991 did financial reforms proper start (Joseph, 1999; IMF, 1999). The first years of the 1990s changed the rules of the financial games in a profound manner. A new Banking and Financial Institutions Act (BFIA) was enacted in 1991; the foreign exchange market was liberalised in 1993; and the Bank of Tanzania act, from 1995, replaced the BoTs previous multiple objectives with the single one of price stability (Nyagatera and Tarimo, 1997).

It will be useful to consider the profound changes taking place under the reform programme under four headings. First, the financial sector reforms attempted to create a new policy environment by improving the legal and institutional framework, by creating greater autonomy in decision-making and by increasing competition in the banking sector. The legal framework has improved through changes in the legislation, allowing, for instance, private and foreign banks to compete in the market; by refocusing and sharpening the role of the Bank of Tanzania; and by providing new regulation regarding the capitalisation of banks. Decision-making autonomy has been increased through the removal of BoT's responsibility for setting interest rates (in June 1992, with further liberalisation in June 1995) and by the introduction of market-based and unified exchange rates through the introduction of bureaux in 1993 and the creation of the IFEM in 1994). In addition the scrapping of import and exchange controls in 1991 and 1992 implied that banks are free to allocate capital and foreign exchange as they see fit, subject only to the BoTs prudential guidelines and the regulations concerning exposure limits and credit risk (Kimei, 1994).

Second, the reforms have led to substantial restructuring of existing financial institutions. The purpose of the Loans and Advances Realisation Trust (LART), created in 1991, was to provide machinery for removing non-performing assets from financial institutions and to allow them to restore their balance sheets. This was a necessary first step for the restructuring of the sector: by 1996 LART bonds amounting to TZS 150 bn had been issued (amounting to approximately 40 percent of all deposits) and still the restructuring of the National Bank of Commerce (NBC), the major bank with about three-quarters of all deposits in the early 1990s, was incomplete. Indeed, analysis in October 1996 suggested that around two-thirds of the NBCs loan portfolio was bad (Nyagatera and Tarimo, 1997). The restructuring has been profound. The Tanzania Housing Bank was liquidated in 1995 and the Tanzania Investment Bank heavily restructured. The NBC has recently been broken into two parts: the NBC (1997) and a micro-finance bank. While the NBC (1997) inherited a wide network of local branches from the old parastatal, the new demands for efficiency resulting from increased competition has forced several of these to close. Further restructuring, particularly of the National Insurance Corporation, is in the pipeline.

The third area in which wide-ranging change has taken place is with regard to the freedom of entry and exit. The legislation from 1991 and 1992 regarding financial institutions and bureaux de change all allow free entry and exit. As a result over fifteen new financial institutions were licensed in the next four years. Of these the majority were foreign owned. Exit as well has been recorded with the collapse of the Meridien Biao and the Tanzania Housing Bank in 1995. Furthermore, to some extent the legislation has also stimulated the growth of new forms of financing institutions, of which the most notable is the Dar es Salaam Stock Exchange, opened in 1997. Even in the beginning of 1999 only two stocks were listed.

Finally, the new role of the Bank of Tanzania should not be underestimated. From being an instrument for supporting the government’s fiscal policy prior to 1986, the BoT has been changed, primarily through the new Act of 1995, into a modern, independent central bank with one prioritised goal: price stability. In addition, the new regulation mandates the BoT to issue regulation regarding core issues in the financial markets: licensing, capital adequacy, prudential management, exposure limits and off-site reporting (Nyagatera and Tarimo, 1997). The role of the BoT has been strengthened, not only with regard to the conduct of monetary policy proper, but as a regulator of the financial system. Its importance has only increased with the introduction of a floating exchange rate system and the cash budget imposed on the governments fiscal operations.

In sum, then, the institutional and legislative changes in the financial sector have been wide-ranging and profound. It is important, however, not to lose sight of the fact that financial deregulation is not an objective in itself, but is supposed to help intermediate between savings and investment opportunities. As an intermediate objective, financial liberalisation is also designed to increase monetisation and financial deepening in the economy. We next look at some indicators of these aspects.

III.2.3 Impact on financial markets

We consider the effects of the reforms on the structure and size of the financial markets from two angles. First by examining real interest rates and the extent to which monetisation has spread and financial instruments become more sophisticated. Second, we look at the structure of domestic banks, in particular the structure and size of lending and borrowing. It would also have been of interest to analyse the relative size of banks (particularly in view of the NBCs historically dominant role), but such data have not been available.

Some aspects of monetary policy are presented in Table III.2.1. Recall that an important ingredient in financial liberalisation is to remove the ceiling on interest rates and to ensure that the market mechanism becomes more important in the allocation of credit. In addition, increased rates of interest are supposedly important to stimulate formal sector savings (a topic considered in section III.2.4) and are also central to monetary policy.

We use as a measure of real interest rates the difference between nominal rates and the rate of growth of the national consumer price index. Although an imperfect indicator (particularly in an economy in which around three-quarters of the weights in the price index consist of food), it is difficult to find a better one, given the lack of reliable data. In any case, the trends for real rates should give an indication of the extent to which the economy is heading in the right direction.

Table III.2.1: Indicators of Monetary Policy. Nominal rates less inflation

	Real discount rate	Real deposit rate (3-6 months)	Real commercial lending rate (upper margin)
1980	-25	-26	-19
1981	-22	-22	-14
1982	-25	-25	-17
1983	-23	-23	-14
1984	-32	-32	-23
1985	-28	-29	-21
1986	-24	-24	-14
1987	-17	-14	-2
1988	-17	-14	-2
1989	-10	-9	5
1990	N/A	N/A	N/A
1991	N/A	N/A	N/A
1992	-7	N/A	N/A
1993	-11	N/A	6
1994	34	N/A	6
1995	18	-5	13
1996	-1	-6	18
1997	0	-8	13

Source: *IFS on CD-ROM*, December 1998.
Note: The following series are used (IFS codes in parentheses): Discount rate (73860…ZF…); deposit rate (73860L…ZF…); CB lending upper margin (73860P…ZF…); changes in consumer prices (73864…XZF…)

The data in Table III.2.1 provide three different indicators: the real discount rate, which measures (imperfectly) the monetary policy stance; the real deposit rate (for short deposits) which gives an indication of the extent to which increased competition in the banking sector has succeeded in attracting savers; and the upper margin for lending of commercial banks (this is set by the Bank of Tanzania, and is related to the monetary policy stance).

Start with the monetary policy stance. The real discount rate has been negative for most of the period with the exception for 1994 and 1995 when inflation was on its way up and the BoT responded by increasing the nominal discount rate to almost 70 percent. The trend, however, is increasing (meaning that the real discount rate moves towards zero) and there is a clear tendency for a tougher monetary policy. Still, however, Treasury bill holders receive negative real rates of interest. A similar situation exists with respect to the rate of return on savings deposits: the trend is positive but the real rate is still negative.

The final column in the table shows, in real terms, the maximum rate that commercial banks can charge on loans. It is positive and increasing. Moreover, it has been positive throughout the reform period for which we have data. The Bank of Tanzania uses this instrument, in conjunction with reserve requirements, to control the amount of lending by commercial banks. It deserves to be noted that, for the years that we have data, the difference between the maximum lending rate and the savings deposit rate, the spread, is around 20 percentage points. Similarly, the difference between what banks pay to borrow in the central bank, the discount rate, and what they can charge when lending is around 15-25 percentage points. Such margins do not seem to suggest increased competition, particularly not since they have been more or less constant for several years.

Financial repression prevents money to spread in the economy and, in particular, prevents the development of more sophisticated financial instruments. One common indication of the extent of financial deepening is the ratio of broad money to GDP. It is not exactly clear which measure of broad money that is the most appropriate here, but we use money plus quasi-money (which roughly coincides with M2) simply because it is a common indicator in the literature. However, we should be careful when interpreting this measure. It is important to recall that throughout the period of financial reforms, Tanzania has also attempted to pursue an ambitious stabilisation program, the prime target of which has been (and is) inflation. To contain inflation, the rate of growth of money has been limited, and to do that in a sustainable fashion, fiscal prudence has been attempted.

The problem here is that the IMF program for stabilising the economy has been focused on limiting the degree of deficit financing, while at the same time financial reforms have sought to increase the M2/GDP ratio in order to improve credit allocation. It is not entirely clear, then, if M2 (i.e., money plus quasi-money) is an appropriate indicator of financial deepening, or if that would simply be an indication of failed stabilisation. The check for that we examine M2 as well as M2 minus M1 (which consequently corresponds to quasi-money alone, i.e., to means of payment with relatively low liquidity, which can be expected not to be affected by deficit finance. Table III.2.2 presents the relevant data.

Financial deepening in the sense that the ratio of M2 increases in relation to GDP is usually considered to be a precondition for self-sustained growth. However, Tanzania shows instead a declining ratio of M2 to GDP. The decline is particularly pronounced for M1, i.e., for liquid means of payment. This declined is not matched by any increase in quasi-money, meaning that the usual indicator for financial development shows no clear trend.

Table III.2.2: Indicators of Financial Deepening

	M2/GDP	M1/GDP	(M2-M1)/GDP
1980	0.41	0.31	0.10
1981	0.42	0.31	0.11
1982	0.39	0.29	0.10
1983	0.42	0.29	0.12
1984	0.35	0.24	0.11
1985	0.34	0.22	0.12
1986	0.33	0.23	0.10
1987	0.20	0.14	0.06
1988	0.17	0.12	0.05
1989	0.18	0.13	0.05
1990	0.21	0.15	0.06
1991	0.21	0.14	0.07
1992	0.23	0.15	0.08
1993	0.23	0.13	0.10
1994	0.24	0.13	0.10
1995	0.24	0.13	0.11
1996	0.21	0.11	0.10
1997	0.19	0.10	0.09

Source: IFS on CD-ROM, December 1998

Note: M2 is money plus quasi-money; M1 is money. Money is IFS-code 73834..BZF…; Quasi money is 73835…XF…

While we do not have an unambiguous explanation for this, it does seem reasonable to suspect that the stabilisation program plays an important role. The indicators fall in particular from about 1983 and up to 1988 and then increase somewhat (and that increase is entirely due to an increase in the ratio of quasi-money to GDP; M1 continue to fall). One possibility is that the figures tell us little about financial deepening, but say more about the changing ways of financing the fiscal deficit.

While the data in the table probably are marred by several years of monetary restraint to fight inflation, it deserves to be noted (a) that the policy has not been entirely successful, as shown in Table III.2.1; and (b) that the fight against inflation has been partly helped in the second half of the 1990s by an appreciation of the real exchange rate (cf. Section II.3). Consequently, the monetary authorities in Tanzania face a dilemma. On the one hand, restoration of the international competitiveness for producers in the tradables sectors requires depreciation (or at least stability) of the real exchange rate. This, in turn, is likely to fuel inflation, which is something that should be avoided. On the other hand, the existence of two-digit inflation is difficult to square with the attempts at increasing the attractiveness of formal financial institutions. To lure more risk-willing capital into that sector, it is necessary to raise real interest rates to positive levels, while avoiding the high rates usually associated with imperfect competition, and which would jeopardise relative price stability (through increasing costs for borrowers).

Table III.2.3 provides some indicators of competitiveness in Tanzania's financial markets. It should be noted that this issue cannot be resolved by simply counting the number of banks. Even if the NBC has been restructured, it still dominates the market through its links to the ruling party, and the wide chain of local branches established in the pre-reform period. In addition, several of the recently established banks in Tanzania are active only in the major commercial centres, Dar es Salaam, Arusha and Mwanza, and show few signs for expansion into other areas. In addition, current land legislation renders banking activities more difficult. Land cannot be owned and consequently not used as collateral. As most banks traditionally require full collateral on loans, potential banking customers are those with sufficient assets.

Table III.2.3: Indicators of Competition in the Banking Sector. Selected years.

	1990	1993	1996	1998[a]
Bank of Tanzania discount rate	22.0	22.0-27.0	14.9-40.8	15.5-20.0
Savings rate (fixed, 3-6 months)	17.0-29.0	22.0-25.0	2.0-33.0	4.0-12.0
Short-term lending (3-12 months)	20.0-31.0	22.0-31.0	28.0-46.0	20.0-25.0
Long-term lending (1 –2 years)	21.0-31.0	21.0-39.0	29.0-38.0	21.0-32.0
Reserve requirement	3.0	3.0	12.0	10.0
Inflation	35.9	25.2	21.0	14.4

Source: Bank of Tanzania, *Economic Bulletin*, Vol. XXVIII
[a] March

There are several reasons to suspect, first, that monetary policies are not very tight and, second, that the competitive situation in financial markets in Tanzania, while improved since the early 1990s, still leaves a lot to be desired. First, with the exception of short episodes, the discount rate has been negative throughout the 1990s. In a situation when investors have few alternatives to buying Treasury bills, a negative real rate will be sufficient for mopping up excess liquidity. However, as a means for restricting demand in the economy, and to control inflation, it is difficult to believe that a negative rate will be sufficient. Second, the nominal difference between the discount rate and the long-term lending rate is currently between ten and fifteen percent and has increased in the 1990s, probably as a result of liberalisation. Third, the difference between banks' borrowing and lending rates has increased drastically during liberalisation. Currently, the nominal rate for a savings account is approximately ten percent below inflation.

Consequently, even if Tanzania has come a long way from the regulated system that existed in the 1980s, markets do not appear to be characterised by competition, efficiency or sophistication. We now turn to the issue of the structure of banks' lending and borrowing. Table III.2.4 provides some relevant data.

Table III.2.4: Structure of Bank Activities. Percent and selected years

	1990	1993	1996	1998[a]
Lending				
Overdraft	75.7	70.2	77,7	74.1
Commercial Bills	5.3	9.8	5,5	5.4
Foreign	0.0	0.0	0,5	0.3
Other	18.9	20.1	16,2	20.1
Securities				
T-bills	0.0	2.1	34.9	40.1
Other GoT securities	100.0	97.9	65.1	59.8
memo: Lending-to-deposit ratio	141.4	102.2	25.5	28.2

Source: Bank of Tanzania, *Economic Bulletin*, Vol. XXVIII

[a] March

If we look at Table III.2.4 the impact of liberalisation shows itself in two major ways. First, the opening up of the current account (Tanzania accepted Article VIII of the IMF in 1995) and the consequent growth of foreign exchange accounts increased the amount of lending in foreign exchange shortly after the liberalisation took place. However, the share of total lending being conducted in foreign exchange is less that one percent of total lending, and there are no indications that it will increase. Second, as financial liberalisation gained momentum in the early 1990s, the government introduced new instruments for monetary policy. In particular, Treasury bills were used, from 1993 onwards, as the major instrument for mopping up excess liquidity and for steering interest rates. As a share of banks' total securities, T-bills grew rapidly and account for almost half of total securities. The fact that what is not held as T-bills is held as other government securities is yet another indication of the lack of sophistication characterising Tanzanian financial markets.

The most interesting figures in the table are, however, contained in the last row: the ratio of lending to deposits. The amount of lending has decreased dramatically in relation to deposits. There are two major explanations for this, both related to the reform programme. First, privatisation and more prudent banking rules have prevented parastatals from covering losses through borrowing in state-controlled banks. In the pre-reform period, state-controlled companies operated under soft budget constraints (cf. Eriksson Skoog, 1998), which allowed them to cover financial losses with loans primarily from the NBC. The reforms changed this situation in two ways. First, the introduction of hard budget constraints for the majority of the state-controlled companies led to large restructuring and massive liquidation so the demand for loss-covering loans diminished radically. Second, the restructuring of the bank sector, with introduction of hard budget constraints implied, as noted above, that substantial shares of the loan portfolio were transferred to the LART. Consequently, the willingness of banks to provide loans against insufficient or non-existing collateral and with scant possibility of repayment, decreased. What does seem worrying, however, is that parastatals' diminishing demand for loans has not been replaced by loans to other actors in the economy. The current lending-to-deposit ratio is ridiculously low, less than 30 percent of deposits are actually recycled. It should be noted that the figures for 1996 and 1998 are by no means all-time lows: the ratio starts falling in 1993 and displays a negative trend (with small fluctuations) thereafter. It indicates that the current regulations or practices on Tanzania's financial markets are not well suited for the new system. In particular, the system of full collateral, in real estate or other assets, prevents small entrepreneurs from accessing the market.

Further evidence regarding the biases against small-scale producers in financial markers is provided in Table III.2.5 that shows the structure of bank lending by sector. The impact of reforms is felt here too, as seen, for instance, in the fact that the amount of borrowing for purposes of marketing agricultural products has diminished radically. This is a consequence of the scrapping of marketing boards and the introduction of hard budget constraints in agricultural parastatals. Another aspect of the lending structure is that the share going to agricultural production and mining and manufacturing, respectively, in no way reflects their relative importance in GDP. Moreover, these share do not appear to have changed substantially during economic reforms. The structure here is a clear indication of the demand for collateral made by banks: small-scale producers are virtually barred from the formal financial sector due to lack of sufficient collateral.

Table III.2.5: Structure of Lending. Percent of Total Lending

	1990	1993	1996	1998[a]
Public administration	7.3	9.7	5.3	2.6
Agricultural production	8.4	6.6	11.7	4.6
Mining and manufacturing	22.7	18.7	25.2	26.1
Construction	1	2.4	2.9	2.3
Marketing of agricultural produce	31.4	25.2	6	2.6
Tourism	0.8	1.9	0.7	1.1
Other[b]	28.4	35.5	48.2	60.7

Source: Bank of Tanzania, *Economic Bulletin*, Vol. XXVIII

[a] March

[b] Includes transportation, exports, other trade and specified financial institutions. The item "other trade" accounts for almost ninety percent of this.

Note also the size of the item "other". While it includes several different sectors, the dominating one is "other trade", meaning that the majority of credits given by banks is short-term and related to trade activities. Consequently, what is lacking in Tanzania's financial markets seems to be two things. First, a bank which is able to provide long term loans. As noted above, the three development banks that existed prior to reforms have either been liquidated or radically cut down their activities. It appears that there is a large potential demand for such credit; for instance, no bank is willing to finance the purchase of a house after the collapse of the THB in 1995. Second, a bank, which is able and willing to provide small-sized credits to small entrepreneurs, particularly in, the agricultural sector. The restructuring of the National Bank of Commerce resulted partly in the NBC (1997), which took over those loans from the old NBC that were not transferred to the LART and which continued NBC's traditional business, albeit at a smaller scale (a number of rural NBC branches have been closed). The other result from the restructuring of the NBC was a micro-finance bank. The idea is to utilise the network of branches inherited from the NBC and to focus on providing credit to small-scale producers in the rural areas. Although this is likely to fill a gap in the financial structure of Tanzania, it should be pointed out that the approach to micro-finance in Tanzania is a very traditional one. Judging from the experience of other countries, the success of the micro-finance bank, despite a large potential demand, should not be taken for granted.

III.2.4 Savings and investments

One purpose of financial liberalisation is to improve the allocation of credit and to improve matching between savers and investors. Since the lack of growth in low-income countries frequently is attributed partly to the lack of domestic savings, one additional purpose is to increase the domestic mobilisation of resources. The main ways for this are to increase the real rate of interest in order to stimulate additional savings (or to channel savings from the informal to the formal market) and to remove credit rationing in order to open the credit market for potential investors have previously been excluded.

To study the effects of liberalisation on savings and investments, one possible point of departure is the savings-investment identity. However, a word of caution is needed regarding the Tanzanian national accounts. The method, in the accounts, for estimating consumption is as a residual. That is, from the national accounting identity $Y = C + I + G + X - Z$, consumption is estimated as $C = Y - I - G - X + Z$. Consequently, to the extent that any of the variables on the right-hand side contain measurement errors, these will be reflected in the consumption estimate. Moreover, total domestic savings are residually measured too, as $S = Y - C$, and the same point applies here: to the extent that income or consumption contains measurement errors, the estimate of savings will be erroneous too.

It has been argued by Agrawal et al. (1993) that in the case of Tanzania exports are seriously underestimated (due to overinvoicing) which would overstate the current account deficit and thereby consumption. Consequently, private savings will be correspondingly underestimated. This existence of a measurement bias is supported by Mpango's (1996) result that imports are likely to be gravely overestimated (because of tariff evasion in the form of underinvoicing). On the basis of the data reported in these two sources, Danielson (1996) assumes that the average misreport is –20 percent for exports and +40 percent for imports and calculates revised figures for private savings which are substantially higher than those reported in the national accounts, the misreport was around 18 percent in the mid-1980s and almost fifty percent in the early 1990s (Danielson, 1996, p. 9). These appear consistent with data collected by the 1991 Household Budget Survey (Sarris and Tinios, 1994), and analysed in Sarris and van der Brink (1993), which found reason to suspect that the national accounts do not represent the entire picture.

If the major source of biased estimates is the existence of misinvoicing, it is possible that data have become increasingly correct as trade has been liberalised. We show in Table III.2.6 three different measures of the rate of private savings: first, data derived residually from the national accounts identity assuming that exports and imports as shown in the national accounts are correctly measured; second, a series where exports are scaled up by 20 percent and imports scaled down by 40 percent; and finally a series where 1989 exports and imports and scaled as in Revision I, but with the additional assumption that the mis-measurement declines over time and reaches zero in 1997.

Table III.2.6: Alternative Estimates of Private Savings. Percent of GDP.

	National Accounts	Revision I	Revision II	Deposit rate[a]
1989	0.01	0.17	0.17	26.0
1990	0.13	0.27	0.25	26.0
1991	0.15	0.28	0.25	26.0
1992	0.15	0.30	0.24	26.0
1993	0.05	0.28	0.16	24.0
1994	0.12	0.32	0.19	24.0-26.0
1995	0.07	0.29	0.12	15.0-27.0
1996	0.05	0.22	0.07	11.1-22.3
1997	0.03	0.16	0.03	7.3-12.8

Source: National Accounts; *IFS on CD_ROM*, December 1998; Bank of Tanzania, *Economic Bulletin*, Vol. XXVIII. Calculations according to text.

Note: The revised series assumes that in 1989 exports are underestimated by 20 percent and imports overestimated by 40 percent. Revision I assumes that these factors remain constant; revision II that they decline continuously and are zero in 1997.

[a] Weighted average of nominal deposit rates for 31-91 days and 3-6 months deposits.

The differences are substantial. If either of the revisions mirror reality better than do the national accounts data, a reinterpretation of Tanzania's external position seems warranted. However, ignoring differences in levels for the moment we note that all three series show a similar trend, viz. an increase in private savings in the early 1990s followed by a sustained fall after 1992: for the Revision II series, where mis-measurement of traded volumes is assumed to decline over time, private savings fall from 25 percent of GDP in 1991 to 3 percent in 1997.

As noted above, the choice of series for private savings is important for the interpretation of the external gap. Consider the following formulation of the national accounting identity:

$$I = S_p + (T - G) + (Z - X) \tag{1}$$

where I is investments, S_p is private savings, $(T - G)$ is the fiscal surplus and $(Z - X)$ is the current account deficit. If the national accounts underestimate private savings, the external imbalance problems are likely to be much smaller than what is usually assumed. Table III.2.7 sets out the data for (1) assuming that investments and the fiscal surplus are correctly measured. Scenario I is based on figures from the national accounts; Scenario II is based on the figures for private savings in the column "Revision II" in Table III.2.6.

Table III.2.7: Savings-Investment Identity. Per Cent of GDP

	1991	1993	1994	1995	1996	1997	1998[a]
Investment	29.6	27.7	24.6	21.7	17.9	19.5	21.7
o/w private	26.6	24	20.5	17.5	13.3	15.8	17.2
Financing							
Scenario I (national accounts data)							
Private Savings	15.0	5.0	12.0	7.0	5.0	3.0	4.0
Fiscal surplus	-0.3	-6	2.1	-2.7	-0.8	1.3	1.1
"Foreign savings"	14.9	28.7	10.5	17.4	13.7	15.2	16.6
Scenario II (Revision II from Table 8.6)							
Private Savings	25.0	16.0	19.0	12.0	7.0	3.0	4.0
Fiscal surplus	-0.3	-6	2.1	-2.7	-0.8	1.3	1.1
"Foreign savings"	4.9	17.7	3.5	12.4	11.7	15.2	16.6

Sources: Table III.2.6; PFP, various
[a] Projection

The differences for "foreign savings" are substantial for some of the years. It deserves, however, to be pointed out that the assumption made for the calculations of Scenario II are rather arbitrary. Although an argument can be made for a declining rate of misinvoicing in the wake of trade liberalisation, it is difficult to find an argument in favour of the assumption that official data correctly measure trade in 1998.

The data in Table III.2.7 indicates a decline in private investments by some ten percent of GDP in the 1990s, hardly an expected result from the liberalisation of financial markets. (The national accounts estimates presented in Appendix A show a somewhat smaller decline.) However, these data should be interpreted bearing in mind that official aid flows showed a substantial declined after 1995, and that Tanzania scores very high on whatever indicator of aid dependence one chooses to use. The private sector is consequently dependent on foreign aid for its operations, and it is likely that there is some degree of complementarity between inflows of foreign aid and the rate of private investments (either directly, or because aid causes public investments, which in turn crowds in private investments).

From the point of view of Table III.2.7, the improved external position observed in the latter part of the 1990s and discussed in Section II.1 is not necessarily a sign of an improved situation. Private investments have declined and the fiscal gap has been closed. Since this has not been countered by a corresponding decline in private savings, the current account deficit, as a matter of definition, has to close. A more detailed analysis (Danielson, 1999) reveals that the decline in the current account deficit is caused mainly by a fall in the imports of capital goods. Since this occurs in conjunction with a drop in foreign aid, a reasonable interpretation is that foreign savings have declined because aid has diminished. This, in turn affects investments directly.

III.2.5 Concluding remarks

In terms of legislative and structural changes, Tanzania has come a long way towards financial liberalisation. The foreign exchange market has been liberalised, a number of regulations in the banking sector have been scrapped or reformulated, the financial industry is increasingly dominated by private firms, and the Bank of Tanzania has been given a clear and limited mandate to strive for price stability.

However, the impact of these changes remains to be seen. Most new banks are still active only in the major commercial centres, few new financial instruments have been developed, and core indicators do not show that competition is fierce. Banking activity, measured for instance by the lending-to-deposits ratio indicate a substantial and sharp drop in lending in the 1990s. While an initial drop should be expected, given that the financing needs of the parastatals virtually ceases with privatisation, liquidation and the imposition of hard budget constraints, it is worrying that the financial institutions, in a deregulated market, have been unable, or unwilling, to find new markets.

In addition, the core target for financial liberalisation, private savings, show no signs to increase and it is difficult to understand why. One possibility is that financial liberalisation is still young in Tanzania. It only started in earnest in 1993, so the impact will eventually show up. Another possibility is that informal financial markets have adapted to the changes in the formal markets to prevent funds from flowing from the former to the latter, and that legislation in other areas of the economy, concerning, for instance, land, prevents expansion of lending. A third possibility, which squares well with the facts, is that the fall of aid in the 1990s has, for the time being, decreased investment profitability in the private sector. If the latter is correct, then the small volumes of lending are a problem of demand, rather than supply.

III.3. Investments and social infrastructure

III.3.1 Introduction

As we have seen in earlier chapters, economic reforms in Tanzania have very much been concerned with reducing and redefining the role of the state. From the point of view of sustained economic growth, however, an active state is probably necessary, since it can provide services, which the market cannot or will not provide. Consequently, the actions taken to reduce the scope of state actions have to be defined carefully, because otherwise one runs the risk that the state reduces the provision of precisely the services that the market cannot supply.

A case in point is the commonly noted point that market-oriented reforms tend to be associated with a decreasing rate of investments (Mosley et al. 1995). The common explanation for this is that reforms usually imply smaller public expenditures and that this in turn means that public investments, rather than current expenditures are reduced. This may be detrimental to efficiency if the activities suffering from contracted government expenditures are those in which the government has a comparative advantage, that is preventive health care, primary education, and infrastructure.

This chapter looks into these issues by examining how the Tanzanian government has responded to reform pressures in terms of its investment pattern. However, this is complicated by the fact that the bulk of public investments in Tanzania for a long time have been donor-financed. This implies that there is not necessarily a correspondence between the government's development vision and the actual pattern of public investment (Helleiner et al. 1995), and that changes in the investment pattern rather reflects changes in individual donors' ideas concerning support to Tanzania, than changes in realities for, for instance, the rate of return of secondary education. The link between cause and effect becomes in other words extremely tangled when we consider the pattern of public investment in an aid-dependent economy. Consequently, it is important to take into account donors' objectives and strategies when trying to assess the relations between public investments and economic growth in Tanzania.

This chapter examines the size and pattern of investment and development expenditures during the period of economic reforms after providing some background about the pre-reform era. Section III.3.2 looks at changes in private and public investments, while investment productivity is discussed in Section III.3.3. Section III.3.4 deals with efforts to improve and expand the education sector and section III.4.5 concludes.

III.3.2. Investments and economic growth

From the Arusha Declaration in 1967 up until the reforms in the mid-1980s policies encouraged public sector investment, while they actively discouraged private sector investments with the help of a complex system of regulations and licenses (Likwelile, 1998). There was also preferential treatment of the public sector in credit allocation (Ndulu, Hyuha, 1984). The public sector dominated investment activity and came to dominate production in major parts of the economy, and trade was confined to a limited number of parastatals (Moshi, Kilindo, 1995). There was a preference for large and capital intensive investment projects, often infrastructure projects, rather than directly productive investments. Gross fixed capital formation stood at 23.7% on average during the pre-crisis period 1967-1978, and then remained above 30% of GDP during the first years of the crisis period before it gradually declined to 18.7% in 1985 (see Appendix A). Tanzania thus invested heavily even during the crisis period, but the productivity of investment fell dramatically. The strategy pursued during the pre-crisis and crisis periods thus shifted investment away from the private sector at the same time as it reduced the effectiveness of investments.

Likewlile (1998) has computed the shares of private and public investment in GDP for the period 1967-1995 (Table III.3.1) using a periodisation slightly different from ours.

Table III.3.1: Private and public sector investment 1967-1995

	Shares of GDP			Shares of Gross Fixed Capital Formation		
	1967-1980	1981-1985	1986-1995	1967-1980	1981-1985	1986-1995
Public investment	13.2	8.1	10.3	54.1	39.3x	37.6
Private Investment	11.3	12.5	17.6	45.9	60.7x	62.4

Source: Likwelile, 1998, p.5. x – own estimates.

We note that the investment levels in Tanzania have been high throughout, but that there has been a strong shift towards private sector investment in recent years. The relative expansion of private sector investment is partly due to the shift in policy, partly due to the lack of resources to finance public sector investments.

We show in Table III.3.2 the distribution of investment across sector during the reform period. Agricultural investments have remained fairly low, where we would have expected a stronger response in this sector from marketing liberalisation measures and improvements in the transport infrastructure. There has been an expansion from low levels in mining, where there has been substantial investments in, for example, gold mines. There has been very little investment in manufacturing for most of the years, which may reflect the lack of profitable investment opportunities in the manufacturing sector as well as lack of credibility in the reform measures. If investors are not certain that the new system is going to persist, they would prefer to put their money in more short-term assets such as Treasury bills. The risk rating has improved in Tanzania, but it is still much below that of other countries in the region (Ndulu, Wangwe, 1997). Much of the new investment has instead gone into infrastructure, trade, finance and real estate. Some of these investments are probably a necessary first step to restore the economic and market infrastructure after a long period of decline. We cannot be sure, however, that there will be a substantial recovery of investments in the directly productive sectors, although there are some recent signs of a recovery.

Table III.3.2: Shares of gross fixed capital formation by kind of economic activity at current prices, Shs. Million

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	Total
Agriculture	0.052	0.039	0.040	0.042	0.049	0.063	0.063	0.063	0.064	0.063	0.097	0.066
Mining	0.030	0.026	0.025	0.032	0.048	0.046	0.041	0.043	0.043	0.043	0.106	0.053
Manufacturing	0.003	0.007	0.002	0.002	0.002	0.003	0.003	0.003	0.003	0.003	0.133	0.026
El&water	0.277	0.213	0.229	0.256	0.237	0.235	0.240	0.244	0.240	0.241	0.111	0.218
Construction	0.182	0.248	0.256	0.178	0.161	0.148	0.152	0.136	0.145	0.144	0.110	0.147
Trade, hotels, restaurants	0.111	0.095	0.098	0.120	0.111	0.116	0.119	0.122	0.119	0.120	0.109	0.116
Transport	0.015	0.051	0.022	0.010	0.010	0.008	0.009	0.010	0.009	0.010	0.111	0.029
Finance, insur., real estate	0.314	0.283	0.288	0.340	0.314	0.324	0.331	0.335	0.330	0.332	0.117	0.290
Public adm., other serv.	0.016	0.038	0.040	0.020	0.068	0.058	0.042	0.044	0.047	0.044	0.104	0.056
Total	1	1	1	1	1	1	1	1	1	1	1	1

Source: Bureau of Statistics: National Accounts of Tanzania Mainland 1987-1997, p.23.

Likwelile (1998) has also estimated a simple function for private investment in Tanzania. He finds that there are four major factor driving private investment in Tanzania. Openness, the exchange rate premium and financial depth positively influenced investment, while there was a significantly negative effect of inflation. The positive coefficient for the exchange rate premium is puzzling, since this was meant to pick up uncertainty that would be detrimental to investment. When Likwelile decomposes the effects by period, though, the results differ very significantly, with the openness variable explaining 95% of investment variation and exchange rate premium only 2%. In the liberalised setting the major factor explaining private investment in Tanzania is thus openness. The openness variable is defined as the sum of exports and imports over GDP, which means that it only indirectly captures the changes in economic policy. Still, that policies have been liberalised is obvious. The major conclusion thus is that an open economy and a well-developed financial sector are important factors influencing private investment.

The investment rates have throughout been fairly high in Tanzania. It is obvious that low levels of capital formation can not explain Tanzania's growth problems. The crucial issue is one of quality of investments rather than quantity. Low quality of investment during the pre-crisis and crisis periods is explained by the highly distorted macroeconomic environment and, in the crisis period, by the government's persistence with the BIS in the face of collapsing foreign exchange availability. The capacity utilisation rate in manufacturing was driven below 30 percent in the early 1980s. The first phase of reforms in Tanzania was clearly designed to address the more drastic distortions associated with quota protection and non-market pricing of foreign exchange. A second constraint on investment productivity in Tanzania, however, has been the dominance of the public sector in the allocation of credit. Until the banking sector reforms initiated in 1992, the parastatal sector had automatic access to credit from the monopoly commercial banking sector, which in turn had automatic access from the Bank of Tanzania. The vast bulk of NBC's lending was to the parastatal sector; in 1980 the private sector accounted for less than 8 percent of NBCs outstanding loans. The parastatal sector made enormous losses through the 1980s (see Eriksson Skoog, 1998)), representing a major drain not only on the budget but also on credit from the banking sector. The point is simple: without hard budget constraints, relative price changes are not likely to produce major reallocations of resources or major productivity gains. To a large degree, the parastatal sector, and particularly the marketing boards and (quasi-public) co-operative unions during the reform period, were able to pass a major portion of the relative price changes they faced into greater losses that were financed by the budget or banking system.

III.3.3. Investment productivity

While the literature often assumes, implicitly or explicitly, that investments lead to economic growth, empirical studies fail to confirm this in a consistent fashion. The relation is particularly shaky for public investments and the reason is simply that development expenditures are not necessarily made to increase incomes (apart from in the trivial sense that investments always increase income via the national accounting identities). Consequently, the financing-gap analyses that often form the basis of projections in the medium term often overstate the impact of investments on growth as they rely on a more or less constant capital-output ratio.

The stability of the investment-to-growth of GDP ratio is further undermined if we consider the situation in an economy characterised by large inflows of foreign aid. The bulk of such aid is frequently financing development projects and unless aid is co-ordinated or the government is able to generate sufficient counter-part funds, such projects, particularly if they depend for their successful operation on imported intermediates, will not contribute to GDP growth. The result, of course, is decreasing investment productivity.

Table III.3.3 shows the most common measure of investment productivity, the incremental capital-output ratio, ICOR, for total investments as well as public investments.[2] Due to lack of reliable data we have used gross investments rather than the more appropriate net investments. However, it is difficult to conceive of convincing reasons for why the rate of capital depreciation should have changed dramatically during the period, so the trends displayed in the table should mirror the series for net ICOR as well.[3]

Table III.3.3: Capital Productivity: Total and Public Investments

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Total ICOR	4.1	3.4	2.5	5.7	4.4	12.2	23.8	41.8	103.9	18.8	16.1	23.5	6.4
Public ICOR	5.1	4.7	4.3	6.1	5.9	13.1	14.7	26.5	8.4	7.4	10.1	14.3	5.2
memo: Local financing[a]	26	22	21	24	22	28	25	20	18	24	7	23	25

Sources: *Public Expenditure Review*, 1998, Vol. 2; *IFS on CD-ROM*, December, 1998; Bank of Tanzania, *Economic Bulletin*, Vol. XXVIII

Note: ICOR is calculated as $I/\Delta Y$, where I is gross investments and ΔY is change in real GDP from previous year (GDP at 1990 prices were used). Total ICOR uses total investments; Public ICOR uses public investments.

[a] The percentage of public development expenditures that is financed from local sources (as opposed to foreign aid).

To the extent that these figures reflect reality, they represent a rather remarkable situation and a substantial improvement over the pre-reform period. The ICOR, which by itself implies no causal relation, is usually interpreted to mean that the growth of GDP is in some sense "caused" by investments. Consequently, under this interpretation a falling ICOR implies that a given volume of investment causes successively larger increases in GDP. However,

[2] Investment productivity is, of course, reflected in the inverse of ICOR.

[3] In addition, depreciation as recorded in the national account is based on taxation rules and does not necessarily have much to do with the rate at which a particular capital goods loses productivity.

"normal", or average, ICORs are in the range of four to seven, implying that four to seven dollars of investment causes a one-dollar increase in GDP. The data in Table III.3.3 suggest that this is the case in Tanzania as well. In addition, one should note the small difference between total and public ICORs. By definition, this means that public investments account for the lion's share of total investments. However, other sources, notably IMF (1996), suggest that public investments, including parastatal investments, account for roughly one-third of total investments. One possibility, which incidentally also would explain why IMF (1996) produce systematically higher ICORs than those in Table III.3.3, is that IMF excludes investments in residential buildings, clearly a sensible approach, if the purpose is to examine investment productivity.[4] Again, the ICOR trends is not substantially different in the different data series available and so we may assume that the sources in Table III.3.3 do not produce less accurate information than other sources.

This is a substantial improvement over the situation in the 1970s and the first half of the 1980s. In this period (particularly in the 1970s), donors provided large and increasing sums of money to an economy with a stagnating export sector and a massively over-valued exchange rate. One result was that projects were able to function properly only to the extent that donors also supplied import support ear-marked for these projects (the story is well told by Doriye et al., 1994). In fact, Danielson and Mjema (1996) calculates that the ICOR increased throughout the 1970s and reached ludicrous levels in the early 1980s: apart from the years when GDP fell (so the concept of ICOR is difficult to interpret), the ICOR increased from the early 1980s to the start of the reform period, reaching values close to 50. However, the ICOR-values in Table III.3.3 show an increasing trend, which suggests that the productivity of investments have been declining during the reform period. This is likely to be a reflection partly of activities (e.g., residential construction) which gradually have moved into the formal economy after the initiation of reforms. Such investments add little to the growth of GDP, but they do add to aggregate investment figures.

The data in Table III.3.3 also suggest that the investment-growth relation in Tanzania is not abnormal when compared to other African economies (Table III.3.4). There are two points to be made from this table. First, it is difficult to ascertain trends for the individual countries. In

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[4] IMF (1996) is not used in Table 9.1. mainly because it does not cover the entire reform period. In addition, a decomposition of investments into residential buildings and other is not available in the national accounts so no adjustment of that data has been possible.

fact, not only if one compares 1975-80 to 1992-96, and notes that for all the countries the former period was pre-reform and the latter a period of reform, are ICORs systematically higher in the former (which is perhaps what one a priori would expect). Second, there are no clear relation between the rate of growth of the investment ratio and the development of the ICOR.

All in all, this suggests that the incremental capital-output ratio is not a very useful instrument for analysing investment efficiency. Apart from data problems (which are quite severe), there are two reasons why ICORs do not necessarily reflect investment efficiency and may, in fact, even be misleading. First, some investments are not made in order to increase the rate of growth directly. This is obviously the case for capital expenditures in areas traditionally the domain of the government: some infrastructure, schools, hospital, etc, but also some private investments, particularly residential housing. Second, even when investments may impact on the rate of growth of income the time lag may be substantial, something that the traditional definition of ICOR cannot capture. Consequently, to claim on the basis of Table III.3.3 that capital productivity has fallen in Tanzania in the 1990s because ICOR has increased would be to neglect those two objections.

Table III.3.4: ICOR in Selected African Economies. Annual Averages

	1975-80	1981-86	1987-91	1992-96	Investment growth[a]
Burkina Faso	-4.42	2.80	-4.57	4.09	2.4
Cote d'Ivoire	2.01	0.38	-2.64	2.62	-1.8
Kenya	3.25	8.47	8.33	13.66	0.0
Malawi	2.94	0.31	6.17	0.02	-2.1
Uganda	N/A	38.09	2.05	2.66	6.8
Zambia	0.46	-4.08	0.97	1.16	-3.6

Source: *World Development Indicators*, 1998
[a] Annual average rate of growth of the investment-to-GDP ratio, 1975-1996. Percent.

III.3.3. Social Investments

One of the most attractive aspects of the Arusha Declaration and the consequent development vision of Tanzania was the emphasis on increasing and improving educational and health facilities for the population. Donors were willing to support this vision by supplying substantial sums of money and technical assistance to these sectors. Consequently, Tanzania prior to the economic crisis of the early 1980s displayed impressive scores on some of the central indicators of social development: literacy, women's participation in primary education, life expectancy, and access to safe water.

One important consequence of the emphasis on social sectors, without an accompanying focus on development of production, was a heavy reliance on donor funding for social sectors. Hence, the early 1980s, when donors support declined substantially and the economy was at the verge of collapse, saw a rapid deterioration in the quantity as well as the quality of both education and health services. The reform period has seen a further deterioration of these services, mainly because of strict limits on the size of government (and in particular its financing) coupled with an inability to increase tax revenues substantially and to rationalise government operations.

Table III.3.5: Comparative Social Indicators

	1980	1995
Gross Primary Enrolment (%)		
Tanzania	93	67
Kenya	115	85
Uganda	50	73
Zambia	90	89
Female students in primary education (%)		
Tanzania	47	49
Kenya	47	49
Uganda	43	44
Zambia	47	48
Access to Health care, % of population		
Tanzania	72	93
Kenya	na	na
Uganda	na	71
Zambia	na	75
Hospital beds per 1,000 people		
Tanzania	1.4	0.9
Kenya	n.a	1.7
Uganda	1.5	0.9
Zambia	3.5	n.a

Sources: *Human Development Report*, 1998; *World Development Indicators*, 1998; GoT (1998): *Basic Statistics in Education*, 1992-1997; Bureau of Statistics (1997): *Demographic and Health Survey*, 1996

Table III.3.5 provides some comparative social indicators for Tanzania and neighbouring countries. The data in the table illustrate at least two important aspects of how social sectors have been affected by economic reforms. First, reforms have forces the government (and donors) to reconsider the strategy for social sector spending. This has meant a certain extent of refocusing and rationalisation. Consequently certain indicators still show wide coverage of social services: over ninety percent of the population has access to health care and girls are almost as likely as boys to attend primary school. However, while quantitative indicators show that social sectors have not been much affected by reforms and expenditure cuts, the quality of services is likely to have deteriorated substantially. Access to health care has admittedly improved, but the number of hospital beds has declined and, similarly, primary school attendance shows a rapidly declining trend.

It also deserves to be noted that on some indicators, not shown here, Tanzania scores substantially lower than neighbouring countries. Thus for instance, gross enrolment in secondary schools in Tanzania in the reform period is only 6 percent, compared to 28 percent in Kenya, and 17 percent in Uganda. Similarly, education expenditures as share of GDP in Tanzania are about forty percent of the figure for Kenya and half of the figure for Ethiopia (but comparable to the figure for Uganda). For yet other indicators—expenditure on health and infant mortality rates—Tanzania, however, shows better results than other countries (PER, 1998, p. 45).

The fact that education expenditures are lower in Tanzania than in Kenya suggests that this sector has become less prioritised in the 1990s. Table III.3.6 shows data for how education expenditures are distributed among different uses.[5] It should initially be noted that the budget allocation reserved for education shows a sharp decline. This is perhaps rather surprising, given that most stakeholders—the government, multilateral institutions, and bilateral donors—all testify to the importance of universal education. However, interviews revealed that some of the larger donors in Tanzania give funds exclusively to higher education.[6]

Table III.3.6: Composition of Education Expenditures. Percent

	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98[a]
Primary	46.1	47.4	47.0	50.6	51.3	57.6	59.1	61.3
Secondary	16.4	19.5	16.9	14.8	14.4	9.6	8.6	8.3
Teacher	7.9	8.0	7.5	4.5	4.3	2.6	2.1	2.7
Higher	19.0	15.3	19.4	19.9	21.0	23.0	21.3	19.2
Adult	2.7	2.6	2.8	2.9	2.4	1.5	2.4	2.1
Other	7.8	7.1	6.4	7.3	6.6	5.8	6.5	6.4
Budget share[b]	6.3	4.3	3.5	3.3	3.3	2.5	2.5	N/A

Sources: *Public Expenditure Review*, 1998; GOT (1998): *Basic Statistics in Education*, 1993-1997
[a] Budgeted
[b] Education budget as percent of total budget

The main message of the table is that the bulk of the burden of shrinking budgets has been carried by secondary education, teacher training, and administrative overheads (captured in "other" in the table). The share of education expenses going to secondary education has been

[5] As university education is administered by the Ministry for Science and Technology and not the Ministry of Education, the shares in Table 9.4 have not been calculated using the education budget proper.

[6] Donor funding for 1996/97 was 45 percent to higher and technical education, 41 percent to primary education, and the remainder to secondary education, and administration (PER, 1997, Vol. II: 52).

halved in the 1990s, and then it should be recalled that the budgetary resources devoted to education have been severely cut (cf. the last row in the table).

Primary education, on the other hand, does emerge as a winner in the sense that a larger share of the budget is allocated to such purposes. Again, however, shrinking resources available to the government in general, and the education sector in particular, means that the increase in terms of constant Shillings is rather modest.

In addition, anecdotal evidence suggests that the quality of schools is deteriorating. Books, and writing material is scarce. Teachers, poorly motivated, on low pay and themselves often the subject of low-quality education, cannot provide adequate teaching. Consequently, dropout rates from primary school hovers around five percent (Forms I and II) and seven percent (Forms V and VI). For some levels, dropout rates have increased significantly in recent years, signifying perhaps a reaction against decreasing quality.[7]

In sum, then, our indicators show shrinking allocations and, consequently, deteriorating performance in education. In addition, the little evidences that exist point to decreasing quality as well. The problem is rendered even worse by the necessity, for some years to come, of a strict budget policy, and by the fact that Tanzania's education sector cannot be sustainably built on donor funding. Again, the issues of expenditure rationalisation and tax collection come to the fore.

The problem of tax collection has already been dealt with. As for expenditure rationalisation, we provide some data in Table III.3.7. A basic principle for guiding the allocation of resources to the education sector should be that expenditure per student should reflect not only costs, but also returns to society. Cost per student increase with educational level, but it is difficult to find simple principles against which the expenditure allocation can be judged.

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[7] Dropout rates increased for Form IV and V from 3.5 percent in 1992/93 to 13.6 percent in 1996/97, and the corresponding figures for Forms V and VI are from 4.6 percent to 7.1 percent (GOT, 1998: 10).

Table III.3.7: Per Student Expenditures. TZS, 1995 prices and percent

	FY93	FY94	FY95	FY96	FY97[a]
Primary education	8,287	8,637	12,547	8,779	9,406
Secondary education	108,676	106,681	98,343	56,343	56,075
Ratio to primary	13	12	8	6	6
Teacher training	202,802	159,805	151,473	70,319	78,756
Ratio to primary	24	19	12	8	8
University of Dar es Salaam	1,878,406	1,410,660	967,211	940,883	N/A
Ratio to primary	227	163	77	107	

Source: *Public Expenditure Review,* 1997, Vol. I: 48
[a] Budgeted

It is difficult to understand the rationale of this allocation, unless social returns to university education are substantially higher than social returns to primary education. Unless it can be shown that the social returns to university education is substantially higher than the returns from primary education, the sensible strategy would be to reallocate public resources in favour of primary education, and to involve the private sector in the supply of higher education.

III.3.4 Concluding remarks

Two important problems have been addressed in this chapter, and both relate to the fact that Tanzania is an aid-dependent economy. First, the relation between investments and growth is not an easy one, particularly not if one takes into account causal relations. This has partly to do with the fact that investments are not necessarily geared directly towards growth, so to the extent that there is a relation, it may be characterised by a long time-lag, and partly with the fact that public investments are donor-financed to a large extent, and the co-ordination between donors is not perfect. Consequently, donor-financed investments may be carried out without ensuring that finance exists to cover operational costs. Consequently, and this is particularly relevant for the 1970s and 1980s, projects did often not operate even close to full capacity, which decreases investment productivity as measured by the ICOR.

Second, the crisis in the early 1980s and the accompanying fall in donor assistance affected social sectors negatively. This trend was exacerbated by an inability to raise domestic revenue and to rationalise public expenditures sufficiently. While some improvement in social sectors can be discerned in the 1990s, dependence on foreign assistance for education and basic health is still heavy, which is reflected in the structure of spending in those sectors. Thus for instance while spending seems unjustifiably biased in favour of higher education, one university student costs more than 100 primary students, this bias is also reflected in donor funding: almost half of all foreign aid into the education sector goes to higher education.

In terms of sustainability of reforms, the preceding analysis of social investments suggests that the problems in this area are similar to the problems noted in other sectors. The high degree of aid dependence creates problems in terms of coherent planning and certainty if flows of funds. The best, and perhaps the only, way out of this situation is to address the domestic problems of tax collection and public overspending.

Part IV. Public sector management and economic performance

IV.1. Securing the private/public sector boundary

IV.1.1. Parastatals and the soft budget constraint

In the drive towards socialism and towards political control the government set up a large number of parastatals. This is one of the most dramatic examples of dysfunctional government. They were both under-capitalised and over-loaded with tasks, and the managers often had limited experience and worked in a climate where the profit motive was frowned upon. Financial problems soon emerged, but the managers had incentives to seek government assistance and the bureaucrats had incentives to provide it. The parastatal financing gaps increased over time and contributed to macro-economic problems already in the early 1970s. The government did not respond to this by reconsidering the strategy, but instead sought to set up a regulatory system that could preserve the parastatal system. The financing problems of the parastatals soon became endemic, and the managers gradually found it harder to deal with the financing gaps. Gun Eriksson (1998) shows in her study of the parastatal sector how managers faced growing difficulties in improving financial performance as autonomy weakened and shortages grew, while opportunities for bargaining with the bureaucracy increased. For bureaucrats, it became all the more difficult to hold managers financially accountable, since they had contributed to their financial problems, and their dependence on the parastatals increased. The stricter system of regulations also made more resources available for discretionary allocation. Managers and bureaucrats gradually learnt that seeking and granting external assistance to parastatals in financial trouble was a successful way to handle the problems. By the end of the 1970s the soft budget rule had been firmly established.

The performance problems of the parastatals were at their peak during the crisis period, 1979-1985, but the system remained intact and even expanded further after that. Parastatal losses were growing, but they had by now learnt how to operate the system and they were successful acquiring various forms of finance from the government, banks and foreign donors. This made it possible even for chronic loss-makers to survive. Eriksson notes that the soft budget constraint also made it easier for the actors to adhere to the requirements of the system, and to deal with both their political duties and pursue their private aims. The actors co-ordinated their interaction, which brought stability to the system and kept the parastatal organisational structure intact. The actors could reap informal gains, but of course parastatal performance suffered. The soft budget constraint weakened incentives to economise on costs and lead to an enormous waste of resources. Once the system was established there was a strong momentum of interests, which interacted to maintain the system in spite of its obvious inefficiencies.

When reforms started in the mid-1980s, they included attempts at eliminating the soft budget constraint. Initially, the efforts were not very successful, but eventually the sources of finance dried up. The reforms gradually changed the economic environment. Commercial principles became more important, but major actors saw their positions threatened so bureaucratic bargaining remained important. Since reforms in the parastatal sector initially were very limited at the same time as relative prices changed and competition increased, the looses of the parastatals grew rapidly. Still, the soft budget constraint delayed structural adjustment and reduced the effectiveness of stabilisation measures.

IV.1.2. Progress on privatisation

We noted in Part 1, that Tanzania was a highly socialised economy. Several branches of the economy were completely dominated by parastatal enterprises. At independence in 1961 the country had 3 parastatals, while the number had increased to about 450 in 1985. By that time it had become clear, however, that they were not performing efficiently and was a heavy burden on the state budget.

Parastatal reform was acknowledged as a priority by the Tanzanian government as early as 1985.[1] Action has come only recently, however, and primarily in the form of (1) a transfer of bad debts from NBC to the government and the adoption of standard commercial practices in its lending; (2) the creation of the Loan Advances and Realisations Trust (LART) to liquidate non-performing assets; and (3) creation of the Parastatal Sector Reform Commission (PSRC) to oversee the privatisation effort. In the meantime, the shift of investment towards the private sector has clearly come at the expense of central government rather than the parastatal sector. The parastatals suffered a sharp decline in investment share during the crisis period, but then their share increased during the reform period as the central government share fell by more than half. Although the parastatal share of investment fell back in the early 1990s to the lower level

[1] Bagachwa *et al* (1992) note that the Tanzanian Advisory Group had expressed serious concerns about parastatal performance in 1982 and that President Mwinyi, soon after taking office, spoke publicly of taking an "iron broom" to clean up the parastatals.

prevailing in the early 1980s, the level was still high and out of proportion to the sector's contribution to GDP. As emphasised by Gavin (1993), Eriksson (1993) and others, the delay in parastatal reform has certainly exerted an important drag on growth.

In the mid-80s when the government started to realise that there was a problem, the idea was that this was due to technical obsolescence and mismanagement. This would then be solved by joint ventures where external managers would be brought in. Studies undertaken in the late 1980s showed, however, that this was not sufficient. The problems were more deep-seated. In the 1990 the ruling party therefore decided to move towards complete private ownership. The Parastatal Sector Reform Commission (PSRC) was formed in March 1992, but it was not fully operational until mid-1993. The first phase consisted mainly of diagnostic studies of the parastatals. They had to be identified and some idea formed as to how they should be handled. Since then there has been a Master plan of activities, that has been revised every year.

The progress of the privatisation process has been slower than originally anticipated. First the PSRC dealt with the smaller units, but now it has started to work on the major companies such as the utilities. These were originally considered to be strategic, and from 1992 the original idea was to bring in private management and to let them work under performance contracts. This was not as effective as hoped for, so from 1996 private ownership is envisaged in the strategic industries including railways, telecommunications, harbours, and Air Tanzania.

All along the process have had several problems. First there is the problem of bad debts. Most firms have run up debts to the government. suppliers, foreign investors, pensions funds for the workers etc. Most of the time the government has taken over those, and sometimes it has been possible to make some form of deal with the other party. The directive from the government is that as much as possible, and preferably all of the debts should be liquidated against receipts from the sale of the firm. If that is not possible it has to be done against the Common fund, which contains money collected in the privatisation process. The PSRC needs permission from the Ministry of Finance to be allowed to do this.

A second major problems concerns the treatment of the redundant employees. Parallel to this privatisation there is process of civil service restructuring, and for those retrenched there the severance packages have been rather generous. The packages available in the parastatals sector has been considerably worse, and there has been vehement protests against this Aunfairness@.

What are paid, as terminal benefits are only the statutory requirements and some times some ad hoc additions?

A third problem has to do with among other things the political sensitiveness of the issue. Many of the old guard did not approve of the changes, while other were concerned that those that could afford were non-indigenous, either Asian Tanzanians of foreigners. This is a sensitive political issue in Tanzania, where the whole ideology since the days of Nyerere was based on the notion of self-reliance. Attempts have been made to facilitate widespread indigenous ownership, but the progress has so far been limited. A stock exchange has been started, but so far only two firms are listed on the exchange.

Of the 383 forms that the PSRC had on the books when it started, 230 had been dealt with by June 1998. Another 50 are expected to be processed during the fiscal year 1998/99, while the rest might take a few years more. Than the PSRC is to be phased out, when its task is accomplished. The parastatals that have as yet not been privatised are still a drag on the government budget, although the magnitude of the cost has fallen. The amount of money collected under the contracts done up to June 1998 is Tshs 25.8 billion plus US$ 40.6 million.

The privatisation of the big utilities means that what are essentially monopolies are shifted from the public to the private sector. This requires regulations, but so far there is only one regulatory office in place - Tanzania Telecommunications Commission from 1993. For the others the Minister in the respective Ministry is the regulator (with the help of a few officials in the ministry).

IV.1.3. Investment incentives

The government has adopted a National Investment Promotion Policy to promote private sector investment. The Tanzania Investment Centre issues Certificates of Incentives to firms that meet the criteria laid down. To qualify for a certificate the minimum investment cost for new, rehabilitation and expansion projects should be at least USD 100,000 for projects wholly owned by Tanzanians or a locally registered company whose majority shares are held by Tanzanian citizens and USD 300.000 for projects which are 100% owned by non-citizens or a company which is registered in another country.

The incentives provided are protection against non-commercial risks, favourable investment allowances and 100% write-offs of investments in industrial buildings, plants and machinery and on agricultural expenditure, reduced import tariffs on project capital items (5 per cent in priority sectors and 0 per cent in the lead sectors mining and infrastructure), total exemption for sales tax on imported project capital assets, straight line accelerated deprecation allowances on capital goods, yearly appreciation of unrecovered capital investment in mining operations, an indefinite carry-over of all business losses against future profits, a corporate tax rate of 30% and low withholding tax rates on dividends (10%) and on loan interest (0%), the right to transfer out of the country 100% of foreign exchange earned, profits and capital, ease of obtaining permits such as residence/work permits, industrial license, trading license etc, and automatic permit of employing 5 foreign nationals in the project (Tanzania Investment Centre, 1998b). There are still restrictions on foreigners' rights to invest in Tanzanian firms.

There are also special incentives provides for petroleum exploration and development. The mineral sector had been tightly controlled since the Arusha declaration, but in 1989 the government liberalised mineral trading to tap revenues which were lost in the parallel market. This meant that mineral export revenue increased from USD 15.9 million in 1989 to USD 53.2 million in 1992. Liberalisation of trading was followed in 1990 by liberalisation of mineral exploration and production, and the sector was identified as a priority sector. A particularly favourable regime was set up for the sector. As a result 450 mineral rights licenses have been issued to local and foreign inventors between 1990 and 1996. The large number of licenses is not reflected in a very significant increase in production, though. Some of the licensees have simply bought ore from small-scale operators without investing at all.

Another lead sector is petroleum and gas. Here the state has a parastatal called Tanzania Petroleum Development Corporation, which helps implement the sector policy and though which it is to participate in production sharing agreements and joint ventures. Tourism is also a priority sector, where there has been some progress, but here Kenya is a much larger market. In 1996 there were 326,000 tourist arrivals, which is still significantly more than the 202,000 in 1992.

Table IV.1.1: Summary of approved investment projects between September 1990 - June 1998

Sector	Total Projects approved	New projects	Exp/Reh projects	Local projects	Foreign projects	Joint ventures	Total employ.	Total investm.Tshs Mill
Agriculture	89	49	40	22	23	44	27562	77125
Natural resources	70	57	13	28	14	28	22188	303554
Tourism	161	126	35	72	27	62	15814	212787
Manufacturing	552	414	138	297	88	167	87846	965040
Petrol.&mining	40	36	4	12	6	22	4872	223554
Construction	47	42	5	23	10	14	4627	985568
Transport	59	38	21	20	9	30	5060	64454
Services	39	30	9	16	8	15	5630	62557
Computer	2	1	1		1	1	20	281
Financial	18	18		3	7	8	830	334186
Telecom.	7	7		1	1	5	458	21942
Energy	1	1				1	90	97800
Human Reso.	1		1	1			50	1038
TOTAL	1086	819	267	495	194	397	175055	3349605

Source: Tanzania Investment Centre files.

IV.1.4. The private/public sector boundary

Likwelile (1998, p.10) lists the reforms that have been undertaken since the mid-1980s to level the playing field between private and public firms as follows: “(i) permit private traders to enter various stages of agricultural marketing and exports; (ii) Improve the competitive environment for the private sector by holding parastatals to the same commercial standards: (iii) encourage private entrepreneurs to operate and invest in production and trade; (iv) improve the general business environment by revising and simplifying regulations governing private sector activities.” Other measures that have been important include measures to strengthen the banking sector, rehabilitation of various forms of infrastructure and improvements in public sector services. It has also begun to accept the informal sector as a vehicle for employment creating and growth and opened up for private banks.

Despite all these measures the private sector response has been somewhat muted. There is a range of other factors that hold back investments, for example high real interest rates. The government still absorbs a lot of investment resources via treasury bills, which receive high interest rates. These are obviously less risky as well. Investors view private sector investments as risky because there is a lack of strong contract enforcement mechanisms and there is also a fear of policy reversals due to the high levels of public sector indebtedness, both domestic and external (Ndulu, Semboja, Mbelle, 1998). Likwelile (1998) has estimated standard deviations of inflation and the real exchange rate in Tanzania. For inflation it is found to be 11.0, while Collier and Patillo (1996) estimated the average figure for Sub-Saharan Africa at 3.0. For the real exchange rate the Tanzanian figure was 28.9, while the one for Sub-Saharan Africa was 3.3. Historically, thus volatility has been very high in Tanzania compared to other countries in the region, and it takes time to build confidence. The volatility is found to be lower for the period 1991-1995, but still higher than what is typical for Sub-Saharan Africa.

IV.1.5. Conclusions

There has been progress with regard to the privatisation programme, which has been characterised by the World Bank as one of the better in Africa. The dismantling of the parastatals will be concluded within a few years. The problem will then shift to issues of regulation of various utilities with a virtual monopoly position, and the system for handling these issues is still very weak. Thus, the division of responsibilities between the functions of government and those of producers has made large strides forward, but many still remains to be done before this is translated into an efficient industry.

IV.2. Good governance and policy reform

IV.2.1. Public sector management and mismanagement

Governance is by many considered to the crucial constraint on the prospects of development in Tanzania. After coming to power President Mkapa appointed a presidential commission against corruption (the Warioba Commission) to look into the issue of corruption, and its extensive report has been published. It described the extent of corruption among politicians, government officials and law courts. Since then, however, little concrete action was taken, although some lover level officials were dismissed from the government. This may be because those that could act are not clean either, or because the elite is a rather tightly knit network where everybody know everybody. This makes it harder to act. The Parliament does not really play an independent watchdog role in Tanzania. Throughout the history of the country its role has rather been to support the government=s Adevelopment efforts@. There is mainly two pressure groups- the press and the donors - which are capable to change government policy or force it to take action against malpractice. So far, however, people that misbehave tend not be fired or brought to court. They are transferred to some other activity.

Although corruption was put high on the political agenda by the President Mkapa, little seems to have been achieved so far. Transparency International's 1998 corruption index places Tanzania fourth from the bottom and ranks it as more corrupt than Nigeria and for example its neighbours Kenya and Uganda (The East African, 28 Sept 1998). The index includes the perception of local businessmen, international inventors and risk analysts who advice on investment and risk. The index is a measure of the risk for example foreign investors see of investing in a country. The Tanzanian environment thus seem to be one of the most scary for foreign inventors, and this may be one of the explanations of the extremely low levels of foreign investment in the country. There is also a perception that its is more risky to pay bribes in Tanzania. The system is more complex than that of its neighbours, so one cannot be sure that the recipient of the bribe really can deliver what is promised. Also this may make investors see Tanzania as risky. There is also more extensive red tape in Tanzania for inventors and there is less effective protection in courts of investors' interests.

It is of course hard to measure the extent of corruption in an uncontroversial way. It seems rather clear the grand corruption at high levels is more extensive in Kenya, where a number of major scandals have surfaced during the last decade. It may be that grand corruption is somewhat lower in Tanzania than in for example Kenya, but there is a perception that petty corruption is very widespread in Tanzania. This may of course to some extent be a reflection of the very low levels of remuneration that has existed since the 1970s. It has been noted in the press that some Tanzanian civil servants have built houses worth up to half a million US dollars without even taking loans. Former chief executives and employees of now bankrupt parastatals are said to have stolen from their firms without being brought to court. On becoming president Mkapa took the unusual but commendable step of declaring his wealth. Apart from him, however, only the Prime Minister Sumaye has declared his wealth. The Attorney General even pointed out to the parliamentarians that under the law they were not obliged to reveal their wealth.

The Warioba commission recommended that certain ethical standards should bind all public leaders and be listed in the law, and that the list should be amended by parliament as the need arises. Mr Warioba also proposed that the penalties for breaching the code should be specified in the law. If members of Parliament broke the code, their cases would be tabled in the parliament for decision. If an appointee of the president committed the breach he would be obliged to remove him from office himself. The report also recommended that the Ethics commissioner, who is a Judge of the high court, should be given the mandate to look into cases of suspected corruption and makes his conclusions public. Finally, it was suggested that all leaders would declare their wealth within six months of taking office. So far no parliamentarian has been indicted. The Ethics Commission complains of being toothless when it comes to investigating possible breaches of the code, and hardly any leaders have declared their wealth. The fact that they have not done so in spite of reminders from the president indicates that the pressure is too low. There seems to be a culture of silence.

IV.2.2. Public sector reform

The civil service reform programme was officially launched in July 1991. The first two years were devoted to work on various background papers on the problems of the civil service, but it was not until in 1993 that the government embarked on designing a programme to implement reforms to strengthen the management of the public sector. The aim of phase one of the programme was to reduce the scope of government operations to affordable levels, to rationalise the government machinery, to develop an open, objective and competitive pay structure, to decentralise executive responsibilities to local government, and to improve quality and performance of civil servants. (Public Sector Reform Programme, 1998, p.1).

The main achievement of stage one of the strategy was the redefinition of the role of the state. The government is in the process of withdrawing from production activities, tries to reduce its role to affordable levels and enhance the participation of the private sector and NGOs in service delivery. Between 1993 and 1997 there has been a 30% reduction in the size of the work force from 355,000 to 270,000. The bulk of civil service work force is now found in social services and local government. Employment in the traditional ´civil service is down to 50,000 or 17% of the total. There has been a 75% increase in real civil service salaries between 1992 and 1997, but the absolute levels are of course still very low. Regional government has been reduced to deal with only co-ordination and support of local authorities. The average staffing levels have been reduced from 700 to 80. The number of ministerial divisions has been reduced by 25 per cent. There has been a vast improvement in the control of wage bill expenditures. In 1994/95 the wage bill expenditures exceeded the budget by 40%, while the wage bill in 1996/97 was only 2 per cent above budget. There have been improvements in the control of employment levels through tighter recruitment procedures. There has also been training and various forms of restructuring of local government and regional administration. There have thus been considerable achievements during the last few years, but this does not change the fact that the performance of the service still is far below acceptable levels.

The new 5-year strategy for public sector management and employment builds on what has been achieved so far, to try to achieve better levels of performance. A lot of efforts is to be devoted to attempts aimed at strengthening public sector discipline and develop clear lines of responsibility and accountability and generally to develop modern management principles. The aim is to deliver quality public services under severe budget constraint.

The new programme has one interesting budget based incentive built in. When a ministry or an agency has managed to operationalise a services improvement programme on the basis of the performance improvement model it will be graduated out of the Acash budgeting@ exchequer release mechanism. This means that the Ministry of Finance will from the outset commit to fund fully and predictably the approved budget of the organisation. This is regarded as a key output of the public financial management reform programme, and it seems to be a rational way out of the tight cash budget system. Those that have managed to achieve an effective system will be able to run their operations more smoothly in the future. A second incentive mechanism is that institutions will be allowed to retain a significant portion of the cost-savings realised on the implementation of restructuring and private sector rationalisation programmes. Monitoring and evaluation mechanisms will also be strengthened. There is also going to be increased private participation in public sector service delivery. As usual in the case of Tanzania one must remember that there often is a yawning gap between plans and implementation.

Civil service salaries

The crisis years in Tanzania led to a dramatic deterioration of real civil service salaries. By the late 1980s the real salary of a civil servant was only one fifth of what it was in the early 1970s. (Guidelines, 1998, p.2). There had developed very severe distortions and inequities in the compensation structure, and the morale of the service had as a result of this deteriorated very significantly. Performance was poor, and absenteeism, moonlighting and corruption were growing. The government has tried to rectify these distortions by rationalising the scales and by increasing the real income levels.

Many donors offer remuneration incentives (local cost compensation) in various forms to civil servants working in their projects. According to a recent estimate about 1000 civil servants benefit from local cost compensation (Guidelines, 1998, p. 4) at a cost of 13 billion Tshs. This system of course may make the donor project function better, but in the longer term the system tends to undermine efforts of capacity building in the government sector. The strategy now is that there shall be a convergence between donor pays and government salaries over the next five years. In the future a civil servant that takes up a project job will have to resign from his civil service job.

The aim of the government is to achieve reasonable and competitive wages for its employees. For low level workers the government salaries are often higher than those in the private sector are, but for higher grades the salaries are not competitive. The government will do away with various kinds of benefits, but housing allowances will remain for top personnel. There will also be medical benefits and post-employment security. The current civil service pay scale goes from 42,616 to 550,000 Tshs, while the medium term aim is to shift this to 67,000 to 1,800,000.

Two basic ingredients in the Civil Service Reform Programme was (i) to rationalise the compensation structure by making it more transparent, equitable and efficient; and (ii) to enhance civil servants salaries to levels consistent with satisfactory performance motivation and productivity (Civil Service Pay Reform .., p 1). Now there are 45 grades under four scales, against earlier 196 grades under 23 scales. The non-salary benefits to civil servants are now restricted to the following: 1) Retirement benefits for all permanent employees. 2) Housing entitlement to civil servants in salary grades 18 and above. 3) Free use of car for civil servants in salary grade 20 and above.

Table IV.2.1.: Government employment

FY71	138,603
FY75	148,223
FY81	215.099
FY85	260,806
FY88	299,138
FY93	354,612
FY94	315,963
FY96	285,624
Dec97	270629

Source: Civil Service Pay Reform ..., p. 4.

There may be a further reduction of the civil service to 225,000 employees, but this may be hard to achieve since it will be costly in terms of redundancy compensation. There are also ESAF constraints on the share of GDP that may be devoted to the wage bill. It is programmed to be at most 4.8% of GDP during the next few years. Therefore growth is required if remuneration is to increase. It is noted in the report on civil service pay reform (p.9) that Athe compression of the civil service salary structure was one mechanism by which the Government accommodated growth in employment at the same time as the decline in real revenue available to compensate its employees. Consequently, for example, while the compensation value of the top salary grade in the civil service in 1969 was about 30 times the salary of the lowest grade employee, but the mid-1980s the salary structure compression had reduced that ratio to only about 6 to 1, and this did not change appreciably until the early 1990s.@ The recent reforms has increased the ratio to 16 to 1. Egalitarian considerations from the late 1960s favoured higher salary increases at the bottom of the salary structure, which eventually made government salaries highly uncompetitive at the levels where its needs to attract and retain staff. At the minimum level the government had no problem to recruit.

It is thus necessary to increase pay for technical and professional staff in the civil service. This will be done along four routes. First, decompression of the salary structure. Second, comprehensive job evaluation. Third, merit-based promotions. Fourth, benchmark the grading to market salary levels, and target to move the pay levels of civil servants towards market pay levels in the medium term.

IV.2.3. Concluding remarks

The private/public sector boundary has definitely been strengthened, but since the state-parastatals links were very strong, it will take time before behaviour adjusts fully. Privatisation is underway, but the pace has been slower than anticipated. It is by now clear, anyway, the investment and growth will have to come in the private sector. The government will need to provide an appropriate infrastructure, though, and this is, as we noted in part III, a major problem. Part of the problem is that governance remains a basic problem. Since this to a considerable degree is related to the low levels of resources available, it will take time before we see a professional and effective public sector in Tanzania. The reform measures seem to make sense, but without increased funding their impact will still be limited. Tanzania will therefore not be able in the short term to provide an environment that is conducive to investors, and the country will therefore continue to find it hard to attract private foreign capital.

Part V. Conclusions

V.1. Introduction

The starting point for this project was the proposition that to maximise impact donors should seek out successful African countries and concentrate aid to those. The argument is that these would then become leaders for the rest. We presented a set of criteria to help us investigate whether Tanzania is such an economy and whether it can be said to have taken off into self-sustaining growth. In this section we discuss these issues in light of the evidence, and reach some conclusions.

V.2. Is Tanzania an emerging economy?

Tanzanian growth has recovered during the reform period, but per capita incomes have still only grown by 0.6% per year. Investment levels have been acceptable, but investment efficiency has remained fairly low. Has Tanzania taken off? At the start of this report we set out a number of aspects to consider when trying to determine whether Tanzania is in a sustainable growth process. We will here summarise out findings.

1) Macro stability. The recent introduction of the cash budget has improved budget controls and reduced the need to take recourse to deficit financing in the central bank. This has meant that the government has been more successful in achieving macroeconomic stability, although this has had a cost in terms of increased difficulties for institutions in the government to plan and implement projects. Still, the basic economic constraint on what can be achieved is the continued low level of domestic revenue collection, although the creation of the Tanzania Revenue Authority has had a positive immediate impact on revenue levels. After the initial increase, however, the revenue has been rather stagnant. Thus, some degree of macro stability has been achieved, but as yet it seems fragile. The macroeconomic stance is now good.

2) Competitive domestic markets. A set of structural reforms has managed to move Tanzania in the direction of a market economy. The crippling control of parastatal marketing organisations has ceased, price controls in the goods markets have been eliminated, the financial market is being liberalised, the exchange rate is market determined, and labour markets are less tightly regulated. The situation has improved significantly, but as we have noted the markets are still thin and often highly inefficient. Much remains to be done before one would be content with regard to the functioning of domestic markets.

3) A stable financial system. The financial system of Tanzania was until recently not really a system. The commercial banking sector consisted largely of the National Bank of Commerce that was without competition. It has almost an overwhelming share of domestic deposits. The bank is now in the process of privatisation and its share of deposits has fallen to 70%. Still, the spread between deposit and lending rates is huge, indicating that the market is not very competitive. Some of the newer banks and also very vulnerable, and we may see bank runs also in Tanzania of the type that has occurred in Kenya and Uganda.

4) International competitiveness. There has been a measure of export expansion, but little has been achieved outside traditional agricultural exports. The exchange rate is now market determined, but over the last few years the real exchange rate has still appreciated due to the inflow of external resources and inability to control domestic inflation. The relatively strong Shilling may have contributed the relatively limited progress on exports, but there seem to be a range of other factors that producers in Tanzania cannot achieve international competitiveness outside a narrow range of natural resource-based sectors.

5) Human capital for competitive production. Tanzania still lacks skills required for efficient and competitive export production. In some areas there exist competent personnel, while in other areas there are shortages. Generally it seems as if the general level of education in the country has declined both during the periods of economic crisis and subsequent reforms. Enrolment rates have been falling in recent years, and the quality of public education is often low.

6) Effective physical infrastructure. This is one of the areas where the old regime failed most miserably. The situation has improved somewhat during the reform period, but the situation is still very poor. The government departments do not have the competence or resources required to manage the system effectively. Roads are of poor quality and electricity supply is unreliable and tariffs are huge. The costs of production in Tanzania are thus much higher than one might presume. It is very hard to attract foreign capital if the functioning of the infrastructure is generally poor and unreliable.

7) Unbiased market institutions. An efficient market requires a level playing field, and in this area there have been improvements. Previously the parastatals very favoured across the whole range of institutions, but now private firms are treated relatively fairly. Contacts are still important, though.

8) Private and public sector demarcation. During the Nyerere era, the economy was dominated by the parastatals. They were highly inefficient, but they could still survive on the basis of government subsidies and preferential access to credit. The private sector was both actively blocked by various regulations and indirectly crowded out from the credit market. Here there have been major improvements. The parastatal system is dismantled and the budget constraint has hardened. Tanzania is on its way to become a market economy.

9) Good governance. Here much remains to be done. Tanzania is now ranked by investors as one of the most corrupt countries in the world. The government has pronounced that anti-corruption activities are high on the agenda, but so far not much has been achieved. Donors complain that corruption holds back economic growth. They bemoan that the government has failed to act on the recommendations of 1997 Warioba Commission on Corruption. It may be, though, that higher salary levels and increasing tightness of budgetary procedures have reduced the incidence of malpractice. Foreign investors are discouraged from entering in the Tanzanian market, since it takes 18 to 36 months to establish a business in Tanzania and because there are still a lot of approvals required.

A particular concern has been the lack of commitment among many leading politicians to the reform efforts. During the earlier stages of the process, the government undertook reforms because it felt it had no choice. Many saw the reforms not as a positive choice, but rather as a temporary setback. This was not a good basis for a successful transformation of the economy. This situation has change and there is now fairly solid support for the reforms. At present the constraint is rather the lack of competence and lack of resources to see the reforms through in an effective manner.

10) Aid not crucial for growth. Tanzania has been one of the most aid dependent countries in the world over the last decades whichever criteria of aid deference one uses. Although there has been some reduction of the aid to GDP ratio, it remains very high at about 15 per cent. The deficit in trade and goods and services is a reflection of the aid inflows. The point of aid is to make it possible for the recipient country to spend more than it produces itself. Aid inflows obviously are crucial for the growth of the economy at present. Since one would expect aid flows to shrink in the future, it is important that the government makes endeavours to make sure that private flows can fill the gap.

The level of aid dependence in Tanzania reached so high levels that the attitude of the government was affected. It possibly undermined the sense among government officials and politicians of being those that were ultimately responsible for the country's development efforts.

11) Controlled level of foreign debt. With regard to this criterion one must say that Tanzania has a debt burden that is far beyond its capacity to serve it. The debt situation is therefore not under control, and to meet the "necessary" payments to the IFIs and the Paris club is a very large item in the budget. It currently takes about 30% of total revenue. On top of this there are arrears building up to other creditors. The debt situation will remain precarious until the country manages to achieve HIPC status. According to the regular schedule this cannot be achieved until 2002, but there are indications that the donors may be willing to provide a short cut.

12) Domestic savings major source of investment finance. Investment levels have been rather high, but excessive state bureaucracy and poor infrastructure undermines foreign investment. The latter have increased quite rapidly in the last few years, but from insignificant levels. Domestic savings are fairly low and must increase if one is to characterise the process as sustainable. Of course, domestic savings tend to fall when aid increases. Some of the inflow goes into consumption as the recipient optimises between consumption now and in the future.

13) A broad-based development pattern. For growth to be sustainable it is essential that the fruits of aggregate growth do not accrue to a small part of the population, but that broad segments benefit. There may have been some decline in poverty since the worst crisis years, but at present it is hard to see that the level of poverty is declining. Most of the poor are to be found in rural areas, and there the initial improvements brought about by the reforms have not been sustained. Whether this is due to temporary natural shocks or not is hard to say.

On most of the criteria we have looked at we note that Tanzania still is far from achieving satisfactory levels. We do acknowledge, though, that there have been significant steps forward during the reform period in a number of area, and per capita income at least has increased slightly after having fallen for an extended period of time. There are thus some grounds for optimism, but the step to a self-sustained and stable pattern of growth still remains large. But the achievements have failed to translate in to higher economic growth because of bureaucracy and poor infrastructure.

V.3. Policy conclusions for Tanzania

Ownership of the development process would be reflected in the government's actually taking the strategic decisions. This should be reflected, for example, in the preparation of Policy Framework Papers. Often first drafts have been prepared in Washington by the World Bank and then commented upon in Dar. In the last few years this has changed somewhat, and the procedures used since 1997 have changed the situation for the better. Tanzania needs to develop effective policy making machinery that can take responsibility for policy making

The process of actually handling the aid flows needs to be put in the hands of the government. This would include budgetary control, monitoring and auditing. The present system with some form of joint control between Ministry of Finance and the Planning Commission seems cumbersome. The Ministry should take control.

The Tanzania Audit Commission (TAC) has been given the responsibility to monitor the new system of balance of payments support, but as noted in a recent evaluation, the process of monitoring has been made very difficult by of incomplete records. The audited reports fall two to three years behind and then become useless for monitoring purposes (Mutalemwa, Noni, Wangwe, 1998, p. 19). All in all the government institutions are as yet not up to the task of record keeping, reporting, accounting and auditing. Capacity building is necessary as well as well-defined responsibilities and the provision of appropriate incentives. The management of aid should be vested with the Tanzanian authorities and not with some parallel structures set up by the donors.

The supply of budget support may have slackened the incentives of the government to collect revenue. This was in any case the perception of the donors in the first half of the 1990s, when they decided to withhold support. Intensified efforts to generate tax revenue is one of the most important areas for the government, but there are also limits as to hard one can tax new and fragile industries. Still, the firms should pay according to the existing tax schedules.

Investment efficiency in Tanzania is low by any standard. Historically this has been due to the dominance of the parastatal sector and the necessity to invest a lot in public sector infrastructure that later on has deteriorated due to poor management and then needed further rehabilitation investment. Investments in agriculture and other directly productive activities have been low in Tanzania even during the reform period. Still, the main problem ahs been, and still is, that growth remains low in spite of fairly high levels of investment. This is certainly a reflection of the overall level of efficiency of the system.

Expenditure programmes are streamlined, but there is a contractual problem with donors. Too many projects have been started, and these have recurrent expenditure implications that are hard to control. Meeting on a donor by donor basis is not efficient, but should be replaced by sectoral meetings with the whole group of donors involved. This requires sectoral strategies to be put in place, however, and these are still essentially lacking. The setting up of an Education Sector Co-ordinating Committee by the ministry of Education is a step in this direction, though.

V.4. What should donors do?

A major problem in Tanzania is that the mechanisms used to deliver it make local administrators and politician beholden to foreign constituencies rather than domestic ones with a failure of accountability to the domestic political process. There is furthermore a proliferation of externally initiated projects ties up recurrent costs, and sometimes represents a large waste of time and managerial capabilities. Spending, authority, control and accountability need to be returned to the recipient country government.

This could be arranged in a variety of ways. Kanbur's (1998, p.4), suggestion is highly relevant also for Tanzania. He suggests that "every year the government would present its rolling three year (say) expenditure and revenue plan in the framework of an overall development strategy. These plans could be discussed with domestic and donor constituencies on the basis of which the donors would commit resources under certain broadly defined criteria, which do not go into minute details on individual projects. The plans would be scrutinised for broad coherence and feasibility, and policy consistency. But once this is done, donors would contribute to a pool of aid which, along with the government's own resources, would finance the entire expenditure package. There would be no sense in which each donor would require a detailed accounting for where its money went. The dialogue would focus on overall priorities and directions, and donors would not have the false comfort that "their" money is financing schools and not military expenditure. Most important of all, the time energy and political capital of local officials would be saved for analysing and developing local priorities rather than managing the administration of a huge number of donor projects, each with its own accounting and administrative procedures. They would spend more time explaining the tradeoffs to their own people rather than negotiating with aid bureaucrats from donor agencies."

This set up suggests that all aid is programme aid. The literature on fungibility moreover suggests that it is extensive, and that donors primarily should be concerned with the quality of the total expenditure programme of the recipient.[1] The creation of parallel structures for donor project have worked fairly well in Tanzania, since they pay their employees well, but at the same time it creates problems in the general public service, where remuneration remains very low. These projects also have low sustainability in the longer term. This approach of guaranteeing that project succeeds should therefore be discontinued.

When we talk about programme aid a central question is debt. Senior officials spend a lot of time renegotiating debt. Often large gross flows are required to meet debt servicing. Deep debt relief and a corresponding drop in gross flows might be useful way to achieve a resource transfer at the same time as domestic resources that can be allocated according domestic criteria are freed up. The attempts to speed up the HIPC process for Tanzania are therefore extremely important. The way to go in the case of Tanzania might be to pay into the multilateral debt fund, which has been set up. This will involve less of direct interference in the affairs of the recipient country, at the same time, as aid indirectly would have a beneficial effect. Measures that would make it possible for Tanzania use its own resources for its own programmes would create a stronger sense of ownership, which is crucial for sustainable development efforts.

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[1] The literature on the fungibility of aid has produced mixed results, where there is fungibility in some instances but not in others. However, it has not dealt with Africa, so Devarajan, Rajkumar and Swaroop (1999) attempts to investigate this issue for Africa. The analyse a panel data set of 18 African countries. The analysis uses foreign aid variables, fiscal variables, and income and control variables. It looks at the allocation of aid across activities, but a limitation of the analysis is that they only have data on sector allocation with regard to loans and not with regard to grants. First, they show that there is no indication that the governments reduce tax efforts when aid increases. An aid increase of one dollar increases government expenditure by 89 cents. About a third of the final increases goes to current expenditures, capital expenditures and principal repayment. The extent to which aid is fungible varies across sectors considered. Fungibility increases when monitoring is less efficient. This is measured by the number of donors involved in the sector in question assuming that more donors leads to less efficient monitoring. It is concluded that aid to agriculture, industry and health sectors is fully fungible, while loans to energy, transport and communications and education are only partially fungible. The implication of those results is that since aid is highly fungible donors should be concerned about the quality of the total expenditure programme. The results suggest that donor co-ordination is important if the donors want to make sure that the allocation of resources reflects their priorities. The results also show that countries which are highly aid dependent and where aid is highly fungible would be hurt most if aid was reduced, since they will be directed most from their own priorities. An aid cut would be equivalent to a reduction of their own resources.

Alternatively one could choose to channel more aid via NGOs. Since they are operating with a higher degree independently of the governments, aid through this channel does not affect the recipient government activities to the same extent. This form of aid does not imply policy conditionality on the government and thus leaves them to work out their own policies. Nor do NGOs withdraw as quickly if there are disagreements about policies pursued. It is thus a less volatile and risky type of flow from the recipient's point of view. NGOs cannot substitute for an efficient public sector, although they may have a contribution to make in the efforts to reach the more disadvantaged segments of the population.

Tanzania has improved its policy environment very significantly the last decade. However, private investment has been rather low. At present investors perceive risks to be high and many take a wait and see attitude. Recent studies have shown that aid can function as a catalyst for private investment (Burnside and Dollar, 1997) in a reformed policy environment, but there is also need for measures that either reduces risks or insures investors against risks if private investors are to come in on a large scale.

There is on the one hand a need to reassure the investors that there is not going to be a reversal of policy. Botchwey et al (1998) argue that the IMF should be seen to support countries that have graduated to a second stage in their adjustment efforts, that is has graduated out of crisis recovery into a second phase of rising investment (initially supported by the IMF and donors) until the can graduate from IMF support altogether. Botchwey et al argue that an actual shift of countries into a second phase programme would constitute a powerful signal for the investors.

The general conclusion here is that the character of the donor-recipient relationship matters for the effectiveness of aid. The recipient must take the main responsibility for the development efforts, while the donor should provide support in a way that is consistent with such a perspective. The donors are moving in the right direction, but most of the steps remain to be taken.

Appendix: Persons interviewed

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Dr Goodwin Mjema, Department of Economics, University of Dar Es Salaam
Dr Haji Hatibu Semboja, Economic and Social Research Foundation, Dar Es Salaam
Dr Joseph Semboja, REPOA
Dr Masawe, Deputy Director of Research, Bank of Tanzania
Dr. McNab, Swedish Embassy
Dr. Tarimo, World Bank
Mr Baum, European Union
Mr Bell, British High Commission
Mr Bureta, Director of Secondary Education, Ministry of Education
Mr Etukudo, UNDP
Mr Föreland, Norwegian Embassy
Mr Heide, Embassy of Norway
Mr Jingu, Assistant Commission for Budget, Ministry of Finance
Mr Kaligula, Head of Planning, Ministry of Education
Mr Kamogiche, head of Research, Tanzania Revenue Authority
Mr Kitani, Assistant Commissioner for Budget, Ministry of Finance
Mr Lyimo, Deputy Permanent Secretary, Ministry of Finance
Dr Maro, Economic Research Bureau, University of Dar es Salaam
Mr Ndeki, Commissioner, Ministry of Education
Mr Peniel Lyimo, Deputy Permanent Secretary, Ministry of Finance
Mr S.M Mpaze, Senior Economist, Tanzania Investment Centre
Mr Shimwela, Parastatal Privatisation Reform Commission
Mr van Rijn, Netherlands Embassy
Mr. Carlquist, Swedish Embassy
Mr. Olsson, Swedish Embassy
Ms Charlotta Norrby, SIDA, Dar Es Salaam
Ms. Mkoni, Project Co-ordinator, PSRP, President's Office
Ms. Moylan, Embassy of Ireland
Professor Mabele, UDSM
Professor Ndulu, World Bank
Professor Osoro, UDSM

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Appendix: Persons interviewed

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Dr. McNab, Swedish Embassy
Dr. Tarimo, World Bank
Mr Baum, European Union
Mr Bell, British High Commission
Mr Bureta, Director of Secondary Education, Ministry of Education
Mr Etukudo, UNDP
Mr Föreland, Norwegian Embassy
Mr Heide, Embassy of Norway
Mr Jingu, Assistant Commission for Budget, Ministry of Finance
Mr Kaligula, Head of Planning, Ministry of Education
Mr Kamogiche, head of Research, Tanzania Revenue Authority
Mr Kitani, Assistant Commissioner for Budget, Ministry of Finance
Mr Lyimo, Deputy Permanent Secretary, Ministry of Finance
Dr Maro, Economic Research Bureau, University of Dar es Salaam
Mr Ndeki, Commissioner, Ministry of Education
Mr Peniel Lyimo, Deputy Permanent Secretary, Ministry of Finance
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Mr van Rijn, Netherlands Embassy
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Professor Mabele, UDSM
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Professor Osoro, UDSM