Tanzania
The Story of an African Transition

Roger Nord, Yuri Sobolev, David Dunn, Alejandro Hajdenberg,
Niko Hobdari, Samar Maziad, and Stéphane Roudet

INTERNATIONAL MONETARY FUND

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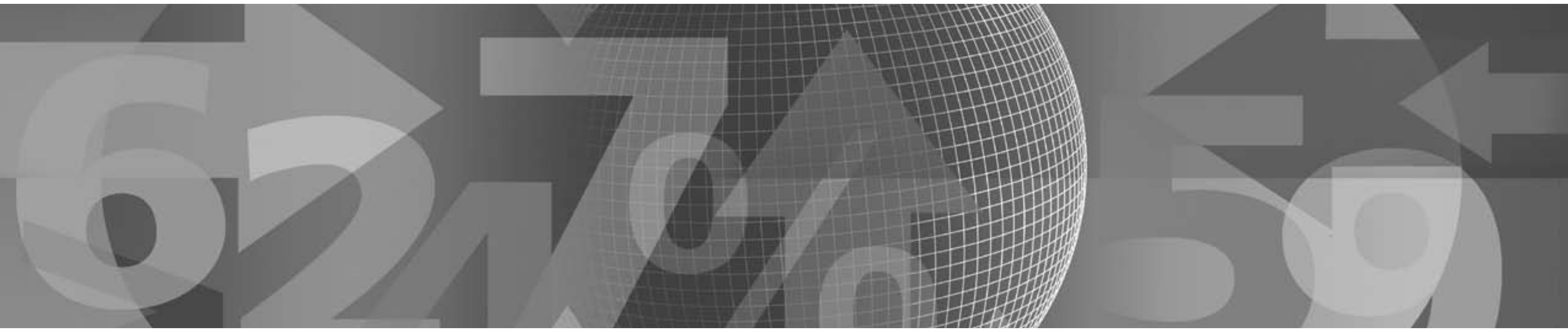

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CHAPTER

1 Introduction

From Ujamaa to MKUKUTA

In 1985, Tanzania was in severe economic distress, plagued by widespread shortages and high inflation. Agricultural production, the mainstay of the economy, had been declining steadily since the 1970s. Exports of cash crops, which traditionally accounted for the bulk of foreign exchange earnings, had fallen by half between 1970 and 1985. A foreign exchange shortage led to a precipitous drop in imports, which in turn caused a crisis in the manufacturing sector, which lacked raw materials and spare parts.

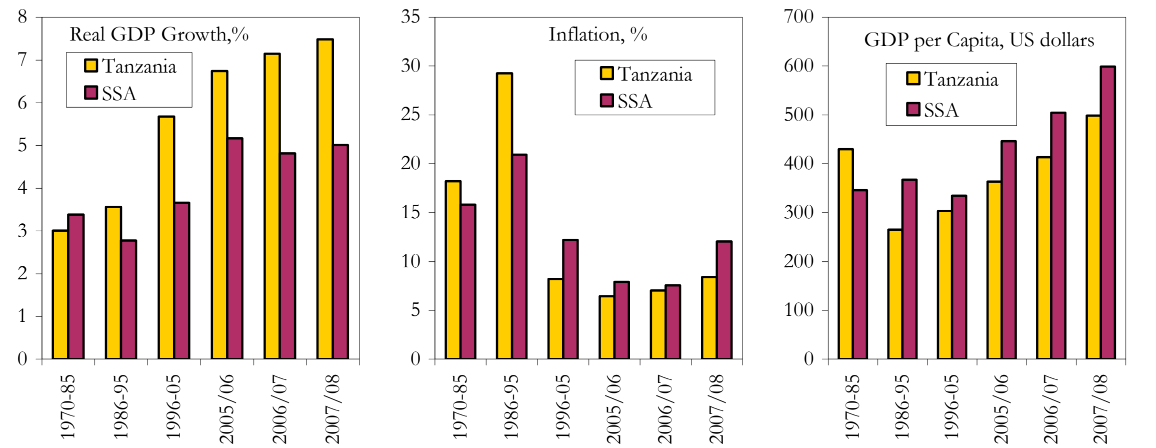
Twenty years later, Tanzania looks radically different. Inflation has declined to single digits (Figure 1). Economic growth is buoyant, averaging 7 percent a year since 2000. Real per capita income has risen by 50 percent. Poverty, while still widespread, is heading downward. Exports are booming, public finances are sound, debt ratios are low (Figure 2), and foreign exchange reserves are ample.

This paper is about the remarkable turnaround, the economic policies that contributed to it, and the road ahead because, while much has been achieved, much remains to be done.[1] It is organized around five thematic chapters, covering the main policy and reform areas, as well as the challenges going forward. But before that, the next few paragraphs provide a chronological overview of Tanzania's economic transformation.[2]

[1]The authors would like to thank David O. Robinson, Ahmed Ndyeshobola, and Lelde Schmitz for their many helpful comments, Alijohn Ghassabeh for his excellent research assistance, as well as Anne Grant, Marina Primorac, Alicia Etchebarne-Bourdin, and Winifred Ellis for their invaluable help.

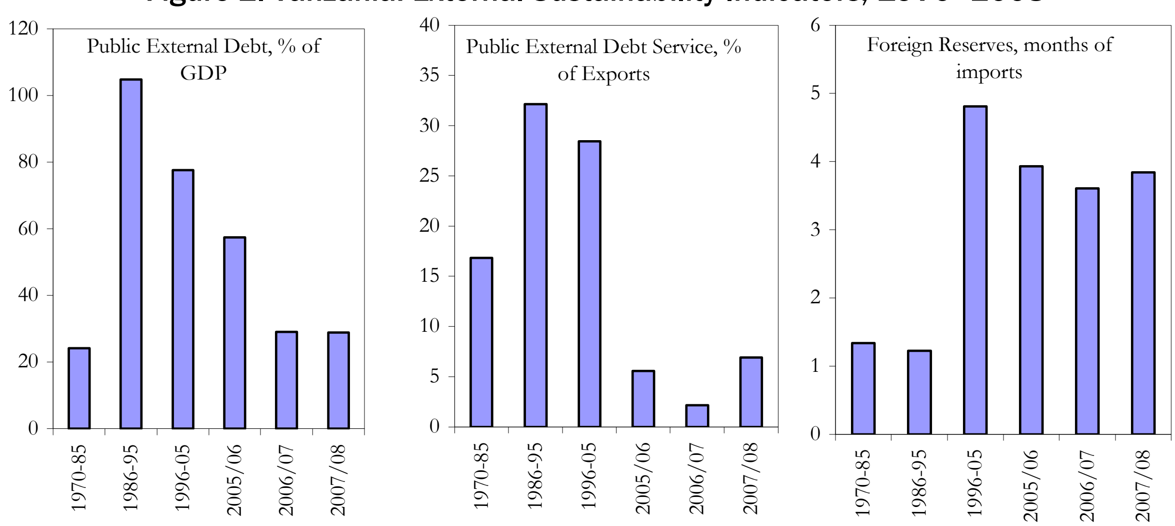
[2]See also Mwase and Ndulu (2008).

Figure 1. Tanzania and Sub-Saharan Africa: Macroeconomic Performance, 1970–2008



Sources: Country authorities; World Bank World Development Indicators; IMF staff estimates.
Note: SSA average is based on calendar year and excludes South Africa, Zimbabwe, Democratic Republic of Congo, and oil-producing countries.

Figure 2. Tanzania: External Sustainability Indicators, 1970–2008



Sources: Tanzanian authorities; IMF staff estimates.

Chronology of Tanzania's Transformation

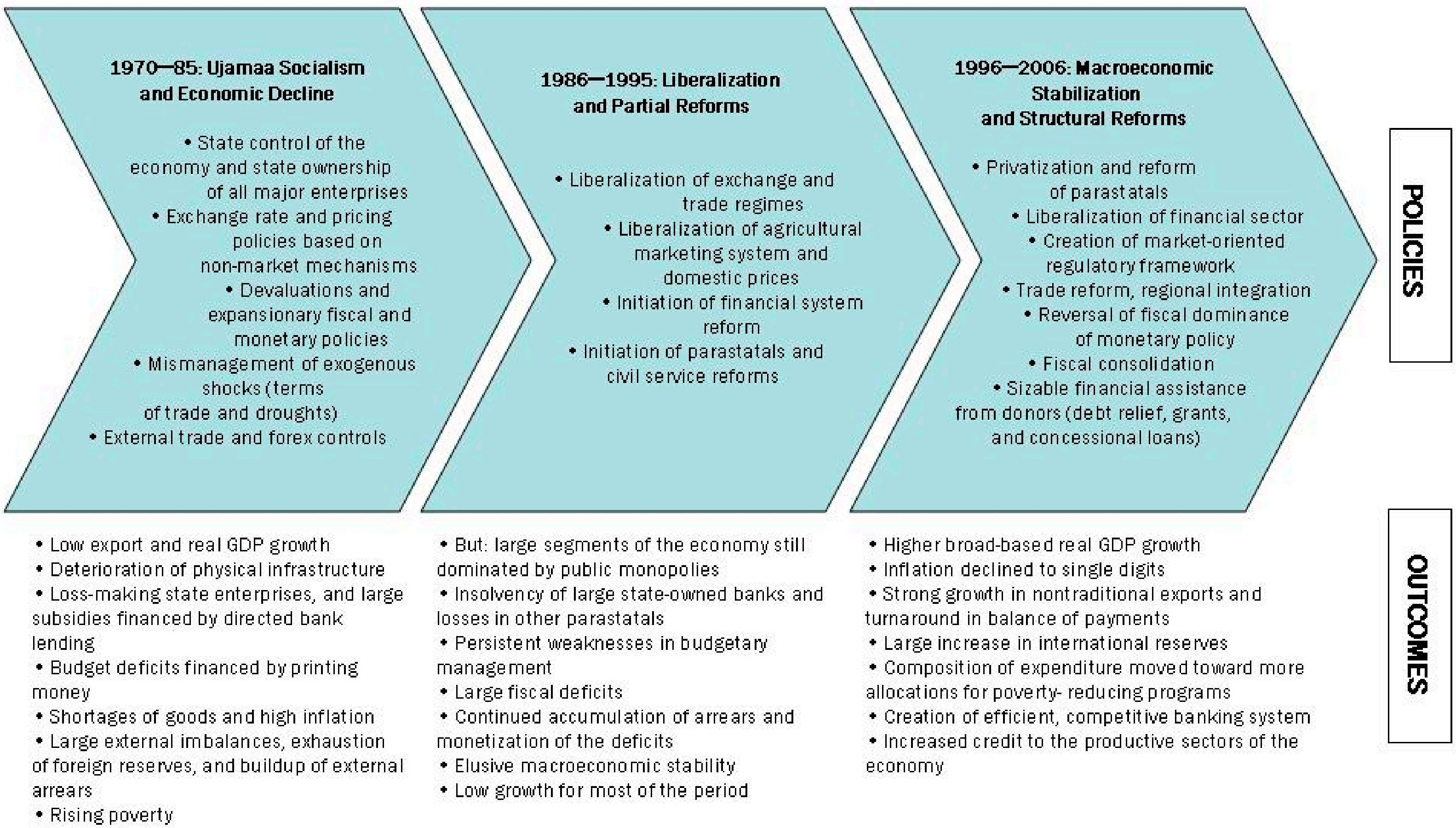
Three main phases can be identified to describe Tanzania's radical transformation (see Figure 3). The first one covers 1970 to 1985. This was the period of Ujamaa Socialism, a model of communalist society based on freedom, self-reliance, and familyhood (Ujamaa). This model of society was envisaged by Julius Nyerere, who led the country to independence and became its first president. Nyerere's vision was set forth in the 1967 Arusha Declaration. Overall, this model proved quite successful in building a coherent, post-independence nation, helped by the promotion of Swahili as the single national language.

However, while Nyerere's policies helped forge a politically cohesive and unified country, Ujamaa Socialism was also accompanied by economic decline. Widespread state ownership and intervention undermined economic performance. Low centrally determined prices and inefficient public marketing boards caused a sharp decline in agricultural production, particularly of export crops. Loss-making public enterprises and large budget deficits were financed by the printing press, causing inflation to rise above 30 percent annually in the first half of the 1980s. Foreign exchange became increasingly scarce, leading to extensive licensing and rationing, not to mention a flourishing black market with premiums that reached 700 percent in 1986. Foreign creditors and suppliers went unpaid, arrears mounted, and shortages of imported inputs became acute.

Recovery and reform took place in two phases. In the first, lasting about a decade from 1986 to 1995, the economy was gradually liberalized. As envisaged under the 1986 Economic Recovery Program, prices were adjusted to market levels, as was the exchange rate, and restrictions on economic activities were gradually lifted. State ownership and government intervention were rolled back. But for most of the period economic growth remained anemic and stability elusive.

It was only in the mid-1990s that the reforms really began to pay off. Unifying the exchange rate and liberalizing imports allowed the private sector to trade freely, fueling an export boom that restored Tanzania's foreign exchange reserves. Wholesale restructuring of the financial sector, including the licensing of numerous foreign banks, provided financing for private investment, while bankrupt public enterprises no longer had access to credit. Public finances were subjected to stricter discipline. As a result, inflation finally started coming down. These successes unleashed a virtuous cycle. Private investment, domestic and foreign, fueled economic growth, which in turn boosted tax revenues. Comprehensive debt relief, which eliminated virtually all of Tanzania's foreign debt, and more generous foreign aid created much-needed fiscal space to finance government priorities. Committed ownership of the reform process was a key to success, embodied in Tanzania's homegrown growth and poverty reduction strategy—MKUKUTA covering the mainland, and MKUZA covering Zanzibar.

Figure 3. Tanzania: The Chronology of Transformation



Opening Up the Economy

Chapter II analyzes the critical reforms that transformed Tanzania from an economy dominated by state-owned means of production to an open market economy. Early steps were opening up the marketing and distribution of food crops to the private sector and lifting the marketing board monopolies for export crops. Legalization of foreign exchange bureaus, which permitted the free purchase and sale of foreign exchange for current account purposes, and simultaneous trade liberalization, which eliminated most import licensing requirements, boosted private sector development.

Privatizing or liquidating public enterprises took longer. Manufacturing and trading companies were sold, largely to local investors, but most utilities and transport companies remained in the public sector. Finally, the increasingly private-sector-dominated economy required market-oriented regulation. The legal base is still being built.

Placing Public Finances on a Durable Sound Footing

Chapter III examines developments in the area of public finance. In the first phase of recovery and reform, the tax base eroded as easy-to-tax public enterprises disappeared and customs tariffs were lowered. Reinforcing the revenue administration institutions took time, but the creation of the Tanzania Revenue Authority (TRA) in the mid-1990s and the introduction of a more modern tax system have now borne fruit: the tax-to-GDP ratio has increased by 5 percentage points since the turn of the century. Meanwhile, on the spending side, new fiscal space made it possible to devote more resources to government priorities, benefiting especially education, health, and infrastructure. At the same time, public financial management (PFM) was strengthened to make public spending more effective, and, although much remains to be done, Tanzania is now considered to have one of the best PFM systems in sub-Saharan Africa.

The reforms have paid off. A broader tax base, more assistance from development partners, and strict budget discipline have virtually eliminated the need for government borrowing, reducing costly public debt and providing more room for private investment.

But Tanzania continues to have extensive infrastructure needs, which require significant resources. In the absence of additional scaling up of foreign assistance, the authorities are now considering new financing options to close the country's infrastructure gap. Promoting private sector participation in infrastructure development is one of the options. Borrowing on commercial terms is another possibility under consideration. But, because these options are not without risks for macroeconomic stability, reforms are also under way to ensure that the necessary fiscal space is created without jeopardizing past successes.

Strengthening Monetary Policy and Building a Modern Financial System

Chapter IV looks at monetary policy and financial sector reform. Interest rates were liberalized early in the reform process, but monetary policy instruments were largely ineffective in the first decade of reforms when the central bank was forced to finance large government deficits and could not prevent the state-owned commercial banks from continuing to finance bankrupt public enterprises. It was only with the emergence of a diversified private financial system in the mid-1990s that market-based monetary policy instruments started to gain traction. Central bank independence and budget discipline put an end to fiscal dominance. Treasury bill and foreign exchange auctions, and later other open-market operations, became the main instruments to control liquidity.

The financial system was radically transformed. Dominated by a single commercial bank and a few special-purpose institutions, all state-owned, in 1985 the Tanzanian banking system was one of the smallest in Africa. Twenty years later, two dozen private commercial banks, as well as a range of other financial institutions, provide a variety of financial services. Credit to the private sector has been growing by 30–40 percent a year since the turn of the century, drawing on a fast-expanding domestic deposit base, and bank soundness indicators have improved remarkably.

Priorities are now to broaden access to financial services, a key objective of the second generation financial sector reform program. Gradual capital account liberalization, consistent with regional harmonization objectives, will also help attract longer-term sources of savings.

Foreign Aid

Chapter V reviews the linkages in Tanzania between aid—which it has long received in significant amounts—growth, and competitiveness. Cross-country research on the impact of aid on growth has yielded ambiguous results. While aid boosts investment, which should raise growth, it can also reduce incentives to raise domestic resources. Aid inflows can also complicate monetary and exchange rate policy, potentially causing real exchange rate appreciation and reducing competitiveness.

In Tanzania, the economic reforms of the past two decades would seem to have mitigated these risks. The tax base is much more solid, despite the availability of more foreign aid. The exchange rate has not appreciated unduly, and export performance suggests that Tanzania is quite competitive. And while the country has surely benefited from aid-financed investment, it appears that productivity growth rather than increased capital or labor inputs has been the main driver of economic growth. This suggests that the structural reforms have indeed improved the capacity of the economy to generate growth and employment.

The Road Ahead

Twenty years of successes have made Tanzania one of the leading reformers in Africa. But much remains to be done to enhance long-term sustainable growth and meet the millennium development goals (MDGs). At the same time, because it brings an end to a decade of supportive external environment, the current global financial turmoil presents an unprecedented challenge for Tanzanian policy makers. What lessons can be gleaned from Tanzania's experience? And what should now be the priorities?

In the long run, only the private sector can generate economic growth, create jobs, and thus reduce poverty. But private-sector-led growth will require a better business environment and governance that is reinforced by modern regulation and an efficient court system. Tanzania must eliminate infrastructure bottlenecks, particularly in roads and energy supply, and invest in health and education to provide the human capital needed for a modern economy. In all these areas, the public sector will continue to have a role to play. As domestic institutions become stronger, dependence on foreign assistance will decline, placing an even greater premium on sound management of the economy and harnessing regional integration as an engine for growth.

Tanzania is well-placed to meet these challenges. But, at the same time, the international environment will be more challenging, probably for some years to come. And, while Tanzania has built up a sufficient cushion to weather temporary shocks, policies will need to ensure that long-term macroeconomic stability is maintained. Keeping Tanzania's economic reform progress on course in the face of an inevitable economic slowdown is a crucial test—to succeed will be another decisive step toward reducing poverty and lifting living standards for all Tanzanians.

CHAPTER

2 Opening Up the Economy

The chapter reviews the reforms that transformed the economy from one characterized by extensive state ownership and intervention to an open market economy.

Throughout the 1970s and the first half of the 1980s, the Tanzanian authorities used trade restrictions and exchange controls to support their development priorities. Producers of export cash crops, traditionally the main source of export earnings, had to sell their products to marketing parastatals that offered prices that did not give them enough incentives to produce more. Exporters of other (nontraditional) goods had to surrender their foreign exchange earnings and were subjected to a cumbersome and opaque system of export permits that required them to obtain a license for each consignment and effectively gave individual ministries the right to regulate a wide range of exports on an ad hoc basis. Similarly, all imports were regulated through administrative allocations of foreign exchange and an import licensing system, both of which became increasingly restrictive toward the end of the 1970s as foreign exchange reserves declined due to the overvalued exchange rate.

As the economic crisis deepened, Tanzania in 1986 initiated a comprehensive Economic Recovery Program (ERP) designed to both restore economic stability and accelerate structural reforms.[3] The economic reforms evolved in two distinct phases. During the first phase, 1986 until approximately mid-1993, Tanzania gradually eliminated market and policy distortions in the external sector by removing import restrictions, adjusting the exchange rate regularly, progressively reducing the foreign exchange surrender requirements, and reforming export marketing. By opening the domestic economy to international competition, the reforms allowed the transmission of appropriate price signals.

[3]First attempts to accelerate reforms had already been made under the 1982–86 Structural Adjustment Program.

However, the Tanzanian shilling remained overvalued in this phase, and there was still a spread between the official and the parallel exchange rates, though a much smaller one. In 1992, the reform of the exchange system accelerated when Tanzania introduced foreign exchange bureaus, which were authorized to buy and sell foreign exchange at freely negotiated rates. At the same time, a far-reaching liberalization of Tanzania's foreign exchange legislation was introduced, which allowed Tanzanian citizens to hold foreign currency deposits at domestic banks. The parallel market rate premium was finally eliminated in August 1993. At the end of the first phase in mid-1993, Tanzania had unified the exchange rate and liberalized the exchange system for current account transactions.

In the second phase, starting in 1994, the authorities gradually lowered and rationalized tariff rates, liberalized foreign direct investments, and kept the exchange rate flexible. As a result, Tanzania's export growth in recent years has accelerated rapidly, particularly in gold and manufacturing goods.

Removal of Price, Production, and Marketing Controls

Price controls, particularly on food and essential industrial items, became a prominent feature of the Tanzanian economy in the early 1970s, when they were introduced with the dual objectives of sheltering low-income groups from the effects of inflation and preventing price arbitrage among manufacturers and traders. Price controls were administered at the national, regional, and district levels: The National Price Commission (NPC) set the same price for essential commodities regardless of location and cost of transportation. Regional Advisory Committees set retail prices on additional goods to reflect differences in transportation and other costs. Finally, District Advisory Committees were responsible for setting prices for essential commodities locally.

By the early 1980s there were price controls on over 400 categories of products. Producer price adjustments were rare and were not sufficient to provide incentives to agricultural production. By the mid-1980s, when official producer prices for export crops had been eroded in real terms by 20–50 percent, the volume of marketed food crops and traditional agricultural exports declined significantly. The adverse impact of eroding price incentives on both agricultural exports and foreign exchange earnings was exacerbated by shortages of essential inputs, transportation difficulties, inefficient marketing, and the overvalued exchange rate. When the government attempted to compensate producers for exchange rate overvaluation, losses accumulated for the crop marketing boards that had been responsible for purchasing, processing, distributing, and marketing all major crops in Tanzania.

As more liberal economic policies were adopted the second half of the 1980s, the number of commodities under price control was gradually reduced; by mid-1991 controls had been lifted for all commodities except petroleum products and public utilities. The government monopoly on importation of refined petroleum products was abolished in 1997, and by the end of 1999 the state-owned refinery was closed and retail prices fully liberalized.

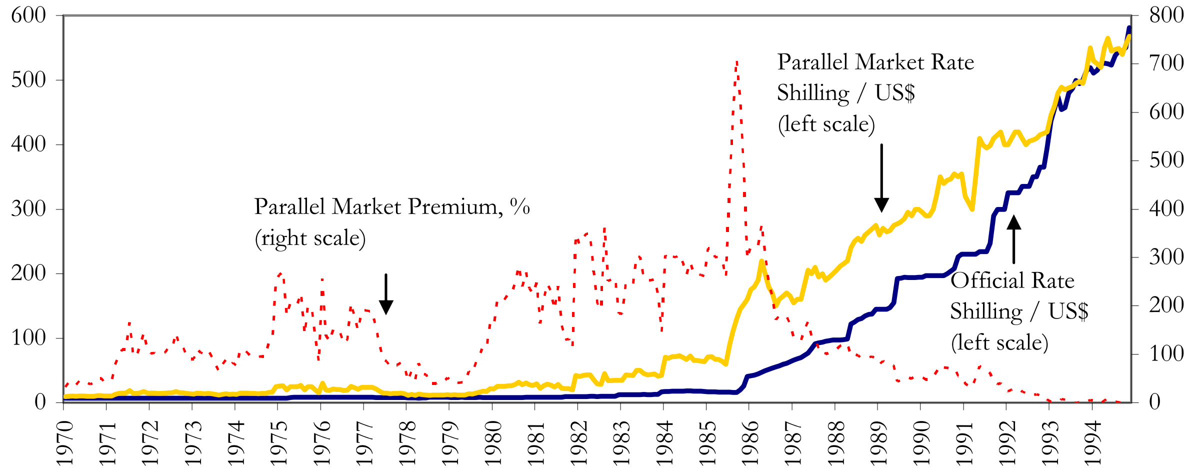
The government went to work in 1987 both to boost agricultural production and encourage private participation in agricultural marketing and to increase reliance on market forces as a basis for investment in agriculture. Marketing and distribution of food crops was opened up to the private sector and the major export marketing boards were restructured solely as marketing agents for cooperative unions. Starting in late 1992, the government took steps to move beyond its earlier agricultural reforms. To enhance timely availability of agricultural inputs, the government withdrew from marketing and distribution and allowed international companies to import and distribute agricultural inputs. To correct for the impact of the overvalued exchange rate on the incomes of agricultural exporters, the government gradually brought the official exchange rate down to the more depreciated market rate (see the section below on the unification of the exchange rate). The marketing and processing of traditional agricultural exports—hitherto a monopoly of marketing boards and cooperative unions—was liberalized by the Crop Boards Act of 1993, which gave the private sector entry into the marketing of export crops and the establishment of processing facilities. Agricultural input subsidies, which caused distortions and encouraged rent seeking, were phased out.

Unification of the Exchange Rate

In the 1970s and early 1980s, as foreign exchange earnings dwindled, the extensive trade and exchange controls resulted in a growing premium between the market and official exchange rates. The authorities devalued the official exchange rate several times in the first half of the 1980s, but because the effect of these devaluations was more than offset by high inflation, the parallel market thrived. The premium increased from an average of about 100 percent in the 1970s to about 250 percent during 1980–1985, peaking at over 700 percent in March 1986, just before the ERP was adopted (Figure 4).

Tanzania adopted a crawling peg exchange rate regime in 1986. The objective was to depreciate the real exchange rate of the shilling gradually and thus gradually reduce the parallel market premium until it was eventually eliminated to give protected sectors time to adjust to market forces. The nominal exchange rate was depreciated significantly over the next several years, but though the parallel market premium declined significantly it remained high—about 60 percent in early 1992.

Figure 4. Tanzania: Official and Parallel Market Exchange Rates, 1970–95



Sources: IFS and Pick's Currency Yearbook and World Currency Yearbook for the parallel market rate.

In January 1992 the parliament adopted a Foreign Exchange Act that substantially liberalized exchange control regulations. It allowed all Tanzanian citizens to hold foreign currency and maintain foreign currency accounts at domestic banks and legalized the opening of foreign exchange bureaus. These bureaus, which started to operate in April 1992, were allowed to buy and sell foreign exchange at freely negotiated rates. The volume of transactions carried out by bureaus quadrupled within a year—from about $100 million in 1992 to about $400 million in 1993—financing nearly 20 percent of total commodity imports. The authorities continued to depreciate the nominal exchange rate of the shilling, significantly reducing the differential between the official and the bureau exchange rates until it virtually disappeared in August 1993. At that time the Bank of Tanzania (BoT) was conducting weekly auctions to sell foreign exchange to the bureaus and commercial banks.

Since the exchange rate was unified in mid-1993, BoT's participation in the foreign exchange market has been mainly to mop up aid-related liquidity injections and to smooth out temporary fluctuations in the exchange rate.[4]

[4]There have been times, however, when the BoT temporarily moved away from this policy. In 2002, for example, the BoT sharply reduced aid absorption, while the government continued to fully spend increasing levels of aid. This change of policy, which reflected the authorities' concerns about Dutch disease effects following the sharp real appreciation of the shilling in previous years, contributed to a rapid increase in international reserves and also encouraged depreciation of the nominal exchange rate (Berg and others, 2007). Since 2003, the BoT has returned to its policy of intervening in the foreign exchange market to smooth out temporary fluctuations, and aid has since then been fully absorbed, while the coverage of reserves has gradually declined.

The importance of foreign exchange sales as an instrument to control liquidity has increased over time (see Chapter 4) as the focus of monetary policy shifted away from accumulating reserves to targeting money growth while allowing greater exchange rate flexibility.

Liberalization of Foreign Trade

1986 to mid-1993: The first phase

During this phase, in addition to successive devaluations, the Tanzanian authorities used a variety of schemes to encourage production of exports and ease import controls (Box 1). While the operations of these schemes were gradually expanded under the ERP, their scope remained limited into the early 1990s. By 1990, for example, five years after the ERP began, the share of imports under these schemes amounted to only about half of total goods imports.

In 1991–93 the authorities intensified their trade liberalization efforts. The Foreign Exchange Act of 1992, which replaced the Exchange Control Ordinance,

- opened up the external sector to market forces;
- eliminated most official allocation of foreign exchange for imports;
- truncated the list of imports that required official approval;
- simplified export and import documentation procedures;
- transferred responsibility for granting approval of foreign exchange for imports from the BoT to commercial banks and foreign exchange bureaus; and
- abolished all exchange control documents, including all import and export licenses.

Mid-1993 onward: The second phase

In the second phase, Tanzania's trade reform program was largely shaped by its efforts to fulfill the liberalization objectives of the Cross-Border Initiative (CBI). The CBI, which 14 African countries initiated in 1993, set common targets and timetables for its members, notably with regard to reducing import tariff rates and the number of tariff bands, eliminating nontariff barriers, and removing export restrictions.[5]

[5]The Cross-Border Initiative Concept Paper was adopted in August 1993 by Burundi, Comoros, Kenya, Madagascar, Malawi, Mauritius, Namibia, Rwanda, Seychelles, Swaziland, Tanzania, Uganda, Zambia, and Zimbabwe. Each participant was required to submit a letter of CBI policy laying out the program of action it intended to implement to reach the CBI objectives.

Box 1. ERP Foreign Trade Incentive Schemes

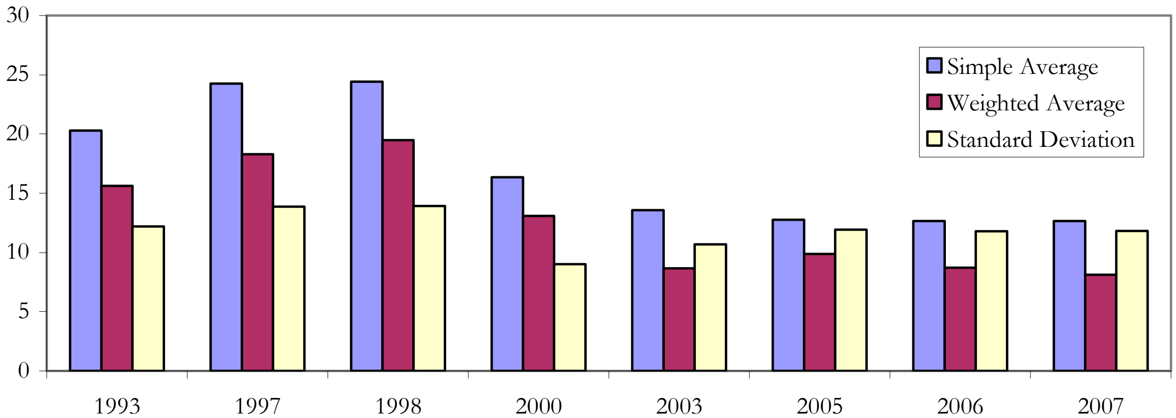
Own-exchange imports. This scheme, introduced in 1984, mainly targeted foreign exchange earned from unrecorded exports of goods and services. Originally only a very limited list of commodities could be imported under the scheme. The ERP gradually expanded the list and considerably liberalized approval of applications for import licenses. In addition, the domestic price of the own-exchange imports generally reflected the parallel market exchange rate. The scheme was phased out in mid-1993.

Export retention scheme. This scheme, introduced in 1984, complemented the own-exchange imports scheme by allowing exporters to keep l0–15 percent of their foreign exchange proceeds and use them for importing inputs related to their activities. The operation of the scheme was very cumbersome, involving different retention rates for each exporter, which were approved on a case-by-case basis. The ERP gradually liberalized the scheme by allowing exporters of nontraditional exports to retain 50 percent of their foreign exchange earnings. It also allowed for retained earnings to be freely transferred between export traders and export producers through banking channels at prevailing official rates. The scheme was modified further during the late 1980s/early 1990s to ease accessibility to foreign exchange and reduce the differentials in retention rates. The scheme was terminated in mid-1993.

Open general license (OGL). In 1988 the Tanzanian authorities established the OGL facility. It was originally subject to a positive list of permitted imports for which import licenses were automatically granted but was gradually expanded to cover a larger variety of mainly intermediate goods. All other commodities had to be specifically licensed by the BoT. But before a letter of credit could be opened at a commercial bank, the BoT still had to approve all imports, including those under OGL. However, the intensification of liberalization efforts in 1991–93 eliminated all administrative allocations of foreign exchange and abolished the system of import licensing. On January 1, 1992, the negative list governing access to foreign exchange under the OGL import system was substantially shortened with the objective of limiting quantitative restrictions only to goods that the government wished to control for health and security reasons and a small number of luxury consumer goods. Together, the restricted goods accounted for 7 percent of total non-oil imports. In July 1993, the BoT, which had been reviewing applications for imports and allocating foreign exchange to successful applicants, divested itself of this function, leaving commercial banks and bureaus to evaluate applications based on commercial considerations. In February 1994 the negative list was restricted to health and security-related goods.

Most of Tanzania's trade restrictions were eliminated by 1993, except for restrictions on petroleum product imports, which were not eliminated until January 1, 2000. Tariff rates were reduced in steps: first, as part of a fiscal strategy to improve revenue collection by widening the tax base, removing exemptions, and improving compliance and, more recently in response to regional trade integration initiatives and the EAC Customs Union (Figure 5 and Box 2).

Figure 5. Tanzania: Tariff Rates, 1993–2007
(Percent)



Sources: World Bank WITS, UNCTAD.

Box 2. EAC Customs Union

The East African Community (EAC) Treaty between Kenya, Tanzania, and Uganda came into force on July 7, 2000, to substantially enhance cooperation and tighten economic ties. It was extended on July 1, 2007, to include Burundi and Rwanda. It envisaged a single market and investment area, harmonization of policies to promote cross-border trade and investment, facilitation of cross-border movement of people, development of regional infrastructure, and enhancement of technological and human resource development. At the same time, Tanzania announced its withdrawal from the Common Market for Eastern and Southern Africa (COMESA), intending to focus its regional efforts on the Southern African Development Community (SADC), which envisaged a more gradual timetable for internal and external duties and placed greater emphasis on investment in regional infrastructure.

Economic cooperation resulted in the establishment of the EAC customs union in 2005 with a common external tariff (CET). The Customs Union Protocol came into effect on January 1, 2005, and is to be implemented over five years. It established a customs union between the three partner countries with one three-band CET—0 percent import tariff on raw materials, 10 percent on intermediate products, and 25 percent on finished goods—and set the stage for elimination of intra-EAC tariffs and other charges, such as suspended duties or discriminatory excise duties.

Despite significant progress so far, the level of trade protection and tariff dispersion, as well as the potential for trade diversion associated with the EAC CET remain relatively high and underline the need for further trade liberalization (Box 3). In particular, lowering the top CET rate would likely encourage trade creation, improve the efficiency of resource allocation, and create welfare gains.

Box 3. Tariff Protection and Dispersion under the EAC CET

The CET resulted in an average MFN tariff in the EAC that is somewhat lower than in sub-Saharan Africa and low-income countries generally. However, it is still relatively high compared to other regions and middle-income countries. Moreover, tariff dispersion has increased since the CET was introduced, and it does not cover a small but important group of goods. Besides the increased number of tariff bands (three within the CET and eight outside), a total of 36 "sensitive" products are subject to tariffs in excess of the CET maximum of 25 percent. Together with the sizable share of imports falling within the 25 percent band, about a fifth of EAC's imports are subject to relatively high levels of tariff protection. Measured by maximum tariff rates, standard deviation of tariff rates, and coefficient of variation, tariff dispersion in EAC countries is relatively high compared to sub-Saharan Africa and other regions.

Regional Comparisons of Simple Average Tariffs and Tariff Dispersion, 2007

		Tariff Dispersion Measures		
	Simple Average Tariff	Average Maximum	Standard Deviation	Coefficient of Variation
EAC 5	13.9	72.0	11.0	0.8
EAC 3	12.7	100.0	11.8	0.9
Tanzania	12.7	100.0	11.8	0.9
Sub-Saharan Africa	12.6	65.1	11.2	0.9
Low Income	12.1	60.7	8.9	0.7
Middle Income	9.8	129.3	12.6	1.3
High Income	5.9	144.3	8.8	1.5

Sources: UNCTAD TRAINS; IMF staff estimates.

The CET has increased the risk of welfare-reducing trade diversion. Relatively high external tariff protection together with zero intra-EAC tariffs and the increased tariff dispersion are likely to encourage trade diversion—imports of manufactured goods from EAC partners are substituted for less expensive higher-quality imports from more efficient producers elsewhere. Even though the trade ratios in the EAC countries are comparable to those of the low-income countries group, their higher aid dependency and greater trade imbalances might suggest that the EAC is not integrated into the world economy, and if aid were not financing a large share of imports, including capital goods, the trade ratios in the EAC would likely be lower. Lowering the CET could therefore help to boost trade and export creation in the EAC and integrate it into the world economy more deeply.

Note: See also Everaert, Palmason, and Sobolev (2008).

Table 1. Average Growth of Goods Exports in Tanzania and Selected Sub-Saharan African Countries, 1970–2008
(Percent)

	Average growth rate			
	1970s	1980s	1990s	2000–08
Ghana	13.5	-0.7	9.9	12.7
Kenya	17.1	-0.2	7.6	13.4
Malawi	15.9	4.0	7.3	8.2
Mozambique	9.0	-6.6	11.4	30.9
Tanzania	9.2	-0.8	3.5	17.5
Uganda	...	5.9	14.5	14.9
Zambia	...	1.7	-4.6	25.3
SSA (excluding oil exporters)	15.5	5.1	2.6	14.5
EMCs	22.4	5.7	8.3	17.8
World	20.6	6.6	6.5	13.3

Sources: WEO database and IMF staff calculations.

How liberalization affects external trade

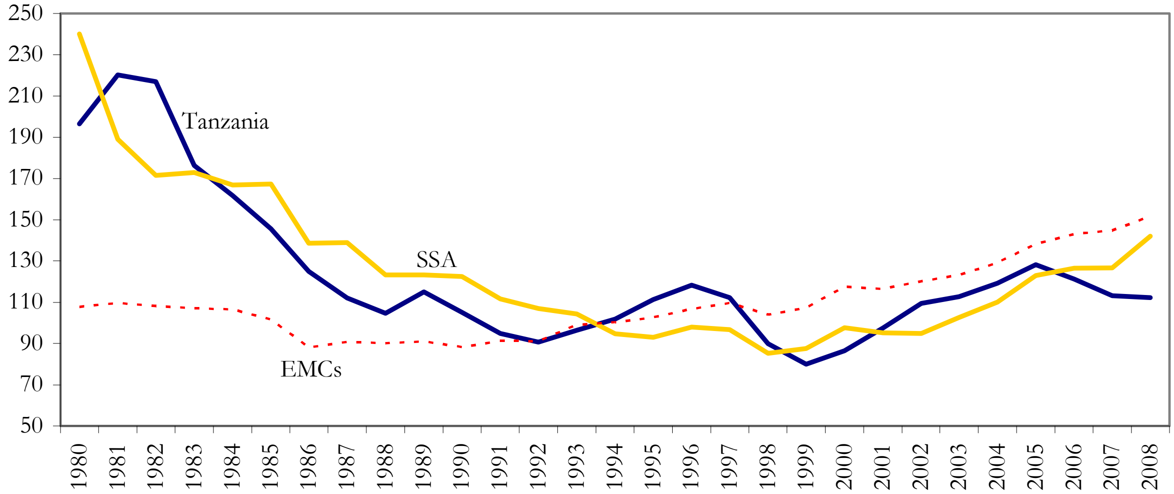
Liberalization of the exchange and trade regimes has had a dramatic impact on Tanzania's export performance. Tanzania's export growth has accelerated significantly (Table 1) and the country has been regaining some of its lost export market share (Figure 6).

Tanzania's exports have also become more diversified. The share of food and beverages, which averaged over 60 percent of total goods exports for 1970–99, had dropped to 45 percent by 2007, supplanted primarily by gold and manufacturing exports (Figure 7).

Privatization and Reform of Parastatals

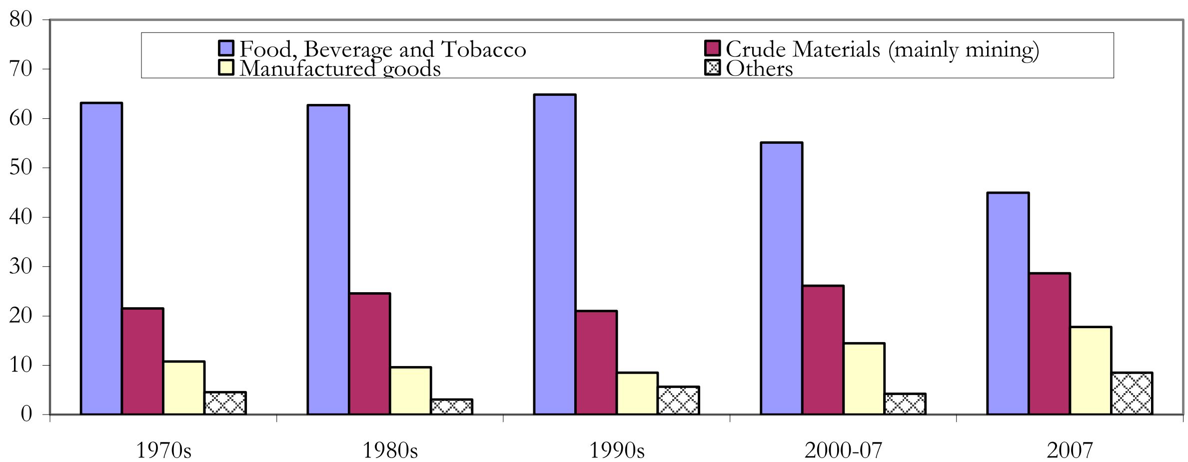
With a view to promoting self-reliance and the collective ownership of resources articulated in the 1967 Arusha Declaration, the government set out to nationalize a number of private enterprises; soon state-owned enterprises dominated practically all sectors of the economy, especially finance, manufacturing, utilities, and agricultural marketing and distribution. By 1988,

Figure 6. Tanzania: Share in World's Non-oil Goods Exports for Tanzania, Sub-Saharan Africa, and Emerging Market Countries, 1980–2008 (Index, 1990s=100)



Sources: IMF staff estimates; WEO database; WITS.
2008 figures are estimates.

Figure 7. Composition of Goods Exports
(In percent of total exports of goods)



Sources: World Bank WITS; UNCTAD.

some 400 parastatals accounted for 20 percent of GDP and about two-thirds of employment in the formal sector; their activity was largely controlled by line ministries.

The parastatal sector generated persistent deficits, which were financed by direct budgetary support and often unfettered access to bank credit. By the

Box 4. The Parastatal Sector Reform Commission (PSRC)

The PSRC was established in 1993 to coordinate and implement the privatization of parastatals in Tanzania. Its mandate was to (1) identify and evaluate parastatal entities; (2) determine the privatization method case by case; (3) prepare entities for sale or liquidation; (4) carry out the sale or liquidation; and (5) give the government policy advice on privatization incentives, safety nets, and compensation packages for employees. The PSRC had wide-ranging powers, but final decisions about privatization or liquidation were made by the Cabinet. Before entering into agreements or transactions relating to the value, sale, or disposal of parastatals, the PSRC had to consult with the Ministry of Finance, the responsible line ministry, and the Attorney General. It was also required to consult and obtain consensus, and in some cases clearance, for certain divestiture stages from other parties, such as the Office of the President, the Treasury Registrar, holding companies, and the Loans and Advances Realization Trust.

mid-1980s agricultural marketing boards were suffering from low export prices, an overvalued exchange rate, and rising operational costs. Other public enterprises, particularly industrial, suffered from a shortage of imported inputs and spare parts that lowered capacity utilization by 20 to 50 percent. Their financial difficulties were exacerbated by officially controlled prices that did not cover operating costs. As a result, though government subsidies increased from 1 percent of GDP in 1985/86 to 4 percent in 1992/93, most parastatals built up salary and tax arrears and failed to service their commercial debt.

In December 1991 the government issued a comprehensive policy statement on parastatal reform; in January 1992, parliament approved a new Public Corporations Act intending to divest the state of all commercial parastatal enterprises in order to remove the burden they placed on the budget and enhance the role of the private sector in economic activity. In 1993 the Parastatal Sector Reform Commission (PSRC) was established to execute the privatization agenda (Box 4).

A technical committee within the PSRC determined the privatization strategy for each parastatal, taking into account past operational and financial performance, the government's preferred post-divestiture shareholding, the sector as a whole, the preferred divestiture method, and the need to develop market access.

The privatization of manufacturing and commercial parastatals, virtually complete by 2003, was largely successful.[6] Viable enterprises were privatized;

[6]The divestiture process took longer than expected due to factors related to resolution of parastatal debt, staff retrenchment, and asset valuation.

nonviable ones were liquidated and their assets and liabilities regularized through the Loans and Assets Realization Trust (LART). Parastatals with no commercial function were absorbed into the government and hard budget constraints were imposed on those remaining in the public sector. Most divested companies were in industry and trade, followed by agriculture and tourism. Some two-thirds were sold to local investors; the rest were sold to foreign investors or turned into joint ventures.

The reform and development of the infrastructure sector and public utilities proved much more difficult because of the technical aspects of offering these enterprises for privatization or liquidation, weak investor demand, the absence of effective regulation, and the need for elaborate consultation to achieve political consensus. By 2007, only the telecoms and international container terminal had private sector participation; power, water, ports, and air and rail transport remained in public hands.

Market-Oriented Regulation and an Attractive Business Environment

Once imports were liberalized, domestic industries were subjected to competitive pressure from foreign goods. To facilitate adjustment to the new competition, in June 1990 parliament promulgated a new investment act that set forth more liberal rules for private investment and allowed direct investment by private foreign interests in all but a few industrial subsectors that were reserved at the time for public investment or joint public and private enterprises. In conjunction with government-commissioned studies of the possibilities of private sector participation in key industrial subsectors, the act also established the Tanzania Investment Center (TIC) to promote investment.

By the late 1990s the government was working to promote and facilitate private investment more effectively. The role of the TIC was transformed from granting investment certificates and tax incentives to providing the services of a modern investment facilitation center. In 2000 and 2001, the TIC initiated various steps to enhance its role in investment facilitation, including visits to sites of ongoing investments by TIC professional staff; setting up a computerized investor tracking system; and handling of new enquiries within 48 hours and all new applications within one week.

In 2002 the government launched a series of consultative initiatives to improve the investment climate. The Tanzania National Business Council (TNBC) was created as a forum for exchange between the government and the local business community, the International Investors' Roundtable (IRT) brought chief executives of large multinational corporations investing in Africa together with senior government officials, and the Business

Environment Strengthening for Tanzania (BEST) initiative was developed by bilateral donors, the government, and the private sector to improve regulation of business and make public institutions interfacing with the private sector more effective. These forums helped identify priority areas for attention: land ownership; labor policy and legislation; the legal system; licensing of business activities; infrastructure bottlenecks; and issues affecting the agricultural sector. Subsequent IRT meetings aimed at intensifying dialogue with the business community and reviewing the progress in the areas noted at the July 2002 inaugural meeting.

A number of reforms to build up the private sector have been implemented in recent years to address factors identified by investors as undermining the investment climate: the business licensing and registration system has been simplified; labor laws addressing employment relations have been reviewed; the role of crop boards has been limited to regulation; agricultural and local government taxation have been harmonized and simplified; the Commercial Dispute Resolution (CDR) system has been set up; and the capacity of commercial courts has been enhanced. Additional measures to streamline the legal and regulatory environment were launched to facilitate business formalization, voluntary registration and compliance, revenue collection, and bank lending, and to improve the laws related to land titling and commercial dispute resolution to ensure that land may be used as collateral for commercial transactions. A World Bank report on business indicators, *Doing Business 2007* (World Bank, 2006) identified Tanzania as one of the 10 best reformers of business regulations worldwide in 2005/06. Finally, efforts were initiated to improve the quality of infrastructure, governance, and public accountability. All the different efforts to make the business environment more attractive are coordinated through the BEST program.

However, despite this progress, Tanzania still compares poorly to other countries, including neighboring Kenya and Uganda, in terms of doing business, and is ranked 127 out of 181 economies covered by the World Bank's Doing Business 2009 report (Table 2).

Table 2. Tanzania: Ease of Doing Business Rank in Comparison to Selected Sub-Saharan African Economies, 2009

Mauritius	South Africa	Botswana	Kenya	Ghana	Zambia	Uganda	**Tanzania**	SSA mean	SSA median
24	32	38	82	87	100	111	**127**	136.7	148.5

Sources: World Bank (www.doingbusiness.org).

CHAPTER

3 Putting Public Finances on a Durably Sound Footing

The emergence of a strong Ministry of Finance (MoF), supported by technical assistance from the IMF and other development partners, was instrumental in accelerating fiscal reforms and fostering a turnaround in fiscal performance. This chapter reviews the evolution of public finances and the reforms implemented in the area of public financial management and revenue mobilization. It also touches upon the new challenges facing fiscal policy.

Overall Performance

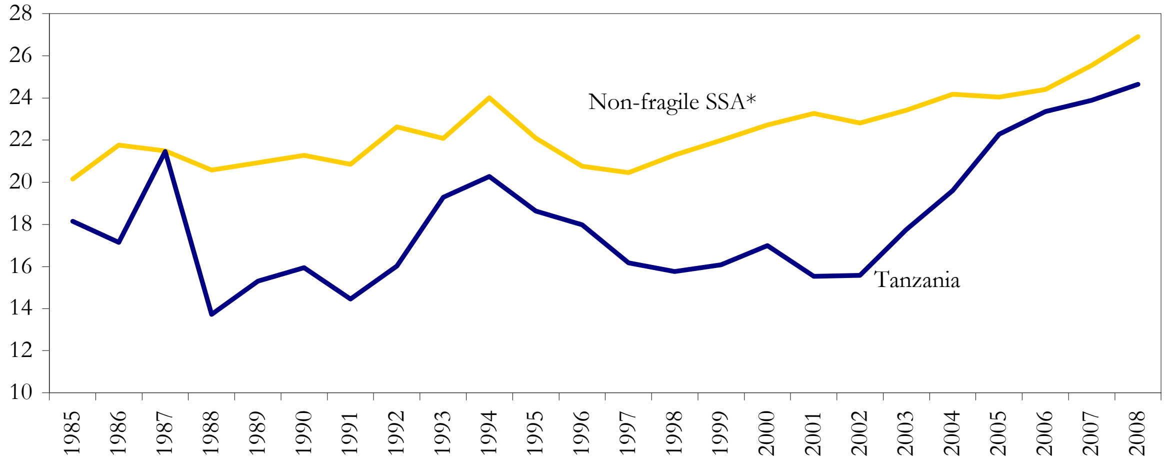
Tanzania's public finances have performed remarkably well in recent years. The public debt position is comfortable, domestic revenues have grown impressively, and the increased confidence of development partners in Tanzania's institutions has translated into a significant increase in foreign aid. Thus, government expenditure, especially on priority sectors, has almost doubled between 1995 and 2008 (see Figure 8).

While reforms of revenue administration and tax policy started early, consolidating the necessary structures took time. Revenue only began to pick up in the past four years. This was to some extent a consequence of the shift in Tanzania's economic structure. The tax base gradually moved away from the large, easy-to-tax public sector to the private sector, which was largely informal, while the liberalization of trade led to a drop of revenue from customs duties. Also, as fees and contributions were streamlined, less was collected in indirect taxes.

Tanzania turned the revenue corner in fiscal year 2002/03.[7] Since then, and coinciding with more determined reform efforts at the Tanzania Revenue Authority (TRA) and additional policy measures, revenues have increased by

[7]The fiscal year runs from July through June.

Figure 8. Tanzania: Government Expenditure in Tanzania and Non-fragile Countries in Sub-Saharan Africa
(Percent of GDP)

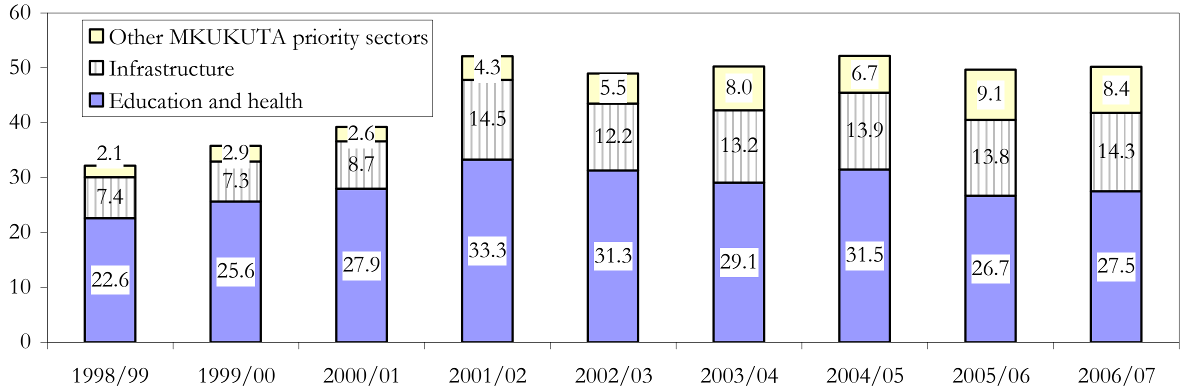


Sources: Country authorities; IMF staff estimates.
Note: The countries in this group are Benin, Burkina Faso, Ethiopia, Ghana, Kenya, Madagascar, Malawi, Mali, Mozambique, Niger, Rwanda, Senegal, Tanzania, Uganda, and Zambia.

about 6 percent of GDP. Moreover, this took place as external aid was increasing, allaying concerns about its impact on incentives for mobilizing domestic revenue.

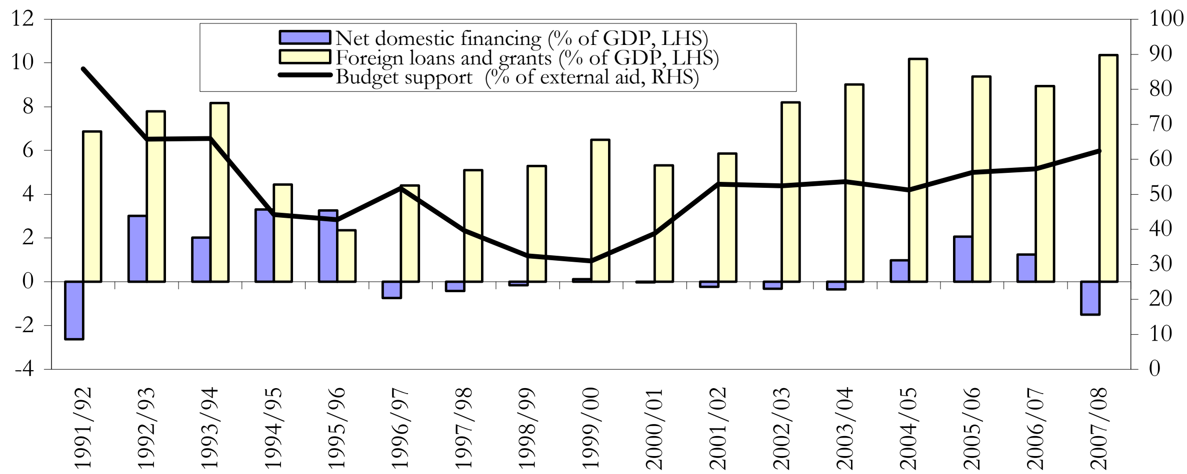
Increased revenue and external aid have allowed a substantial increase in spending without endangering debt sustainability—and this after spending had remained flat as a percentage of GDP during the initial period of economic stabilization. Moreover, structural reform has also resulted in a shift in the composition and effectiveness of spending. The formalization of the government's economic strategy in a Poverty Reduction Strategy Paper (the first one prepared in 2000, followed by MKUKUTA in 2005); the development of a medium-term expenditure framework; and the conduct of an annual public expenditure review (jointly with the main stakeholders) resulted in a redirection of spending toward priority areas, most notably education, health, and key elements of economic infrastructure, such as roads and water facilities. (Figure 9). Debt relief provided through the HIPC and MDRI initiatives, as well as lower domestic financing, freed up additional resources for productive spending. Improvement in spending effectiveness has been sought through reforms to the public service (Box 5), through increased devolution of government functions to the local governments (Box 6), and by strengthening public financial management (the topic of the next section).

Figure 9. Tanzania: Priority Spending
(Share of total spending, percent)



Sources: Tanzanian authorities and IMF staff calculations.

Figure 10. Tanzania: External Aid and Domestic Financing



Sources: Tanzanian authorities and IMF staff estimates.

The composition of public financing changed drastically: consolidation of the fiscal accounts in the mid-1990s pushed down domestic financing, while external flows in the form of loans and grants on concessional terms surged. Moreover, increased trust in government and better coordination with donors resulted in the resurgence of budget support and basket funding rather than project financing as the prime modality for external support (Figure 10). In the past few years, external aid accounted for about 40 percent of the budget (see also Chapter 5).

Box 5. Public Service Reform

In the 1970s and 1980s the capacity and performance of the Tanzanian civil service declined considerably. Civil service employment grew disproportionately, real wages declined drastically, and the pay scale became severely compressed. Personnel management deteriorated, and skilled and experienced staff departed. All this resulted in an unproductive civil service and poor service delivery.

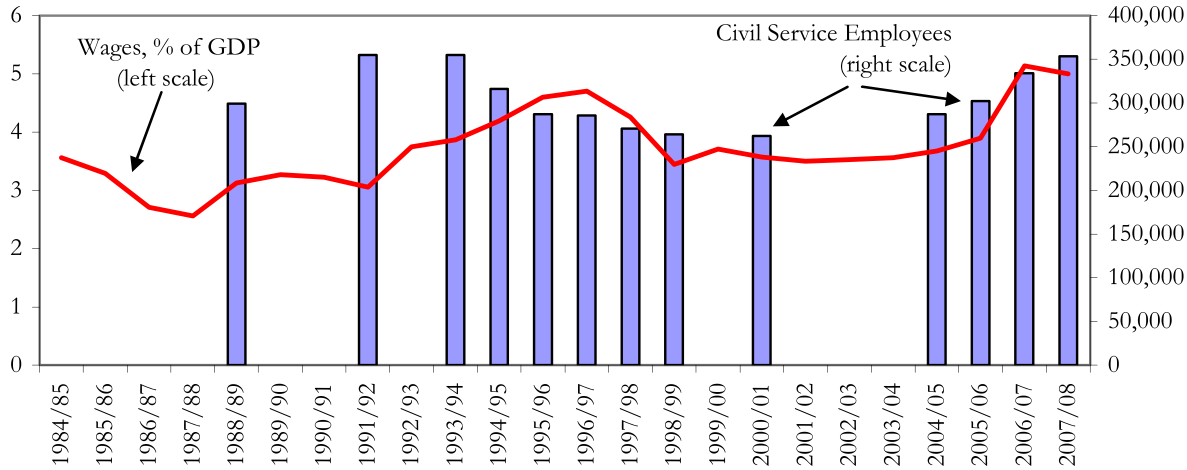
Reform efforts in this area started in 1991 with the Civil Service Reform Program (CSRP). This program, implemented between 1991 and 1999, was designed to reduce the size of both the civil service and the wage bill to contain costs while strengthening managerial capacity and improving the organizational structure. The main achievements were a decline in the number of central government personnel from a peak of 355,000 in 1992 to 264,000 by 1998/99 (Figure 11); better control over employment levels using a personnel database and a computerized payroll system (the wage bill exceeded budget by 40 percent in 1994 but by only 2 percent in 1999); and recomposition of the aggregate wage bill by rationalizing and decompressing the pay structure and consolidating allowances into basic salaries.

The next stage of reform, the Public Service Reform Program (PSRP), spanned 2000–07. The focus changed to improving delivery of public services. While improvements were made in some areas, progress was slow. Positive areas included the introduction of a performance management system and more decentralized policy making. However, poor service delivery persists in many areas, accountability remains weak, and there are limited value-for-money assessments.

The PSRP sought to adjust salary scales to attract and retain qualified staff. For this purpose, it incorporated the medium-term pay policy, which had been adopted by the government in 1999, aimed at gradually increasing civil servant remuneration over the following five years, as well as enhancing the salaries of key professional, technical, and managerial personnel. The policy envisaged a gradual increase in the wage bill of about half a percentage point of GDP by 2003/04, together with a further decline in the size of the civil service. Its implementation was uneven, but the significant wage increase introduced with the 2006/07 budget (reflecting in part a consolidation of allowances previously recorded separately from wages) put remunerations close to the targeted level. Even so, retaining quality staff remains challenging. A further substantial salary increase was granted in 2008. At the same time, the wage bill increased by more than originally envisaged, as the government recalibrated its employment strategy to achieve the MDGs and substantially expanded the hiring of education and health workers.

To enhance performance and accountability and better align its operations with MKUKUTA, a second phase of the PSRP has recently been launched. It emphasizes building the capacity of government entities to formulate policies; decentralizing human resources processes and systems; retaining quality staff through adequate remuneration and incentives; institutionalizing performance management systems; and increasing public sector accountability. The government is still aggressively hiring teachers and health care workers to address pressing social needs. A revised Medium Term Pay Policy is under preparation.

Figure 11. Tanzania: Civil Service Employment and Public Sector Wage Bill



Sources: Tanzanian authorities; IMF staff estimates.

Stronger Public Financial Management

Though today Tanzania is considered to have one of the best public financial management (PFM) systems in sub-Saharan Africa,[8] until the mid-1990s, PFM suffered from severe deficiencies. The basic elements for effective control of expenditures were not in place, leading to large fiscal deficits and the accumulation of arrears; budget assumptions were unrealistic, with expenditure allocations based on needs rather than available resources, and cash management and commitment controls were nonexistent. Accounting and reporting, internal and external audits, and procurement were also inadequate.

A crucial step toward restoring fiscal discipline was the introduction of effective cash budgeting. In 1996, payment was centralized in the Central Payment Office at the MoF. This measure was accompanied by the institution of a single treasury account at the BoT, which contributed significantly to effective control of payments. Previously, budget users maintained their own bank accounts outside the control of the Treasury, some of which accumulated significant idle balances even as the Treasury had difficulty meeting demands for resources. These measures were coupled with

[8]Data as of October 2007 for the Public Expenditure and Financial Accountability (PEFA) exercises conducted in 23 sub-Saharan African countries show Tanzania with the highest score, on par with 10 other countries.

the introduction of a rationing system that limited cash releases to Ministries, Departments, and Agencies (MDAs) to cash availability. This system prevented spending units from accessing central bank overdraft facilities directly and placed their spending authority within the limits of cash releases centrally controlled by the MoF. The system tightened up in-year cash management to ensure that priority sectors were fully funded. Since then, cash releases have been effected monthly except for priority sectors, which receive full cash allocations quarterly.

Systematic reform began with the launch of the first phase of the Public Financial Management Reform Program (PFMRP) in 1998. Its goals were to promote macroeconomic stability and economic growth and improve delivery of public services. The program began by minimizing the leakage of resources, strengthening financial control, and enhancing accountability, primarily through the reform of budget processes and the introduction of a computerized Integrated Financial Management System (IFMS). Enactment of the Public Finance Act and its regulations in 2001 provided a solid institutional foundation that, among other things, allowed for a commitment control system (supported by IFMS) and better control of the budget.

Budget formulation was facilitated by better macro-fiscal management that produced a more coherent budget and macro framework. Since 1998 the government has introduced a medium-term expenditure framework (MTEF) to guide its planning and has conducted annual consultations, in the form of a public expenditure review exercise, with development partners and representatives of civil society to set spending priorities.[9] Budget formulation was also enhanced by the introduction in 2000/01 of Government Finance Statistics as the basis for budget classification. More recently, a Strategic Budget Allocation System (SBAS) was created to better link the budget with national priorities as identified by MKUKUTA. Since 2004/05 MKUKUTA has been guiding the allocation of budget resources over the medium term. Clearer budget guidelines have been distributed to MDAs, in particular to improve transparency and accountability; spending plans of line ministries in the MTEF must be reviewed against the MKUKUTA and the expected outcomes identified.

A second phase of the PFMRP launched in 2004 aimed at providing an overarching vision for the program and enhancing coordination of its various elements. Thus, the PFRMP was reorganized in terms of a single set of strategic objectives, articulated in a series of activities to be monitored against

[9]Until the 2004/05 fiscal year, the budget used the concept of priority sectors, which encompassed basic education, primary health, water, roads, agriculture, lands, the judiciary, and HIV/AIDS. Thereafter, the budget has been structured along MKUKUTA categories.

specific performance indicators, and organized in 10 components.[10] Financing was switched mostly to basket funding (with continued project financing, budget transfers, and specific technical assistance funds for certain elements) to make the program more effective. A PFMRP III was approved in June 2008. The focus is on enhancing the predictability and availability of resources to executing agencies. As such, while it continues to emphasize the core areas of earlier PFMRP, additional focus is placed on winding out the reform effort to both line ministries and local governments.

The most progress has been made in the last four years in external audit, procurement, and oversight by parliament. In recent years the Controller and Auditor General has issued audits on time, and the audits are of better quality. They have also have had an active response from the government, and actions are being taken to implement their recommendations. Procurement practices have been realigned with the 2004 Public Procurement Act in line with good international practice, and are monitored by the Public Procurement Regulatory Authority and the Public Procurement Appeals Authority. Procurement agencies are now audited regularly, and inadequate practices are being identified. In recent years, parliamentary oversight of public organs has been strengthened. There are currently three oversight committees—the Public Accounts Committee, the Local Authorities' Committee, and the Public Bodies Committee—each chaired, by law, by an opposition MP. In addition, the Finance and Economic Affairs Committee of the Parliament plays an active role in debating the budget guidelines that are key in the budget preparation process.

Looking ahead, meeting Tanzania's economic growth and poverty reduction objectives will require more, and more effectively used, public resources to continue improving health and education services and to build economic infrastructure. Continued work on PFM systems is therefore crucial. There is still room to improve in all aspects of budgeting, namely budget formulation, execution, monitoring, and reporting. There is also significant scope to deepen the fiscal decentralization process. It will also be important to enhance the government's capacity to undertake public investment and to associate with the private sector to upgrade the country's infrastructure.

[10]The 10 components of the PFMRP are (1) policy analysis and development; (2) external resources management; (3) budget management; (4) treasury management and accounting; (5) procurement; (6) information technology services; (7) investment management; (8) administrative support services; (9) external audit services; and (10) program leadership, coordination, monitoring and evaluation.

Box 6. Decentralization by Devolution

Between 1972 and 1984 local affairs were administered through a system of central government de-concentration. Fiscal decentralization started in 1984 when elected Local Government Authorities (LGAs) were set up pursuant to the 1982 Local Government Acts. However, performance of the LGAs remained disappointing for several years, mainly due to weak management capacity, insufficient human resources, and a narrow revenue base.

In 1998 the government adopted a policy of "decentralization by devolution" (D-by-D), which was embedded in the Local Government Reform Program (LGRP). The goal of the policy was to improve the quality of public services, in particular to the poor; it devolved more financial and political responsibility to local governments, especially in the areas of primary education, basic health, agricultural extension, and local water supply and public works. The central government retained the functions of policy guidance, oversight, and capacity building.

Local Government Expenditure in 2006/07
(Percent of total)

Roads	Water	Agriculture	Health	Education	Other
2	3	4	14	53	24

Sources: Tanzanian authorities.

There are 133 LGAs. In 2006/07 local governments accounted for about 20 percent of total government spending, or about 4½ percent of GDP. LGAs rely on central government transfers to finance most of their operations as their own revenue represents only 7 percent of their resources. This is partly because in 2003 a number of local nuisance taxes were eliminated. This helped to rationalize the tax system and simplify revenue administration, but increased dependence on central government transfers.

In the past few years important steps have been taken to strengthen management of local finances. The equity, efficiency, and transparency of the intergovernmental grants improved with the adoption of a formula-based system in 2004. IFMS has been deployed to a significant share of the LGAs. Budget preparation has been systematized through the electronic submission of budget plans via the Local Planning and Reporting system (Plan-Rep) since the 2006/07 budget. A local government finance statistics reporting system was launched in 2006, and now quarterly reports of individual LGAs and their consolidated position are being produced and made available to the public. Evidence of the progress achieved is provided by the increasing share of clean Auditor-General opinions.

The government's Local Government Fiscal Review (2007) identifies the priorities to further the D-by-D policy. Now that significant progress has been made in improving PFM systems, more emphasis is required on allocating resources to priority programs and ensuring value-for-money in the utilization of public resources. Other key areas requiring attention are the strong dependence of LGAs on government transfers; the limited autonomy of LGAs to allocate spending; the intergovernmental transfer system (e.g., there are substantial deviations from the formula-based grants, and there are parallel transfers from the ministries); and the need to strengthen local capacity to manage their finances.

Mobilizing More Revenue

Tanzania's revenue-to-GDP ratio has increased sharply in the recent years (Figure 12). Nevertheless, there seems to be potential for additional gains. It is only since 2002/03, through improvements in both tax policy and tax administration, that the country has achieved the sought-after objective of making its tax system more buoyant.

Tax policy

After several rounds of reforms Tanzania now has a modern tax system with fewer taxes and a broader revenue base. Reform efforts throughout were guided by the objectives of collecting more domestic revenue, reducing donor dependency, and making the tax system more efficient and equitable.

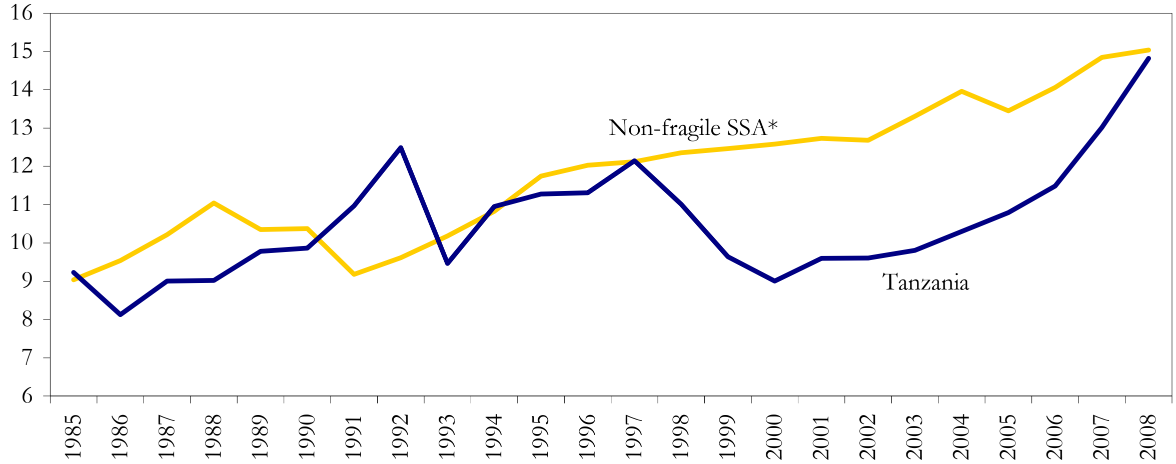
As Tanzania began to liberalize its economy, revenue fell, for three reasons: (1) a shift in the composition of output toward harder-to-tax sectors like agriculture and an expanding informal sector; (2) the declining contribution of parastatals, which had been an easy source of revenue; and (3) a proliferation of tax exemptions and increasing tax evasion.

With the liberalization of the economy it became apparent that the tax system needed to be reformed to better fit new needs and encourage private investment and growth. A first wave of reforms followed from the appointment of a Presidential Commission in 1989 to thoroughly review the tax system. Many of its proposals, issued in late 1991 and implemented in subsequent budgets, brought major improvements: tax bases were expanded, the rate structures of various taxes were simplified, the number of rates reduced, and maximum rates lowered significantly. Personal income tax rates, for example, were lowered from 70 percent to a maximum of 30 percent and the income tax rate for resident companies was lowered to 35 percent. The number of goods subject to excise taxes was reduced from 52 to 6. The cascading of general sales taxes was minimized through a system that exempted producers from input taxes. A start was also made on reducing economic protection. In particular, sales and excise tax rates for domestic and imported products were unified[11] and the number and level of customs tariffs reduced.

However, even though the quality of the tax system improved, many of the measures initially resulted in lower revenue. For example, the 1992/93 budget implemented measures to reduce the tax burden and simplify the tax system; however, planned measures to expand the revenue base by reducing

[11]Differential tax rates remained on domestic and imported tires and tubes, cooking oils, wheat, and flour.

Figure 12. Tax Revenue in Tanzania and Non-fragile Countries in Sub-Saharan Africa
(Percent of GDP)



Sources: Country authorities; Fund staff estimates
Note: The countries in this group are Benin, Burkina Faso, Ethiopia, Ghana, Kenya, Madagascar, Malawi, Mali, Mozambique, Niger, Rwanda, Senegal, Tanzania, Uganda, and Zambia

statutory and discretionary exemptions were not adopted. As a result, revenue collections in 1992/93 fell by 3½ percent of GDP. Revenue later recovered somewhat after some of the rate reductions were reversed and efforts were made to strengthen tax administration.

A major step toward modernizing the tax system was taken in July 1998 with the introduction of the VAT. It replaced the highly distortionary sales tax (which had five different ad valorem rates ranging from 5 to 30 percent), the hotel levy, and the receipt-based stamp duty. Since its introduction, the VAT has become the most important revenue source, accounting for over 30 percent of total revenue collected in 2006/07[12] and making an important contribution to offset losses from reduced customs duties. The buoyancy of the VAT increased significantly after the registration threshold was doubled in 2004 (from about $17,000 to $34,000), which also enabled the TRA to reallocate its administrative resources more efficiently. However, the revenue potential of the tax has been gradually undermined by many additions to the list of exemptions and zero ratings since the original law was passed.

[12]VAT accounted for 40 percent in 2005/06, but the 2006/07 budget eliminated the VAT on fuel products and increased excise tax rates on these products.

Another key measure was the reform of the income tax introduced in 2004. The previous scheme for personal income taxation had three undesirable features: a very low threshold (two-thirds of the minimum wage), which created equity problems and entailed significant administrative costs; a large number of distinct rate bands, again with high administrative costs, but also creating opportunities for avoidance; and a top marginal rate (35 percent) in excess of the CIT rate (30 percent), which distorted the choice between conducting business in corporate form or as an individual. The previous CIT was undermined by excessively generous investment incentives, as well as by exemptions and loopholes. The Income Tax Act of 2004 addressed these shortcomings and introduced a comprehensive modern regime.

Positive steps have been taken to harmonize Tanzania's tax system with those of its neighbors, Kenya and Uganda. The CIT rate and the top PIT rate are 30 percent in all three countries. Each country has a single-rate VAT at broadly similar rates (20 percent in Tanzania, 16 percent in Kenya, and 18 percent in Uganda). There are, however, significant differences in rates on the most important excisable goods—cigarettes, alcoholic beverages, and petroleum products. There are also significant differences in investment incentives.[13] Their harmonization within the EAC will require cooperation among the partner states. One possible way forward would be for the countries to adopt a code of conduct on investment incentives and company income taxation.

Tanzania has made substantial efforts to encourage investments through the introduction of an attractive fiscal framework. However, progress was not always linear and needed to be complemented by an overall favorable business environment. In 1997 a new Investment Act replaced the 1990 National Investment Promotion and Protection Act, and the Tanzania Investment Centre (TIC) replaced the Investment Promotion Centre (IPC). The previous regime contained generous tax holidays, which contributed to the poor performance of tax revenue for a decade without accomplishing the objective of promoting private sector development. The new act eliminated the tax holidays but introduced a system of generous investment allowances under the Income Tax Act and retained interest deductibility and indefinite loss carry-forward. In the end, the new system proved to undermine the CIT more severely than the regime it replaced. In 1998 the government introduced a new regime aimed at attracting investments to the mining sector (Box 7), and, as mentioned above, reformed the income tax in 2004.

[13]Uganda eliminated tax holidays in 1997; Kenya and Tanzania provide tax holidays for companies operating in their EPZs. With respect to capital recovery, Kenya and Uganda provide a generous initial allowance—100 percent in Kenya and 50 percent in Uganda—that reduces the cost to be recovered by depreciation.

Box 7. The Mining Regime

The government adopted the 1998 Mining Act to promote investment in this sector; the fiscal regime for the sector is also regulated by the Income Tax Acts of 1973 and 2004. The system is essentially a tax/royalty regime. There is relief for the industry in the customs law and the VAT act, and companies have been relieved of miscellaneous taxes, including the fuel levy, in the development agreements signed for each license. The main features of the 1997 fiscal regime are the following:

- 5 percent royalty for diamonds and 3 percent for all other minerals
- 30 percent corporate tax rate (i.e., the standard rate)
- Immediate expensing of prospecting and development capital expenditure
- Unredeemed development capital expenditure (i.e., expenditure that has not been offset against profits that would otherwise be subject to tax) is uplifted by 15 percent a year
- Unlimited loss carryover
- 3 percent final withholding tax on technical services fees
- 3 percent final withholding tax on management fees up to 2 percent of operating costs and 20 percent withholding tax on fees above 2 percent of operating costs
- No withholding tax on interest paid on foreign currency loans from third parties
- No limit on debt financing
- A current tax deduction for provisioning for future environmental expenditure
- Exemption from customs duties during pre-production and the first year of production, and a maximum duty of 5 percent thereafter
- Relief for VAT on imports and on domestic purchases
- A $200,000 limit on fuel tax payment
- A guarantee of fiscal stability by reference to laws in force on the effective date of the development agreement

In 2001/02 the additional 15 percent capital expensing was eliminated for new investors. Mining companies have contributed minimally to revenue collections despite the sharp rise in commodity prices of the last years, in part because of the generosity of the tax regime but also because the TRA lacks capacity to audit sophisticated taxpayers. The government of Tanzania is now reviewing the regime with a view to proposing reforms that would bring in more revenue from the sector, while still providing incentives for private sector involvement.

In 2002 Tanzania decided to complement its investment-promotion policy with export processing zones (EPZs). The Export Procession Zones Act of 2002 assigned EPZ development and management to the National Development Corporation (NDC). Investors located in the EPZs are entitled to remission of custom duties and domestic, including local, taxes on all goods and services, except motor vehicles, that are directly related to manufacturing. The firms are also entitled to exemption from payment of CIT for 10 years and payment at a rate not higher than 25 percent thereafter. So far there are few firms registered and none operating in the EPZs. As an additional development instrument, in 2006 the government introduced Special Economic Zones (SEZs). The Special Economic Zones Act allows for setting up geographical areas conditioned to provide a business environment for specific economic activities and provides various incentives, including tax holidays and exemptions, to firms that set up in SEZs. There is so far no activity under this regime.

Revenue administration

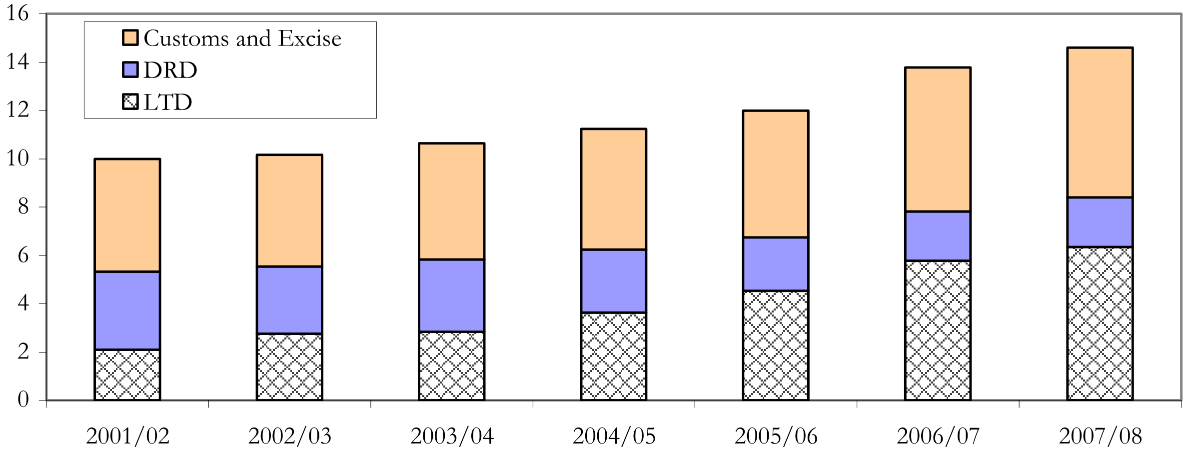
The start of the reform process of revenue administration can be dated to 1996, when the TRA went into operation. Established as a semi-autonomous institution,[14] the TRA consolidated the existing Income Tax, Sales Tax, and Customs Departments.

Since 1998/99 TRA activities have been guided by five-year Corporate Plans that outline the strategic orientation of the TRA, translate it into activities and expected results, and allocate resources accordingly. The first Corporate Plan covered fiscal years 1998/99–2002/03 and was supported by development partners through the Tax Administration Program. The intent of the plan was to make the TRA modern, efficient, and transparent by reorganizing its structure, implementing a user-friendly taxation system, and strengthening services to taxpayers.

Although progress was made in the first years of the program, the results did not meet expectations. The main achievements were (1) introduction of the taxpayer identification number (TIN) in 2000, which made it possible to eliminate the withholding tax on goods and services for TIN holders; (2) creation of the Large Taxpayers Department (LTD) in 2001; (3) introduction of a unified tax appeal mechanism, also in 2001; and (4) biomarking of petroleum products to reduce smuggling and fraud in goods in transit. During this period, the TRA also implemented the VAT. However, disorganization, lack of modern practices, and an underskilled human resource base undermined cost efficiency and negatively affected revenue collections.

[14]The TRA has a separate legal character and autonomy from the public service. It has a board of directors with representatives of the private and public sector and its chairman has no executive position. The TRA is managed by a commissioner general appointed by the president. The TRA Act provides for funding as a percentage of collections, but this provision has not yet been implemented and hence currently, the TRA depends on a budget allocated by the Ministry of Finance.

Figure 13. Tax Collections by TRA Department
(Percent of GDP)



Source: Tanzanian authorities.

Reforms at the TRA took off with the second corporate plan (2003/04–2007/08). Through numerous initiatives, the TRA became a modern organization, capable of promoting tax compliance by applying the tax laws fairly. Structural reforms were supported by simplification of tax laws and regulations, including through the 2004 Income Tax Act, the Tax Administration Act to harmonize procedures for different taxes, and the East African Cooperation Customs Management Act. During this period revenue rose by about 6 percentage points of GDP.

Essential contributors to the success were two changes in the organizational structure of the TRA: the LTD, created during the first phase, was reinforced, and, benefiting from accumulated LTD experience, the VAT and income tax departments were merged to create the Domestic Revenue Department (DRD) in 2005. The reorganization along functional lines rather than types of tax promoted more efficient allocation of resources by eliminating duplicate functions and simplifying the management structure.

The LTD has led the TRA's successful reform. Since 2003, it went from being responsible for 98 companies to over 370. It now collects almost 75 percent of domestic taxes and more than 40 percent of total TRA collections. Over the past five years, the LTD has been responsible for about 50 percent of the increase in tax revenues (Figure 13). It introduced modern procedures such as self-assessment principles for filing and payment, and simplified collection procedures—for instance, taxes can now be paid through commercial banks, which transfer them electronically into the TRA account at the BOT. In late 2007 the DRD began to set up units specialized in medium-sized taxpayers in urban centers. These units will apply the processes used by the LTD.

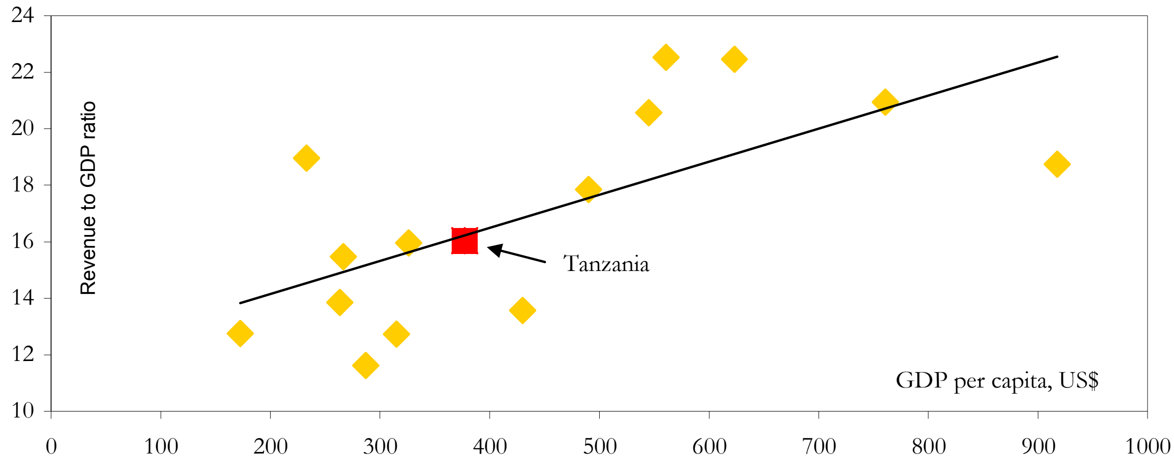
The Customs and Excise department has also been modernized, producing a significant increase in revenues and facilitating international trade. Importantly, the department was reorganized by function. To improve customs processes and procedures, the TRA is finalizing the migration to ASYCUDA++. In 2004 the Pre-shipment Inspection Scheme that had been in place since the late 1990s was replaced by a Destination Inspection Scheme (DIS), and complemented with strengthened post-clearance auditing. At the same time, a Computerized Risk Management System was introduced to streamline inspections. Finally, a web-based system for pre-lodgment procedures and an electronic Import Declaration Form are now in use.

Various other measures contributed to the success of the reforms. The TRA designed and installed ITAX, an integrated computerized system for taxation comprised of different modules, which led to improved auditing processes based on risk analysis, monitoring and reporting of tax collections, and tax services. The Treasury Vouchers and Checks System was introduced in fiscal year 2002/03 to act as a control on exemptions from taxes on imports and local purchases of both individuals and organizations. The TRA has substantially increased the number of taxpayers through a mapping exercise in the Dar es Salaam tax regions conducted under its Block Management System.

As a consequence of the impressive progress in recent years, Tanzania's level of revenue collection now compares well with other countries in the region in (Figure 14). At the same time, there remain opportunities for further gains, although this objective is challenged by the country's economic structure. A large share of GDP is derived from the agricultural sector, which employs almost 80 percent of the population; but has a significant nonmonetary component. The second largest sector of the Tanzanian economy is tourism. This sector is easier to tax than agriculture, but the prevalence of cash transactions in some segments of the sector, such as restaurants, tends to encourage tax evasion. More generally, economic informality in Tanzania is second only to Zimbabwe among the African countries covered by the World Bank's 2008 Doing Business report, and a large number of properties are held extra-legally. The mining and quarrying sector has been one of the most dynamic sectors in recent years, mainly because of exploitation of gold mines, but its contribution to tax revenues is limited by widespread tax concessions granted in the late 1990s as an incentive to investment. These tax incentives are protected by fiscal stability clauses in current contracts that prevent any increases in the effective tax rates.

Satisfying Tanzania's spending needs requires continued efforts to boost domestic revenue. On the tax policy side, there is room to further streamline

Figure 14. Revenue and GDP per Capita in Non-fragile Countries in Sub-Saharan Africa



Sources: Country authorities; IMF staff estimates.
Note: The countries in this group are Benin, Burkina Faso, Ethiopia, Ghana, Kenya, Madagascar, Malawi, Mali, Mozambique, Niger, Rwanda, Senegal, Tanzania, Uganda, and Zambia.

exemptions, increase coordination with neighbor countries, and tighten the regimes of the EPZs and SEZs. In the medium term, current initiatives to reform the mining fiscal regime and overhaul collection of nontax revenue are expected to bring in more funds. The revenue administration challenge is to continue expanding the revenue base, building on the progress of the last few years. The third TRA corporate business plan, which came into effect in July 2008, should bring continued modernization of its practices, reinforcement of the LTD, and significant improvements in collections from medium and small taxpayers, as well as in customs administration. If these efforts succeed, revenue collections could reach 20 percent of GDP over the next five years.

The Challenge of Financing Infrastructure Development

There is no doubt that the infrastructure gap remains a severe constraint on growth and development. It is also clear that the costs of closing this gap are very large in comparison with the resources currently available. Addressing the challenge of boosting infrastructure spending and finding the necessary resources to do so has opened a new chapter for fiscal policy in Tanzania.

The government is pursuing its reform effort in the areas of PFM to enhance the productivity of existing investment programs and revenue mobilization to create further fiscal space, but this might not be sufficient. In the absence of imminent additional scaling up of donor assistance and given limited domestic resources, the government is considering alternative financing options to boost infrastructure spending. Promoting private sector participation in infrastructure development, either through direct investment or through Public-Private Partnerships (PPPs), is one of them.[15] Borrowing on commercial terms is another possibility under consideration, and the government has already initiated the procedures to obtain a sovereign credit rating in preparation for a possible future access to the international capital market.

However, these options are not without risks for macroeconomic stability. PPPs can create significant contingent liabilities—explicit or implicit—for the government. Besides, nonconcessional external borrowing is more expensive and would imply greater risks for the economy. Compared with concessional flows, borrowing on commercial terms would lead to a deterioration of public and external debt profiles. Borrowing externally on commercial terms would also create higher refinancing and debt service risks. Lower-risk avenues should therefore be considered first.

But the government is aware of these risks. It intends to seek in priority concessional loans to finance the expansion of its investment program and explore all other alternative financing options with a view to selecting an option that reduces risks and safeguards public resources. In addition, reforms are under way to ensure that the fiscal space necessary to expand public investment is created without jeopardizing past successes.

To that end, a policy and legal framework for PPPs is under preparation. While targeting increased participation of the private sector in the implementation of infrastructure projects, the proposed framework will seek to ensure a fair sharing of the risks. Within the framework, government departments would be expected to drive the process in their respective sectors, while the Ministry of Finance and Economic Affairs would provide the requisite control mechanisms through a newly created PPP Unit. To ensure that any nonconcessional financing is consistent with long-term fiscal sustainability, the government is also strengthening its debt management capacity, although progress on this front has so far been relatively slow.

[15]See Ter-Minassian, Hughes, and Hajdenberg (2008).

CHAPTER

4 Establishing Effective Monetary Policy and a Vibrant Financial Sector

This chapter reviews reforms in the financial sector that were essential to creating an environment for effective monetary policy and economic stability and examines the challenges for monetary policy stemming from high inflows of aid and private foreign capital.

In the late 1980s Tanzania's financial sector was among the least developed in Africa. There were no capital or money markets. The main financial instrument was government securities issued directly to the state-owned insurance company, pension funds, and the postal savings bank. State-owned banks dominated the banking system and interest rates were set administratively. Allocation of credit—mostly to parastatals—was dictated by the government without regard to creditworthiness. The Bank of Tanzania had no control over monetary policy; it had to print money to finance the fiscal deficit and provide liquidity to the insolvent banking system. Inflation was high and volatile, and controls on prices and foreign exchange, including multiple official exchange rates, were pervasive, as were severe shortages.

After a long period of extensive structural reforms and financial sector restructuring, the picture changed dramatically. Since 2000 Tanzania has achieved one of the best inflation performances in sub-Saharan Africa and financial intermediation has expanded briskly. Commercial bank lending to the private sector is helping sustain Tanzania's economic growth. Increasingly, nonbank financial institutions, notably pension funds, are also channeling significant savings into the domestic financial market and direct investment. Liberalization of interest rates has encouraged domestic savings. While access to financial services must still be broadened, among many other challenges ahead, the contrast is striking between Tanzania's monetary policy framework and financial sector two decades ago and today.

How was this remarkable transformation achieved? When the Economic Recovery Plan was initiated in 1986, it became evident that the financial structure and regulation at the time were incompatible with the new economic policies. Removal of price controls and liberalization of domestic and foreign trade exposed inefficient parastatals to market competition, and the elimination of government subsidies further undermined their position. Commercial bank losses grew as they accommodated the financing needs of the loss-making parastatals, even as the BoT fueled continued monetary expansion and accelerating inflation. Recognizing all this, in 1988 a Presidential Banking Commission (the Nyirabu Commission) was established to draw up a comprehensive plan for rehabilitating the financial sector. As the Commission recommended, the financial and foreign exchange markets were liberalized, a new central bank law was passed, and in the early 1990s indirect market-oriented monetary policy instruments were introduced. However, only when the fiscal dominance of state-owned enterprise system was eliminated could monetary policy become effective and the economy be stabilized.

Financial Sector Reforms

Background

The Arusha Declaration of 1967 nationalized all private commercial banks operating in mainland Tanzania and replaced them with the state-owned National Bank of Commerce (NBC). Subsequently a number of specialized state-owned financial institutions were established following the enactment of institution-specific acts that provided for their operation and regulation.[16] There was no legal structure for harmonizing the activities of all financial institutions and no supervisory body to enforce adherence to prudential standards.

Restructuring of state-owned financial institutions

In 1991, following the Nyirabu Commission's report, the government of Tanzania initiated comprehensive reform of the financial sector. Its goals were to promote efficient mobilization and allocation of savings through a competitive and market-based financial system; redefine the role of the BoT in bank supervision and regulation to make it compatible with the needs of a market economy; and introduce indirect monetary policy instruments within a competitive money market to facilitate stabilization of the economy in the

[16]The banks were the NBC, which enjoyed a virtual monopoly in the mainland and extended credit to parastatals and the government and by the early 1990s accounted for about 90 percent of lending and deposits; the Cooperative and Rural Development Bank (CRDB), the government's main rural banking vehicle; the People's Bank of Zanzibar (PBZ), a quasi-central bank for the government of Zanzibar and sole commercial bank on the isles; and Tanganyika Development Finance Company (TDFC), which provided medium- and long-term loans. The nonbank financial institutions were the Tanzania Investment Bank (TIB), which provided development finance to industry; the Tanzania Housing Bank (THB), which specialized in rural and urban housing finance; and the Tanzania Postal Bank (TPB), which mobilized deposits for investing in government securities.

Box 8. Loans and Advances Realization Trust

The Loans and Advances Realization Trust (LART) was created in 1991 to take over the nonperforming assets of state-owned banks and to help in restructuring them. During 1992–96, TSh 85 billion (about 5 percent of GDP) of nonperforming loans was transferred from NBC and CRDB to LART. In 1996, LART's mandate was extended to cover private financial institutions. As an autonomous government-owned institution, LART holds on behalf of the government the nonperforming loans of banks and financial institutions and administers the Nonperforming Assets Recovery Fund to recover the outstanding amounts, help companies to restructure, and facilitate repayment of the loans. To accelerate recovery of loans, the government established a separate LART Loan Recovery Tribunal with simplified procedural rules that is presided over by a high court judge. At first LART operated mainly as an agent for the government recovering loans mainly through the seizure and sale of assets. After the LART Act was amended in 1996, it operated more as a general recovery agency for all banks and financial institutions.

liberalized environment. To this end, in 1991 interest rates were liberalized and the Banking and Financial Institutions Act (BFIA) enacted. The BFIA legalized private financial institutions and gave the BoT responsibility for licensing, regulating, and supervising them. That same year the Loans and Advances Realization Trust (LART) was created to facilitate recovery of overdue debts transferred from state-owned financial institutions (Box 8). The Bank of Tanzania Act, 1995, and a series of other banking laws and prudential regulations, further consolidated the BoT's supervisory authority.

As part of financial sector reform the state-owned financial institutions were restructured (Box 9). Nonperforming assets of commercial banks and the substantial indebtedness they had accumulated to the BoT were replaced by government bonds. The balance sheets of the BoT and the commercial banks were reconstituted, providing the basis for a more commercially oriented sector and establishing a foundation for future lending operations based on commercial criteria, unencumbered by the large portfolio of nonperforming loans. The reforms also effectively relieved the central bank of its responsibility to act as an automatic and limitless source of liquidity by lending to the commercial banks, thus encouraging them to rely on their deposit base for credit extension.

Regulatory reforms

To support liberalization of the financial sector and ensure its soundness, regulation and supervision were modernized in line with the Basel Committee's Core Principles for effective banking supervision. The Financial Institutions Act adopted by parliament in April 1991 as a framework for banking activities was amended in 1993 to mandate capital adequacy requirements in line with the Basel Standards.

Box 9. Restructuring of State-Owned Banks

In 1992 the government transferred some NBC nonperforming loans to the Loans and Advances Realization Trust (LART) and replaced them with treasury bonds. To reduce operating costs, 2,800 of the 9,000 staff were released and 23 of the 205 branches were closed. These measures, however, proved insufficient; the financial position of the NBC continued to deteriorate. In 1997 the government decided to split the NBC into two banks, the NBC (1997) and the National Microfinance Bank (NMB), and to privatize them. The NBC (1997) was to concentrate on corporate and large business customers and international banking services; the NMB was to be a microfinance bank serving rural and urban small businesses. Though both banks retained branches in the major urban centers, most rural branches were assigned to the NMB. The NMB also retained government accounts to facilitate government payments throughout the country. Of the NBC's remaining employees 2,000 (about half) were released, and the two banks began operations in October 1997 under new management. Privatization of NBC was completed in March 2000 when the South African banking group ABSA bought the majority stake. Privatization of the NMB began in September 2005 with sale of 49 percent and transfer of the managerial control to a consortium led by the Rabobank Group. THB was liquidated in 1995. CRDB was successfully restructured and privatized in 1996.

The BoT now has substantially more autonomy and an enhanced role as the supervisory authority (Box 10). A milestone in financial sector reform was achieved in 2006, when parliament approved the Bank of Tanzania Act, 2006, and the Banking and Financial Institutions Act 2006. These acts, which are now law, increased BoT autonomy and accountability and reinforced the legal foundation for the financial sector with specifications for prompt corrective action, licensing, measurement of the asset quality of financial institutions, and a shift to risk-based supervision. The BoT then initiated a requirement that banks report quarterly on their capital adequacy.

Financial deepening and broader access to financial services

When financial sector reform began in 1991, Tanzania's banking sector comprised six deposit-taking financial institutions. The entry of private banks was permitted in 1992, but none began operations until 1994. Starting in 1998, the financial sector expanded dramatically. At end-2007, it comprised 24 licensed commercial banks (including subsidiaries of major international banks),[17] 10 nonbank financial institutions (NBFIs), numerous foreign exchange bureaus, pension funds, insurance companies, the stock exchange, and several hundred savings and credit cooperatives (SACCOs). Banks account for about 80 percent of financial system assets.

[17]Foreign equity participation accounts for about two-thirds of banking system capitalization.

Box 10. An Independent Bank of Tanzania

The Bank of Tanzania Act of 1965 was amended in 1995 to give the Bank of Tanzania (BoT) more effective mechanisms for managing monetary policy in a liberalized environment. The 1995 act stated that the primary objective of the BoT is to formulate and apply monetary policy with the purpose of achieving price stability, and allowed for a high degree of instrument independence. In 2006, parliament promulgated a new BoT Act that reinforced the mandate for price stability and the Bank's autonomy in conducting monetary policy. The new Act also gave the BoT more political independence by eliminating a bias toward the Ministry of Finance and encouraging cooperation in setting monetary and fiscal policies rather than fiscal policy dominating monetary policy.

In recent years the BoT has become more independent de facto as well as de jure. While measuring central bank independence can be difficult, several studies provide a range of quantitative measures, including cross-country comparisons. For example, in a Bank of England survey of 94 industrialized and developing countries (Mahadeva and Sterne, 2000), the BoT scored 60 out of 100 in terms of overall independence—50 for target independence and 75 for instrument independence. Taking into account the survey results, the new BoT Act, and government efforts to make monetary policy more credible through better communications with the general public, the BoT can be classified as moderately independent.

Before the reform, high inflation, poor access to financial services, extensive state control, and directed lending were key factors explaining how little the financial sector contributed to economic growth and poverty reduction. In recent years, however, a stable economy and substantial reforms have had notable impact on the ability of ordinary Tanzanians and small and medium-sized enterprises to access financial services. By 2007 rapid financial sector deepening had brought Tanzania in line with its neighbors.[18] Still, private banks operate almost exclusively in Dar es Salaam, require high minimum deposit balances, lend primarily for short-term trade finance, and tend to focus on a handful of low-risk, high-value customers. Access to banking services for small and medium-sized enterprises (SMEs) and the rural population, is still limited.

Effective Monetary Policy in a Liberalized Economy

Financial sector reform and liberalization of interest rates in the early 1990s, together with unification of the exchange rate, required the BoT to develop indirect instruments for monetary policy. With progress in the reform of the parastatals and greater fiscal discipline, the BoT undertook a successful

[18]See Table 3.

Table 3. Tanzania: Selected Indicators of Access to Financial Services

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Interest rate spread												
Tanzania	18.4	15.1	14.1	14.2	15.5	13.1	11.4	9.7	10.4	8.8	7.3	7.6
Kenya	13.5	11.1	12.8	14.2	13.0	13.0	12.4	10.1	7.8	8.5	8.2	8.7
Uganda	9.5	9.5	12.8	13.1	14.2	13.5	9.1	12.9	10.9	9.6	9.8	9.7
South Africa	4.6	5.3	5.8	5.3	4.4	5.0	5.2	4.7	4.6	4.0	4.0	3.3
SSA	11.1	11.4	11.8	12.8	12.4	11.7	12.0	11.6	10.7	9.6	10.6	…
Bank deposits (% GDP)												
Tanzania	3.4	2.5	2.3	12.3	13.5	14.9	15.2	15.6	19.4	21.3	22.3	22.0
Kenya	32.6	30.3	30.0	29.6	30.8	32.9	33.9	34.1	33.5	34.6	34.2	36.4
Uganda	9.8	8.7	8.8	8.9	10.5	11.8	11.2	10.1	11.3	11.7	13.4	13.5
South Africa	51.2	54.0	54.4	51.5	54.5	51.0	54.3	53.1	57.8	62.3	65.6	63.4
SSA	20.5	20.9	22.2	23.3	24.3	25.9	27.0	26.8	27.6	28.7	28.5	…
Bank credit to private sector (% GDP)												
Tanzania	3.5	3.8	4.2	4.1	4.4	5.5	6.7	7.6	8.9	10.8	10.8	13.4
Kenya	24.4	24.0	26.6	25.8	23.6	24.2	23.1	25.4	24.5	24.9	25.5	29.7
Uganda	4.2	5.2	5.5	5.7	5.4	5.5	5.3	5.7	5.6	6.4	8.6	11.5
South Africa	63.8	68.3	68.1	69.2	76.3	58.4	63.9	66.1	70.1	77.8	82.8	71.4
SSA	13.8	14.7	15.1	15.1	14.9	15.1	16.2	16.6	17.5	18.6	19.6	…
NPLs (% of total loans)												
Tanzania	n.a	22.9	25.2	17.3	12	8.3	4.5	3.5	4.9	7.3	6.3	6.3
Kenya	20.5	n.a	30	37.2	39.4	39.6	34.9	29.3	25.6	21.3	10.9	9.6
Uganda	27	29	12.6	9.8	6.5	3	7.2	2.6	2.3	2.9	3.4	4.1
South Africa	3.3	4.1	4.9	4.5	3.2	2.9	2.4	1.8	1.5	1.1	1.4	…

Sources: IFS; IMF staff estimates.
2008 data are midyear estimates.

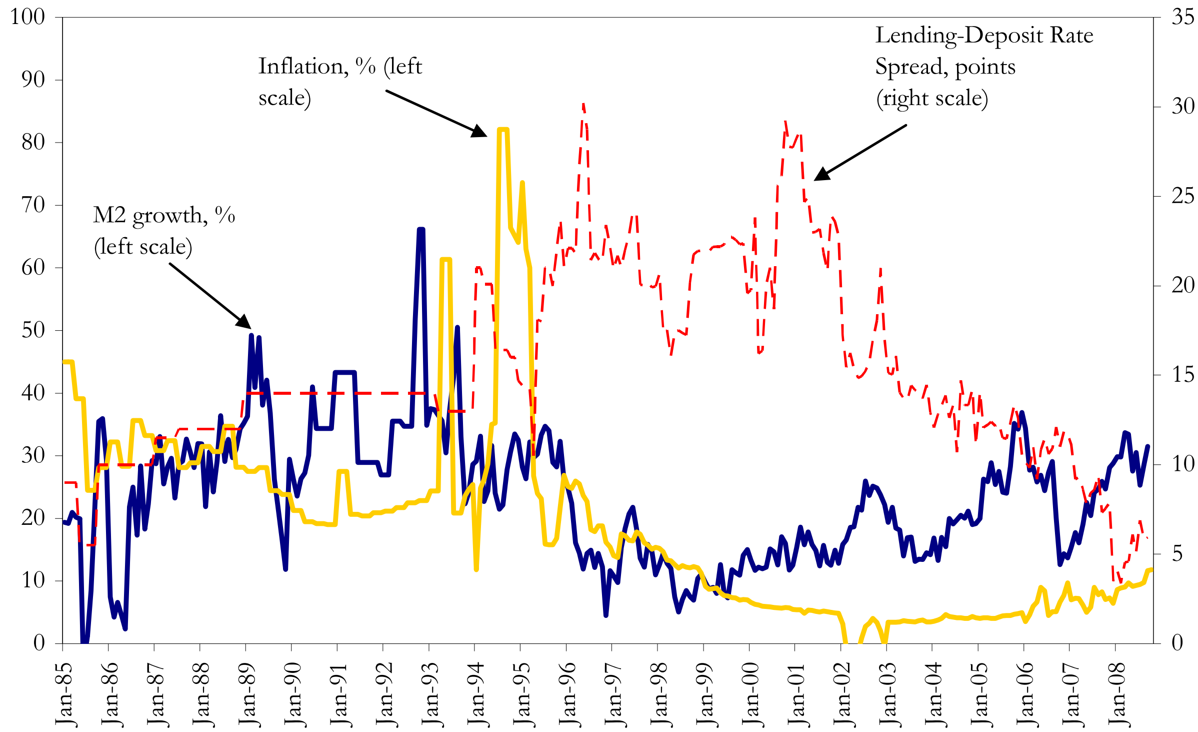
disinflation between 1995 and 1998 bringing inflation from close to 30 percent to the single digit levels (Figure 15). Monetary policy has since focused on maintaining price stability while promoting growth in credit to the private sector credit.

In 2000 the BoT adopted monetary targeting with reserve money as the immediate operating target and broad money (M2) as the intermediate target. It moved gradually from using such direct instruments as the minimum reserve requirement, the discount rate, and the liquid asset ratio to relying more on open market operations and foreign exchange sales. Its commitment to a reserve money target enabled it to keep prices stable despite large aid inflows.

Treasury bill auctions and open market operations

After interest rate controls were abolished in 1991, treasury bill auctions were introduced in August 1993 as a means to manage liquidity and as a vehicle for providing the financial system with a market-determined reference

Figure 15. Tanzania: Broad Money Growth, Inflation, and Interest Rate Spread



Sources: Tanzanian authorities; IMF staff estimates.

interest rate and noninflationary way to finance the budget deficit.[19] However, due to the slow progress in restructuring the banking sector and reforming the large public-sector banks in the 1990s, interest rates did not respond to fluctuations in treasury bill yields.[20] The mechanism for transmitting treasury bill yields to banking sector interest rates improved once the state-owned financial institutions were restructured and

[19]Currently, the 35-day and 91-day maturities are used for liquidity management, while the 182-day and 364-day treasury bills are used for both liquidity management and financing; although new issues are largely for rolling over maturing 364-day bills.

[20]The weak financial position of the state-owned banks also complicated the use of other policy instruments. Burdened with a large portfolio of nonperforming assets, the state-owned banks had difficulties meeting the required reserve ratio. At the same time, the private banks maintained excess liquidity levels (sometimes twice as high as the required reserve ratio), compromising the effectiveness of the BoT's discount rate in influencing bank behavior.

privatized, private banks appeared, and regulation of the banking sector was reformed.

Effective liquidity management in the context of high aid and portfolio inflows

After the foreign exchange market was liberalized, the exchange rate was largely market-determined. However, after 1995/96, when foreign exchange reserves covered less than two months of imports, the BoT introduced a secondary objective of accumulating and sustaining international reserves equivalent to four months of imports. Thus, its interventions in the foreign exchange market were aimed primarily at accumulating reserves and smoothing seasonal volatility rather than managing liquidity (Box 11).

Starting in 2000/01, liquidity management became more complicated as aid inflows to Tanzania increased. The BoT's initial response was to accumulate foreign exchange reserves to prevent undue appreciation of the exchange rate. As a result, by 2004 foreign reserves were equivalent to over eight months of imports, almost double the stock four years earlier. During that period, the BoT was reluctant to use the sale of foreign exchange for sterilization out of concern that this could erode competitiveness by placing upward pressure on the exchange rate; instead, it relied primarily on treasury bill sales to offset the impact of aid flows on domestic liquidity.

The BoT policy of absorbing excess liquidity through open market operations using liquidity paper undermined its profitability, resulting in higher and volatile treasury bill yields.[21] This increased the fiscal costs of sterilization and borrowing costs. High yields on Tanzanian government securities, low inflation, better government debt-servicing capacity, and relative exchange rate stability also attracted foreign investors in search of higher returns. Although Tanzania maintained restrictions on nonresident portfolio investment, there seem to have been substantial inflows of foreign capital into government securities in 2007, which complicated monetary and foreign exchange operations because the BoT's main instruments—issuance of government securities or sales of foreign exchange—tend to increase returns to investors.[22]

[21]Apart from the liquidity conditions that helped push up treasury bill rates, the increases in the level and volatility of treasury bill yields could also be attributed to the oligopolistic market structure and strategic bidding by large commercial banks (Abbas and Sobolev, 2008).

[22]Corresponding heavy demand for shillings in the interbank foreign exchange market created appreciation pressures, against which the BoT acted to purchase foreign exchange. To mop up the resulting shilling liquidity under the reserve money targeting framework, the BoT issued increasing amounts of treasury bills, thus perpetuating the upward pressure on yields.

Box 11. Operations to Sterilize Large Aid Inflows

Both the magnitude and modality of aid delivery have serious implications for monetary policy. When aid consisted mostly of projects, debt relief, and technical assistance, the impact on macro variables—growth, inflation, the exchange rate, interest rates—was muted, at least relative to the amount of the aid flows. Indeed, for these types of aid, much of the foreign exchange component never entered Tanzania, so there was little need for monetary policy to manage the impact. With an increasing shift to direct budget support, monetary policy had to respond to stem potential inflationary pressures by sterilizing the liquidity generated by donor-financed government spending.

In the initial phase of the shift to budget support, Tanzania sterilized the liquidity injections mainly by issuing government securities. Within a few years the BoT had built up international reserves in excess of $1 billion (or about 6 months of imports of goods and services). While this strategy was also driven by the authorities' concern to avoid an appreciation of the Tanzanian shilling, international reserves provided a cushion against shortfalls in disbursements of budget support. However, the buildup of reserves contributed to a substantial and costly increase in domestic debt.

In later years, the BoT shifted more toward a policy of using foreign exchange sales to mop up large amounts of liquidity. While this shift corresponded to a new "spend and absorb" approach to aid, it occurred during a period of adverse shocks that also greatly widened the external current account deficit. The BoT was thus able to sell large amounts of foreign exchange, and the shilling continued to weaken. However, the sales were rather ad hoc; the BoT typically stood ready to sell (or buy) large amounts of foreign exchange directly to individual banks.

Further evolution of the use of foreign exchange sales as a policy instrument came in late 2007, when the BoT stepped up its foreign exchange sales, and its intervention in the foreign exchange market became more systematic. In late 2007, the BoT clearly announced an exchange rate policy or entering the market generally as a seller of foreign exchange and to smooth out fluctuations.

In response, in late 2007 the BoT stepped up its foreign exchange sales for sterilization operations, and its intervention in the foreign exchange market became more systematic and predictable. Together with its recent steps to increase the transparency and predictability of treasury bill auctions and to encourage competition among market participants, this has helped to reduce treasury bill yields significantly.

Second-Generation Financial Sector Reforms

Despite significant progress in recent years, Tanzania's financial sector remains relatively small, and access to bank credit is limited. Among the barriers to greater bank lending to the private sector are the inability to use

Box 12. Second-Generation Financial Sector Reform Action Plan

The second-generation reforms are based on the recommendations of the joint IMF–World Bank Financial Sector Assessment Program (see IMF, 2003) and are aimed at removing structural impediments to broadening access to financial services, including medium- and longer-term lending, and creating an environment more conducive to lending and financial sector development. A comprehensive Financial Sector Reform Implementation Action Plan and its action matrix identify key actions and corresponding development partner support in each of the nine major areas of reform: (1) monetary policy; (2) the banking sector; (3) financial markets; (4) the pension sector; (5) the insurance industry; (6) long-term development finance; (7) micro and rural finance; (8) legal and judicial reform; and (9) land administration.

land for collateral; underdeveloped leasing, equity and export finance markets; and the absence of a centralized system for credit information. Amendments in 2004 addressed the issue of legal protection for lenders, but a key outstanding issue is the harmonization of the Land Act with other laws related to land issues. The judiciary needs to become more effective in enforcing contracts and protecting bank lending. Although Commercial Courts were introduced in 1999, there are still problems associated with the possibility of appeals after banks receive favorable verdicts there. Furthermore, capacity constraints in these courts have undermined speedy resolution of cases and thus the willingness of banks to engage in more broad-based lending.

To address structural obstacles to bank lending and to further improve access to financial services and strengthen prudential supervision, the government is implementing a second generation of financial sector reforms (Box 12). These reforms would address weaknesses in the law and the courts, particularly related to land ownership; facilitate collateralized lending, improve credit information infrastructure and land, company, and mortgage registries; make prudential supervision more risk-based; and reinforce regulation of NBFIs, especially the rapidly growing pension funds.

Capital Account Liberalization and the Effectiveness of Monetary Policy

Looking ahead, fully reaping the benefits of increasing regional and global integration will require further liberalization of capital flows, which remain more restricted in Tanzania than in its principal EAC

Box 13. Making Monetary Policy More Effective: The Case for Inflation Targeting

Over the past decade an increasing number of central banks have turned to inflation targeting to guide monetary policy. While experiences may differ, generally inflation targeting has proved to be an effective policy. Is inflation targeting a viable option for low-income countries?

The elements of inflation targeting include

- commitment to price stability as the main objective of monetary policy, to which all other objectives are subordinated;
- a central bank that is independent enough to attain the announced target;
- emphasis on transparency and communication with the public about central bank objectives and policy decisions; and
- a solid analytical infrastructure to forecast inflation and understand how policy decisions transmit to output and inflation.

Increasingly those requirements are being met in sub-Saharan Africa. A move toward more central bank independence and away from fiscal dominance, an active monetary policy that anchors medium-term inflation expectations in a clear target, and an effort to communicate effectively with the public all demonstrate how monetary policy is evolving in many of the stable economies of the region. This affords the monetary authorities some freedom in using monetary policy instruments to stabilize output and inflation while anchoring long-term inflation expectations.

Would inflation targeting be an option for Tanzania? Tanzania could benefit from it in the future because it would provide more flexibility for conducting monetary policy in the face of high capital inflows, both foreign direct investment (FDI) and donor assistance, while anchoring long-term inflation expectations. Some requirements for inflation targeting are already in place: the new Central Bank Act of 2006, which granted the BoT greater independence and put the emphasis on price stability; clarity in conducting monetary policy; and the significant improvement in BoT communication with the market and the public, which is already having a positive impact on its credibility. The main challenges to Tanzania's formally adopting inflation targeting are the lack of an analytical framework for forecasting inflation—underpinned by a strong statistical framework—the lack of understanding of monetary policy transmission mechanisms, and shallow domestic financial markets.

partners.[23] While foreign direct investment inflows are largely free, portfolio inflows remain restricted. A gradual liberalization would help attract longer-term sources of savings, both within the region and from potential investors further afield. But to be successful, and minimize the risks for macroeconomic stability, capital account liberalization will need to be accompanied by steps to strengthen data collection and financial sector

[23]See Gershenson, Masha, and Dunn (2008).

supervision, some of which are under way. Further integration into global financial markets is likely to place strain on the money targeting regime. As the BoT continues to gain expertise and the financial system in Tanzania becomes more sophisticated, a shift from reserve money to inflation targeting could be a viable medium-term option (Box 13).

CHAPTER

5 Aid, Growth, and Competitiveness

The chapter reviews the linkages between aid and growth in Tanzania and the implications for competitiveness. It also discusses how donor aid can help create fiscal space for increasing public spending and reducing poverty.

History and Evolution of Aid to Tanzania

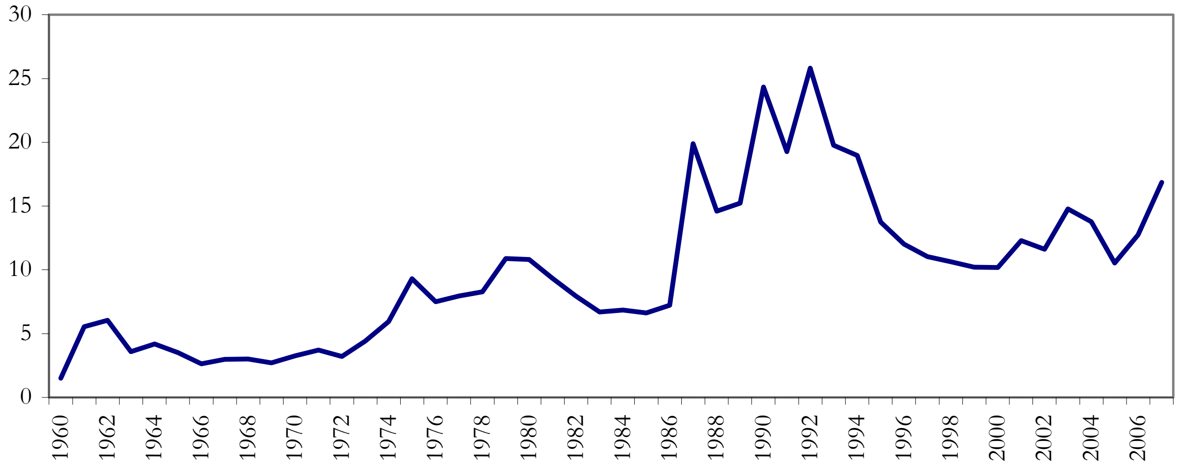
Tanzania has long received substantial amounts of donor aid. Since the mid-1970s, aid has consistently exceeded 5 percent of GDP a year, and it has been rising over time (Figure 16).[24] After peaking at nearly 26 percent of GDP in 1992, aid declined to an average of about 10½ percent in the second half of the 1990s before increasing to about 12½ of GDP for 2001–06. Currently, aid inflows finance about 40 percent of government operations.

To a large extent Tanzania's aid receipts over time have reflected the global pattern for total aid delivery (Figure 17). At the same time, Tanzania's share of the total aid pie has risen along with its economic reforms. In particular, the comprehensive ERP reforms initiated in 1986 drew widespread support from the donor community. In U.S. dollar terms, Tanzania's aid receipts doubled between 1985 and 1988 and continued to increase over the next several years to the peak of 26 percent of GDP in 1992 before declining gradually through the late 1990s. More recently, the donor community has recognized Tanzania's progress on economic stabilization, structural reforms, and poverty reduction by increasing aid from 10 percent of GDP in 2000 to 12.9 percent in 2006.

The composition of donor assistance to Tanzania has changed significantly over the past decade (Table 4). Until the mid-1990s, it consisted largely of project aid and technical assistance, with only limited amounts of direct budgetary support. Since the World Bank approved its first structural

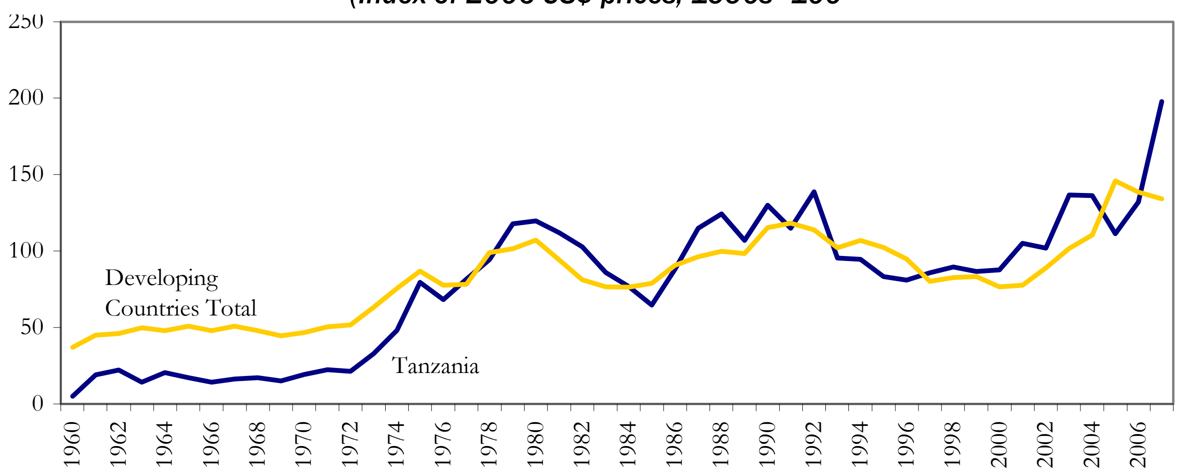
[24]Based on data reported by donor countries and institutions (the OECD DAC database).

Figure 16. Tanzania: Official Development Assistance
(Percent of GDP)



Sources: OECD DAC database; IMF staff estimates.

Figure 17. Net Official Development Assistance for Tanzania and Developing Countries
(Index of 2006 US$ prices, 1990s=100)



Sources: OECD DAC database; IMF staff estimates.

adjustment credit in 1997 Tanzania began to receive increasing amounts of direct support for budgeted government expenditures. Direct budget support expanded further when several development partners signed onto the Joint Assistance Strategy for Tanzania (JAST) program. As a result, budget support has increased gradually from about 2½ percent of GDP in 1996/97 (about 30 percent of total aid inflows), to a projected 6 percent in 2007/08 (just

Table 4. Tanzania: Gross External Program and Project Assistance

	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
					(In percent of GDP)							
Program[1]	**2.6**	**2.9**	**2.9**	**2.5**	**2.1**	**3.2**	**4.5**	**5.1**	**5.5**	**5.5**	**5.0**	**5.9**
Grants	1.7	1.7	1.7	1.7	1.6	2.4	3.2	3.4	4.2	3.5	3.3	3.5
Loans	0.9	1.3	1.2	0.7	0.5	0.9	1.3	1.7	1.3	2.0	1.7	2.4
Project	**6.1**	**4.8**	**4.4**	**5.6**	**5.3**	**3.9**	**3.4**	**4.6**	**4.7**	**3.9**	**3.5**	**5.2**
Grants	3.0	2.6	2.5	2.8	3.2	2.8	2.3	2.6	2.7	2.0	1.2	3.0
Loans	3.2	2.2	1.9	2.8	2.1	1.1	1.1	2.0	2.1	1.9	2.2	2.2
Debt service relief	**0.0**	**0.0**	**0.0**	**0.0**	**0.4**	**0.6**	**0.6**	**0.6**	**0.5**	**0.7**	**1.2**	**0.9**
MDRI	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	1.1	0.9
HIPC	0.0	0.0	0.0	0.0	0.4	0.6	0.6	0.6	0.5	0.5	0.1	0.0
Total assistance	**8.7**	**7.8**	**7.3**	**8.1**	**7.8**	**7.8**	**8.5**	**10.2**	**10.7**	**10.1**	**9.7**	**12.1**
					(In $ million)							
Program[1]	**198**	**277**	**280**	**250**	**220**	**341**	**505**	**614**	**757**	**794**	**763**	**1,121**
Grants	127	158	166	175	167	249	359	410	576	502	509	663
Loans	71	119	114	75	53	92	146	204	182	293	254	458
Project	**466**	**455**	**429**	**573**	**548**	**413**	**386**	**553**	**651**	**559**	**527**	**989**
Grants	225	248	246	286	329	293	264	310	368	281	189	570
Loans	240	207	183	287	219	120	122	243	283	278	338	419
Debt service relief	**0**	**0**	**0**	**0**	**42**	**64**	**69**	**72**	**66**	**96**	**176**	**178**
MDRI	0	0	0	0	0	0	0	0	0	29	164	178
HIPC	0	0	0	0	42	64	69	72	66	67	13	0
Total assistance	**664**	**732**	**709**	**823**	**810**	**818**	**960**	**1,239**	**1,475**	**1,449**	**1,466**	**2,289**

Sources: Tanzanian authorities; IMF staff estimates.

[1] Program support includes both GBS and basket funds.

under 50 percent of total aid inflows); meanwhile, project assistance declined by about ½ a percentage point of GDP.

Tanzania also received extensive debt relief from the HIPC and MDRI initiatives. It qualified for HIPC relief initiative in 2001; cumulative debt relief amounted to approximately $3 billion. Subsequently, in 2006, the IMF, the World Bank, and the African Development Bank implemented the Multilateral Debt Reduction Initiative (MDRI). Under this initiative the multilateral creditors provided debt relief of $3.5 billion. In flow terms, HIPC and MDRI debt relief reached about 1 percent of GDP in 2006/07 and is expected to amount to about ½ percent of GDP annually over the medium term (Box 14).

Factors Behind the Recent Growth Acceleration in Tanzania

Tanzania's economic growth has accelerated significantly in recent years. Real GDP grew by an average of about 7 percent annually for 2001–07, which is more than double the average of about 3 percent for the 1980s and 1990s. This section examines the main factors behind this significant growth acceleration, notably the role of aid, private financial flows, and improvements in total factor productivity.

Box 14. HIPC and MRDI Debt Relief

The IMF and the World Bank adopted the Heavily Indebted Poor Countries Initiative (HIPC) in 1996. Tanzania was among the first countries to benefit (following Bolivia, Mozambique, and Uganda), reaching the HIPC completion point on November 27, 2001. Debt service relief under the HIPC from all of Tanzania's creditors amounted to about US$3 billion over time ($2.026 billion in net present value terms); multilateral creditors accounted for about half of this. As a result of HIPC assistance, the net present value of Tanzania's total external debt was reduced by some 54 percent. External debt service payments were also cut significantly—by an average of nearly 50 percent over time—averaging about $65 million annually for 2000/01–2005/06 (about ½ percent of GDP).

Tanzania: Debt Service Relief from HIPC and MDRI Initiatives

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
				(In millions of US Dollars)					
Total HIPC/MDRI	**42**	**64**	**69**	**72**	**66**	**96**	**176**	**178**	**162**
HIPC	42	64	69	72	66	67	13	0	0
MDRI	0	0	0	0	0	29	164	178	162
				(In percent of GDP)					
Total HIPC/MDRI	**0.4**	**0.6**	**0.6**	**0.6**	**0.5**	**0.7**	**1.2**	**0.9**	**0.7**
HIPC	0.4	0.6	0.6	0.6	0.5	0.5	0.1	0.0	0.0
MDRI	0.0	0.0	0.0	0.0	0.0	0.2	1.1	0.9	0.7

Sources: IMF and IDA.

In June 2005 the IMF and the African Development Fund (AfDF) decided to cancel 100 percent of their debt claims as of end-2004, while the International Development Association (IDA) of the World Bank canceled 100 percent of its claims as of end-2003. MDRI debt relief from the IMF to Tanzania (and another 18 low-income countries) was approved in January 2006, and from the IDA and AfDF in July 2006. MDRI debt relief was about 0.9 percent of GDP in 2006/07 and will decline gradually to about ½ percent of GDP in 2012/13. As a result of these two initiatives, external debt service as a percentage of government revenue was reduced from 2.4 percent in 2000/2001 before HIPC assistance to an average of about 1.9 percent in 2005/06 after, and further to about 1.3 percent in 2007/08 after MDRI relief. This created substantial fiscal space to finance antipoverty and growth-enhancing programs.

The positive impact of donor aid

There is an extensive literature on whether donor assistance contributes to or detracts from economic growth, with arguments supporting both sides of the debate (Box 15). Total aid to Tanzania as measured by total net official development assistance (ODA) inflows has increased from about 10½ percent of GDP in the second half of the 1990s to about 12½ percent for

Box 15. The Literature on Aid Effectiveness and Growth

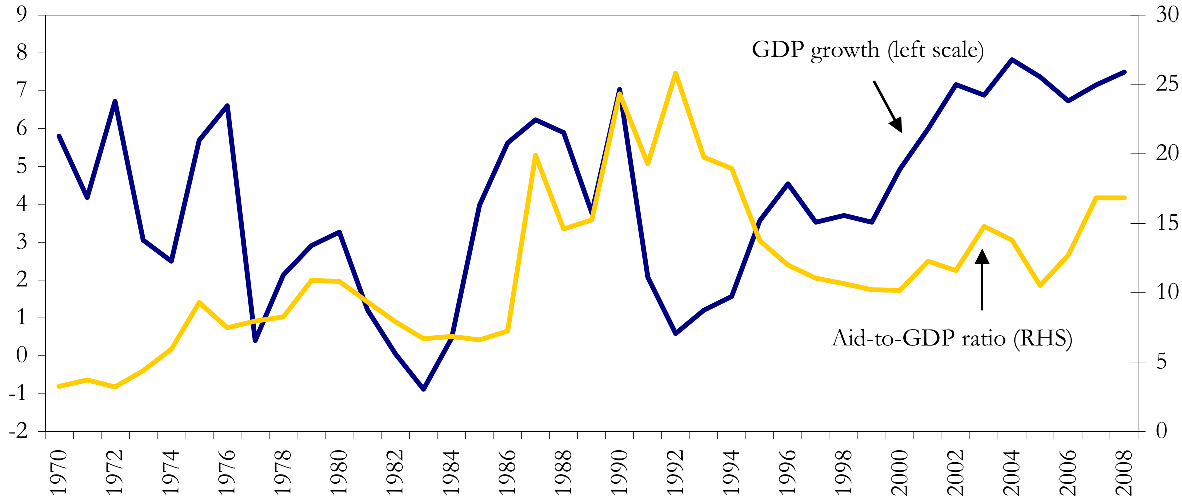
There is a contentious debate, both theoretical and empirical, about the effectiveness of foreign aid in promoting economic growth in developing countries. This box summarizes the differing theoretical arguments and conflicting empirical findings in a number of recent studies on aid effectiveness.

Theoretically, in a simple neoclassical growth model like the Solow model aid increases economic growth through its positive impact on investments in the recipient country. In models with poverty traps, even a temporary injection of aid may help a country take off and reach a permanently higher level of per capita income. However, in game-theoretic models, moral hazard and adverse selection problems reduce the impact of aid predicted by the simple Solow model. Aid critics also point out that to a significant extent aid effectiveness is affected by the political regime, especially the quality of domestic institutions and government policies. They also stress that aid is fungible; additional aid may actually end up financing an increase in consumption rather than investment.

Empirically, too, there is no consensus on the impact of aid on growth. The long and inconclusive literature on aid effectiveness is hampered by data availability, debates about the mechanisms through which aid affects growth, and disagreements about econometric specifications. On the one hand, for example, Boone (1996) finds that aid increases consumption but does not in most cases increase investment or lead to an improvement in basic human development indicators. He argues that his findings support the pessimistic predictions of Bauer (1971) and Friedman (1958) that aid flows basically benefit political elites and do not substantially change government incentives to carry out the programs intended to be supported by the aid flows. On the other hand, Hansen and Tarp (2001) provide empirical support for their thesis that aid raises investment in recipient countries and higher investment in turn has a positive effect on growth. They also find that the aid-growth relationship depends not only on the amount of aid but also on certain policy indicators. In another influential study, Burnside and Dollar (2000) find that aid has a positive effect on growth but only where policies and institutions are good; it has little effect otherwise. More recently, Clemens, Radelet, and Bhavnani (2004) find that while there is no discernible relationship between growth and overall aid, when aid flows are divided into aid that has short- and long-term impact, the former has a strong and statistically significant causal relationship with economic growth.

Findings that support a positive impact of aid on economic growth in some of the studies cited have been challenged more recently by papers that have used updated data sets or different model specifications. Easterly, Levine, and Roodman (2004), for example, find that the aid effectiveness results in Burnside and Dollar (2000) are not robust to a data set with longer time series that covers additional countries. While Easterly, Levine, and Roodman do not argue that aid is ineffective, they suggest that "economists and policymakers should be less sanguine about concluding that foreign aid will boost growth in countries with good policies." Rajan and Subramanian (2005) also find little evidence of a robust positive impact of aid on growth. They find evidence of such a relationship for the period 1980–2000 only when outliers are included in the data set. They also find no evidence that aid works better in stronger policy environments, as suggested by Burnside and Dollar (2000), or that certain kinds of aid work better than others, as suggested by Clemens, Radelet, and Bhavnani (2004).

Figure 18. Tanzania: Aid-to-GDP Ratio and GDP Growth
(Percent)



Sources: WEO, OECD DAC database, IMF staff estimates.
2008 data are estimates.

2000–07. Meanwhile, the share of aid in the form of technical assistance declined by about ¾ percent of GDP.

In Tanzania the data suggest a positive correlation between aid flows and real GDP growth from the mid-1970s through the early 1990s (Figure 18). Notably, the surge in aid that started in 1987 after initiation of the ERP corresponded with a significant growth acceleration. While the causality is not clear, it is likely that aid, particularly donor-funded infrastructure projects, did stimulate the economy, particularly because there was an ample supply of underutilized labor.

Since the early 1990s, however, the direction and the correlation between growth and aid seem to have varied considerably (Table 5). In particular, growth decelerated abruptly in the first half of the 1990s relative to earlier years despite higher aid receipts. Moreover, while growth is currently the highest it has been since the 1970s, the ratio of aid to GDP is significantly lower than its average in the 1980s and 1990s.

These trends indicate low aid efficiency until the early 1990s. The acceleration in economic growth during 1987–90 was not commensurate with the dramatic increase in investment that took place. Fueled by significantly higher foreign assistance starting in 1987, investment more than doubled compared with the early 1980s, but its efficiency was low (Nord and others, 1993), mainly because of the dominance of the large and inefficient parastatal sector, which for many years absorbed the bulk of both domestic

Table 5. Tanzania: Growth and Aid Trends
(Percent)

	1986-90	1991-95	1996-2000	2001-08
GDP Growth	5.7	1.8	4.0	7.1
Aid to GDP ratio	16.3	19.5	10.8	13.7

Source: WEO, OECD's DAC database, Fund staff estimates

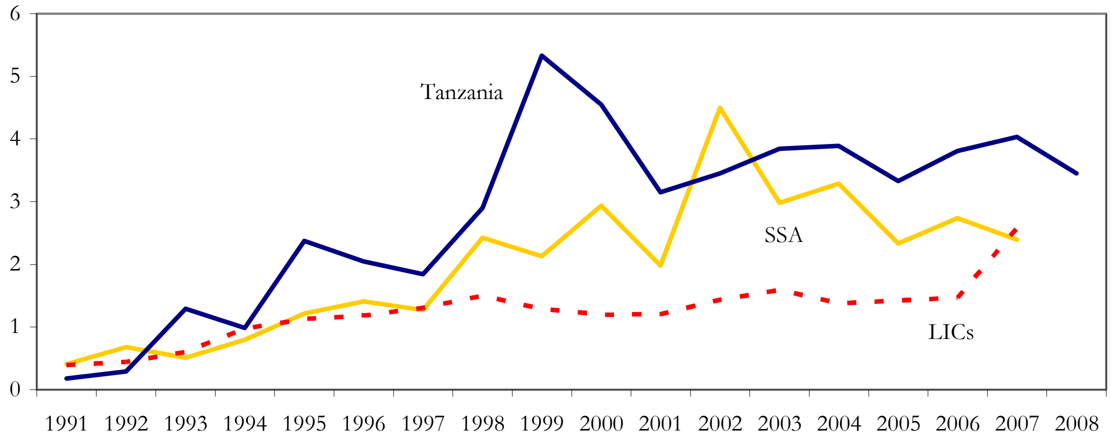
and foreign savings. Limited administrative capacity to absorb the large amounts of foreign assistance was also a factor.

The significant structural reforms that have taken since the mid-1990s—particularly banking sector reform and the extensive privatization of loss-making enterprises—and the gradual shift in aid delivery from project and technical assistance to direct budgetary support seem to have considerably increased aid effectiveness in recent years. The increase in the aid to GDP ratio for 2001–07 relative to the second half of the 1990s, by contributing to the significant rise in capital accumulation during this period (see below), has had a positive role in the recent growth acceleration. These recent developments in Tanzania thus seem to support the view that where economic policies are generally sound, more aid has a positive, hopefully lasting, impact on growth.

Major increase in foreign direct investment

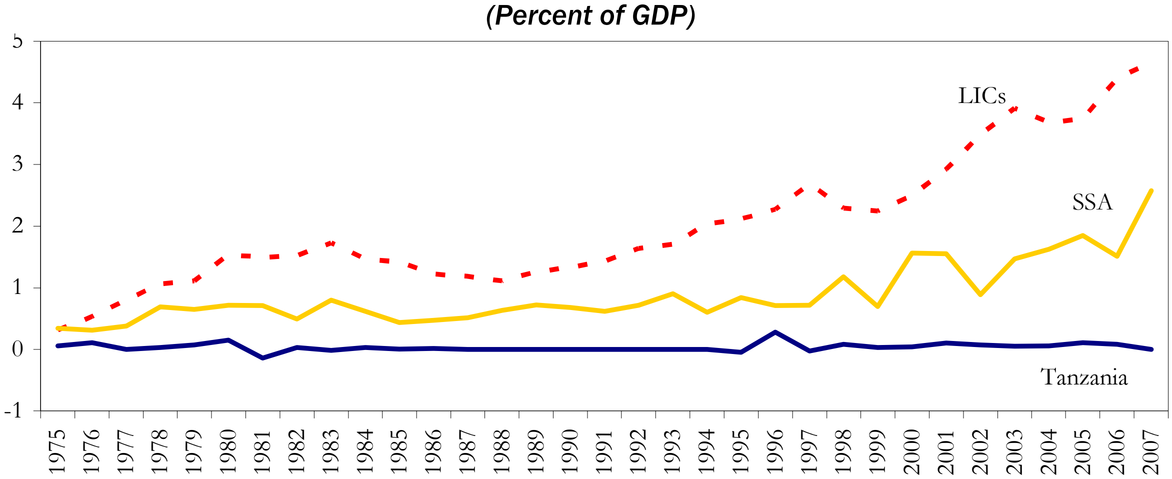
Since the mid-1990s Tanzania has been more successful than other countries in sub-Saharan Africa, and low-income countries in general, in attracting foreign investments. Foreign direct investment (FDI) flows to Tanzania increased gradually during the 1990s to a peak of about 5¼ percent of GDP in 1999 and have since stabilized at about 4 percent (Figure 19). This increase has coincided with higher capital formation in Tanzania, and a brisk acceleration in total factor productivity (see below). The mining sector was the largest recipient for 2001–05 with a share of 30 percent of total FDI inflows. Though this contributed to rapid growth of the mining sector, mining contributes relatively little to Tanzania's GDP. More recently, foreign investors have been showing increasing interest in Tanzania beyond the traditional mining sector and in such areas as tourism, agriculture, and manufacturing, which hold promise of becoming the basis for sustained growth and employment creation in the years to come. Actual FDI inflows, however, while growing steadily, fell significantly short of the overall level of interest registered, reflecting in part the continued difficulties of doing business in Tanzania.

Figure 19. Foreign Direct Investments
(Percent of GDP)



Sources: WEO, World Bank's World Development Indicators, and IMF staff estimates.
2008 figures are estimates for Tanzania.

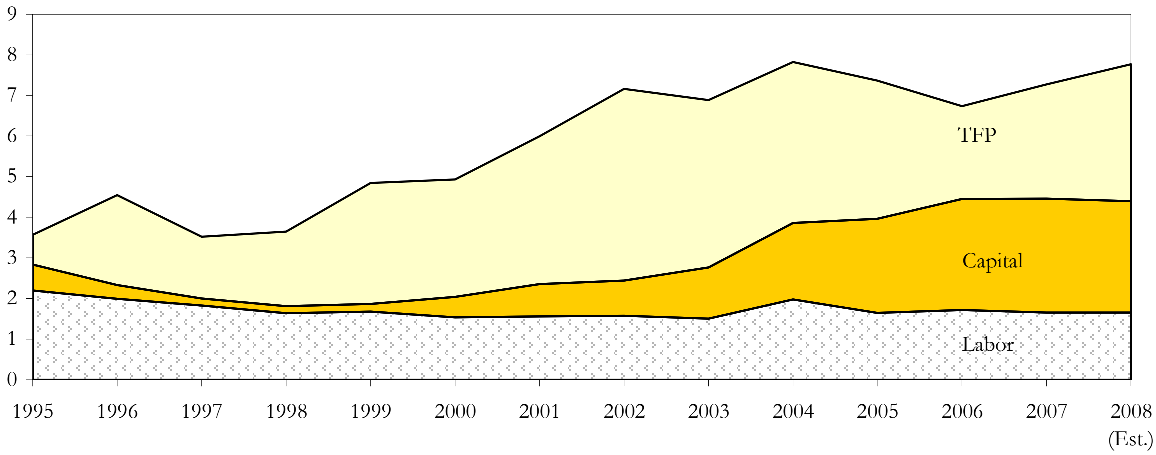
Figure 20. Non-FDI Private Inflows
(Percent of GDP)



Sources: WEO database; World Bank's World Development Indicators.
2008 figures are estimates.

Non-FDI private flows to Tanzania (portfolio and private lending), however, are well below the SSA and LIC averages, reflecting the relatively closed capital account and the limited borrowing capacity of the private sector (Figure 20).

Figure 21. Tanzania: Contributions to Real GDP Growth
(Percentage points)



Sources: IMF staff estimates; Tanzanian authorities.

Table 6. Tanzania: Contributions to Real GDP Growth
(Percentage points)

	1986–90	1991–95	1996–2000	2001–08
Real GDP growth	5.3	1.8	4.3	7.1
Labor force	2.2	2.5	1.7	1.7
Capital	0.9	1.3	0.3	1.9
Total factor productivity	2.2	-2.0	2.3	3.5

Sources: IMF staff calculations.

Acceleration of total factor productivity

The rise in real GDP growth in Tanzania since the mid-1990s has been achieved mostly through improvements in the TFP (Figure 21 and Table 6). Since 2000, increased investment in physical capital has also contributed to growth, whereas the contribution of direct labor force participation has been declining in importance—see also World Bank (2007) for a comprehensive growth accounting exercise.[25]

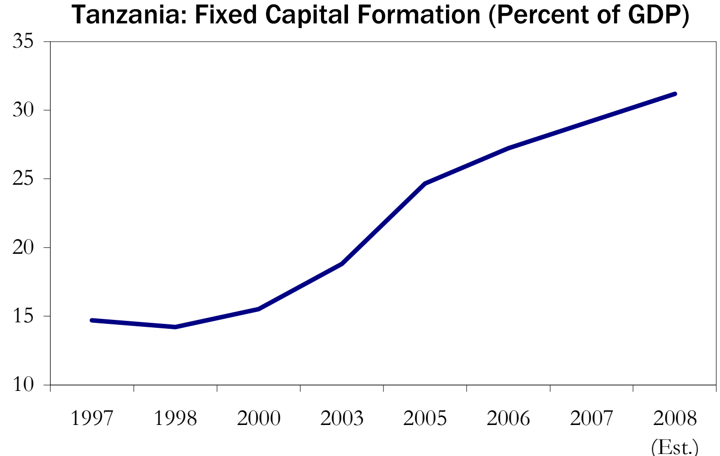
[25]These findings confirm earlier research by Treichel (2005).

Box 16. Estimating Total Factor Productivity in Tanzania

Real GDP growth in Tanzania picked up in the mid-1990s as stabilization was cemented and structural reforms started to bear fruit. It continued to accelerate, averaging about 7 percent annually for 2001–07, more than double the average growth rate of the 1980s and 1990s. Earlier research has shown that such an increase can be attributed to the growth in total factor productivity (Treichel, 2005).

TFP growth is measured as the Solow residual using the conventional Cobb-Douglas production function with constant returns to scale. Growth accounting analysis can be sensitive to the choice of α— the share of capital in the production function—and to the estimation of the capital stock. Collins (2004) estimated TFP for 84 countries, including Tanzania, and used a conventional value of α equal to 0.35; while Senhadji (1999) estimated a Cobb-Douglas production function for 66 countries using OLS and Modified OLS techniques and arrived at an estimate of α equal to 0.25 for Tanzania.

Tanzania: Fixed Capital Formation (Percent of GDP)



Sources: IMF staff estimates, WEO database.

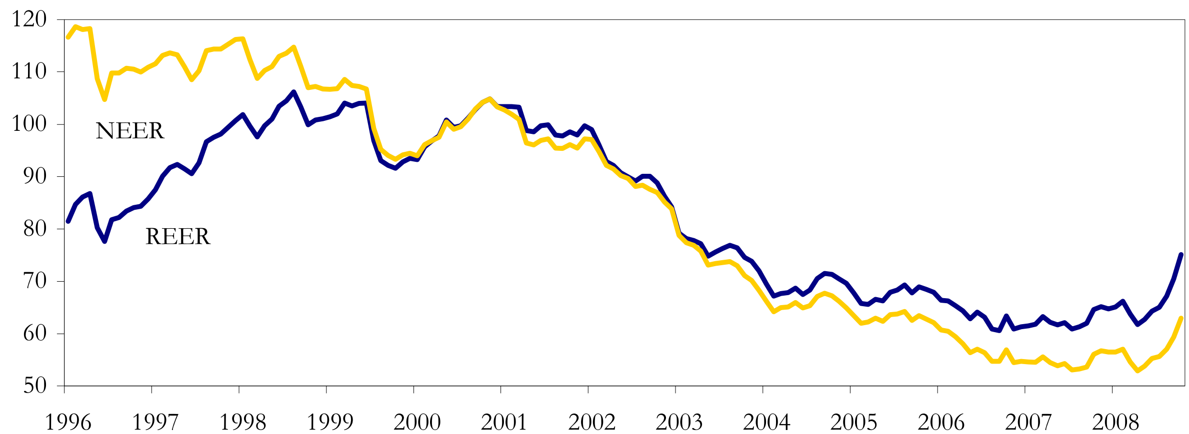
Extending the earlier analysis of TFP in Tanzania into 2007 confirms the previous findings. Using data from 1985 to 2007 and the perpetual inventory method for estimating capital stock, the production function was estimated using OLS following the methodology by Senhadji (1999); this yielded an α estimate of 0.31. The results point to a clear upward trend in TFP since the mid-1990s.

While higher aid and FDI have both contributed to a significant increase in capital accumulation, the recent growth acceleration is largely due to improvements in TFP thanks to remarkable progress with structural reforms and macroeconomic stability that resulted in TFP acceleration and led to a virtuous cycle of higher growth and investment (Box 16).

Impact of Higher Aid and FDI on the Real Exchange Rate and Competitiveness

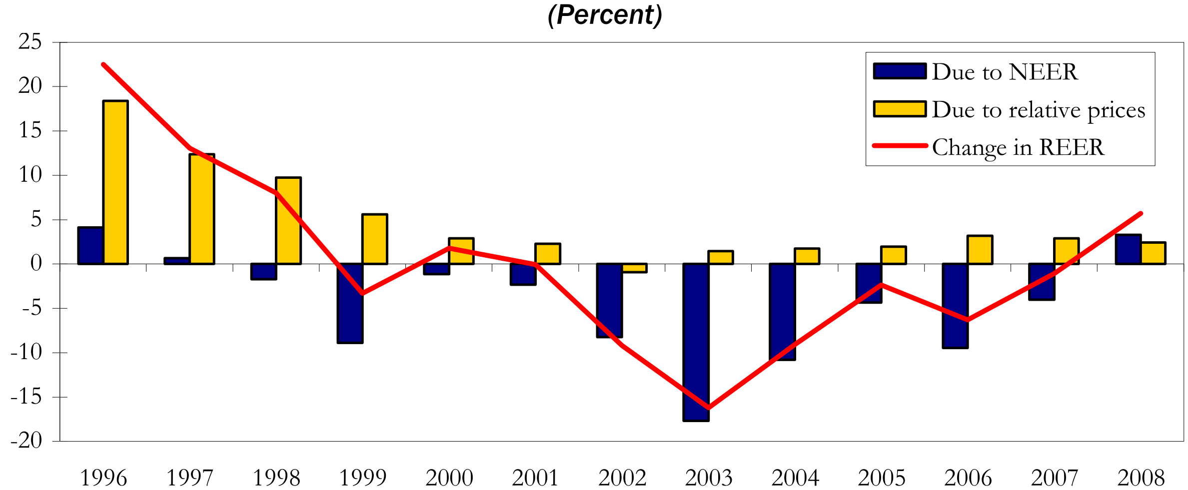
The exchange rate–based stabilization program the authorities adopted in mid-1990s managed eventually to bring down inflation to the low single digits, but only very gradually, which contributed to a significant real appreciation of the shilling in the second half of the 1990s (Figures 22 and 23). As a result, the surge in FDI in the late 1990s, the gradual increase in donor aid, and the shift in aid toward direct budget support complicated the management of economic policy.

Figure 22. Tanzania: Trends in REER and NEER
(Index, 2000=100)



Source: INS database.
2008 data through October.

Figure 23. Tanzania: Decomposition of Changes in the CPI-Based REER
(Percent)



Sources: INS database, IMF staff estimates.
2008 data through October.

Table 7. Tanzania: Aid Absorption and International Reserves
(Percent of GDP, unless otherwise indicated)

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Current account balance (excluding official grants)	-8.5	-7.5	-10.5	-10.1	-12.6	-13.0	-14.2
Program and project external assistance (including grants)	7.4	7.2	7.9	9.6	10.3	9.4	8.5
of which: Program assistance	3.2	4.5	5.1	5.5	5.5	5.0	5.9
Capital and financial account (excluding aid flows)	2.8	4.7	4.3	2.2	1.6	5.5	8.2
of which: FDI	3.6	4.0	4.1	3.5	3.8	4.3	3.8
Change in reserves (-, increase)	-1.7	-4.3	-1.7	-1.7	0.7	-1.9	-2.5
International reserves							
- in US$ million	1,184	1,670	1,878	1,969	1,863	2,153	2,649
- in months of imports	5.9	6.7	5.9	5.0	3.9	3.6	3.8

Sources: Tanzanian authorities, IMF staff calculations.
Note: Current account balance includes errors and omissions.

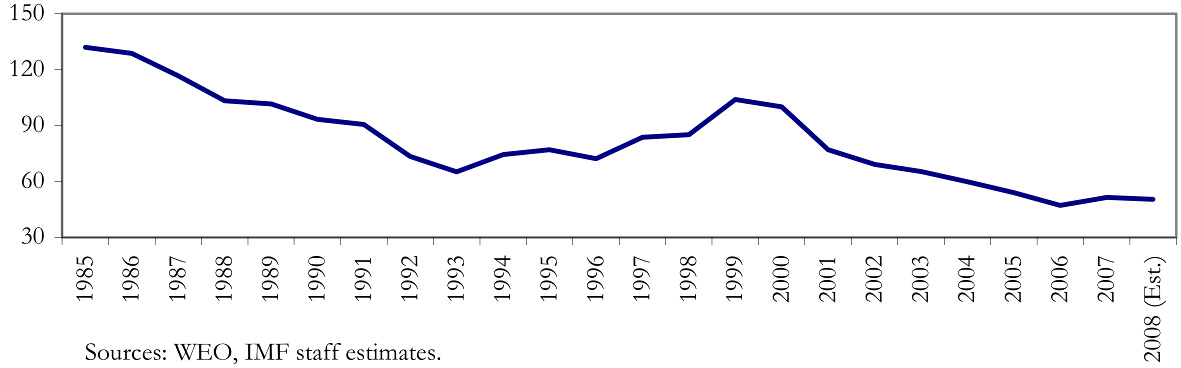
For instance, concerned about Dutch disease effects from the real shilling appreciation since the mid-1990s, the BoT started in early 2001 to limit foreign exchange sales, thus reducing the mopping up of liquidity from aid-financed government spending. This stimulated rapid accumulation of international reserves and an abrupt decline in the current account deficit. In 2002/03, international reserves increased by about 4¼ percent of GDP, and the current account deficit declined by 2¼ percent of GDP, even though aid and other capital inflows were basically unchanged from the previous year (Table 7).

This strategy of engineering a nominal exchange rate depreciation when aid and other capital inflows were high could not be sustained, however, as the rate of reserve money growth spiked sharply, reaching 40 percent in late 2002. In response the BoT first tried to sterilize the excess liquidity through liquidity paper, but this quickly pushed up interest rates. By mid-2003 the BoT had moved to a more balanced strategy for reducing the aid-related liquidity injections, with a combination of higher foreign exchange sales and lower issuance of liquidity paper.

Despite the shift in monetary policy in mid-2003, the real effective exchange rate of the shilling continued to depreciate through mid-2006, mainly because the rapid deterioration in Tanzania's terms of trade (Figure 24). The latter was due to the sharp increase of the oil price, which has more than offset the significant increase in the price of Tanzania's main commodity exports (gold, coffee, cotton, tea, and tobacco).[26] Higher commodity prices led to a deterioration in the balance of payments of 1–1½ percent of GDP annually for 2004–06.

[26]As a result of higher oil prices, in 2006/07 oil imports increased to about $1.3 billion (8¾ percent of GDP), exceeding the $1.1 billion in receipts from exports of gold and other traditional commodities.

Figure 24. Tanzania: Terms of Trade for Goods
(Index)



Sources: WEO, IMF staff estimates.

Box 17. Assessment of Tanzania's Real Exchange Rate

A recent IMF staff study concluded that the depreciation in Tanzania's real exchange rate in recent years reversed the moderate overvaluation of the early 2000s, and that in early 2008 the REER was modestly undervalued relative to the estimated equilibrium level (Hobdari, 2008).

Traditional equilibrium real exchange rate analysis using both panel data and single-country estimates points to an undervaluation of the REER as of early 2008 by 2¼ to 30 percent. Using the external sustainability approach, estimating the level of the exchange rate that is consistent with stabilizing net foreign assets at the mid-2007 level, confirms the undervaluation but would suggest a lesser magnitude, in the 0–10 percent range.

The rate of export growth since the turn of the decade supports a solid recovery in competitiveness. However, the moderation in the rate of export growth since 2005, together with the fact that the overall balance of payments surplus has in recent years declined as a share to GDP, would also support an undervaluation of about 0–10 percent.

Tanzania: Nontraditional Exports Growth
(Percent)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total goods and non-factor	26.3	-13.9	-8.0	3.4	12.2	9.5	12.2	25.4	26.8	15.9	15.6	20.1
Total goods	12.4	-3.2	-20.9	-7.7	22.1	17.1	19.1	24.8	25.3	15.3	14.0	22.8
Gold	24.5	-8.6	-48.6	179.0	143.1	69.7	28.2	36.4	26.6	8.7	12.1	15.3
Manufactured goods	8.4	-6.1	-20.5	-18.0	13.9	26.5	29.9	27.7	24.6	18.2	12.6	23.8

Source: Bank of Tanzania.

Looking forward, higher GDP growth in Tanzania relative to its trading partners and an expected recovery in its terms of trade suggest a trend appreciation of Tanzania's equilibrium REER of about 1½ percent a year. However, capital inflows could be significantly higher than under this baseline, reflecting (1) a further acceleration of FDI and other private sector inflows to take advantage of Tanzania's natural resources and strong policy framework; (2) higher external public borrowing to address infrastructure bottlenecks; and (3) a possible scaling up of aid as promised by donors to reach the MDGs. If so, such higher inflows could justify an additional appreciation of the equilibrium REER by an estimated 5–22 percent relative to the baseline.

Thus there has been no real evidence of Dutch disease in Tanzania from the surge in aid and FDI except for a brief period in the early 2000s. A recent IMF staff study concluded that as of early 2008 Tanzania's real exchange rate was modestly undervalued (Box 17).

Aid, Social Services, and Poverty Reduction

The large increase in aid in the recent years has contributed to the rapid expansion of government spending. In the past few years external assistance has financed about 40 percent of government expenditure (Figure 25). Between 2000/01 and 2006/07, public spending increased by over 8 percentage points of GDP, from about 15 percent of GDP to 23½ percent. Meanwhile, revenue collections increased by about 3½ percent of GDP. The difference, about 5 percent of GDP, was financed by external aid, though spending on priority sectors and, since 2005/06, on MKUKUTA clusters has grown faster than development assistance (Figure 26).

In spite of these efforts, the preliminary results of the latest household budget survey (HBS), conducted in 2007, provide a mixed picture regarding poverty reduction.[27] The data show substantial improvements in education and health outcomes (confirming the positive trends in these areas described in the MKUKUTA Annual Implementation Reports—MAIRs),[28] significant increases in assets, and improved residences. However, income poverty declined only marginally in relative terms and, given rapid population growth, implies an increase in the absolute number of Tanzanians living in poverty.[29] Analysis of the data is ongoing but the results are broadly consistent with budgetary allocations that prioritized education and health, with agriculture (where majority of the population derive their livelihood) lagging behind. These results indicate that while there has been some progress in the fight against poverty in recent years, more is needed.

Scaling Up or Scaling Down?

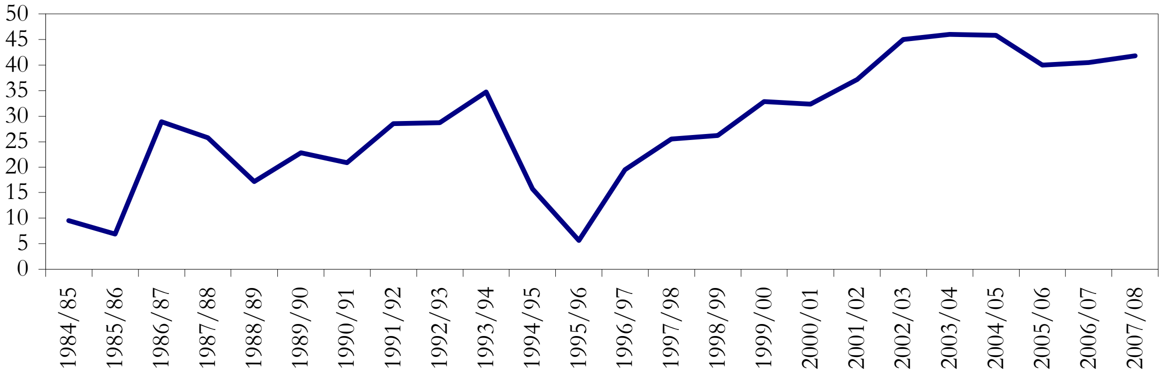
Higher levels of foreign assistance in recent years have created welcome fiscal space, and the growing share of direct budget support has facilitated budget management. In the short term, there is scope for further scaling up of

[27]The HBS report can be found at http://www.nbs.go.tz/.

[28] The MAIRs are available at http://www.povertymonitoring.go.tz.

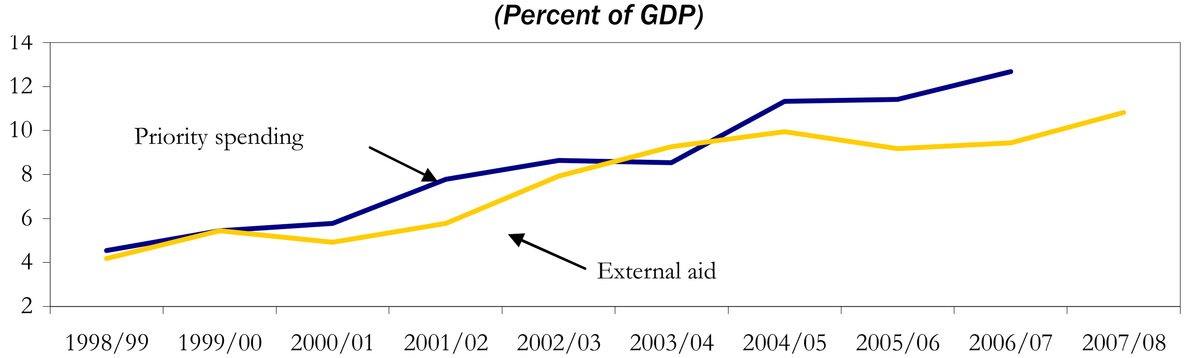
[29]The 2007 HBS indicates that the incidence of poverty declined from 35.7 percent in 2001 to 33.3 percent in 2007.

Figure 25. Tanzania: External Financing of Government Expenditure
(Percentage points)



Sources: Tanzanian authorities, IMF staff estimates.

Figure 26. Tanzania: External Aid and Priority Spending
(Percent of GDP)



Sources: IMF staff estimates; Tanzanian authorities.
2007/08 figures are estimates.

foreign assistance. Domestic revenue efforts have not been eroded by foreign financing; on the contrary, the tax base has widened. Nor have aid inflows caused an undue appreciation of the exchange rate; in fact, export growth has continued to be healthy. If public financial management is further strengthened to ensure efficient spending of aid resources and monetary policy continues to respond flexibly to potentially volatile inflows, more aid can help address pressing social and infrastructural needs. Over time, however, aid dependency can be reduced. With a stronger domestic revenue base, growing private FDI, and eventual access to sovereign bond markets, foreign assistance will become less critical—but only if Tanzania's capacity to manage debt is expanded.

CHAPTER

6 Challenges for the Future

Building on Achievement

Tanzania has made remarkable progress over the past two decades. It has achieved, and maintained, macroeconomic stability. The structural transformation of the economy was gradual, but once a critical mass of structural reforms was in place, growth and poverty reduction accelerated. The combination of economic stability and faster growth resulted in a virtuous circle in which higher private investment, foreign as well as domestic, fueled economic growth, which in turn boosted tax revenues. Together with rising foreign assistance, including comprehensive debt relief, this created much-needed fiscal space to finance government priorities.

What lessons have we learned? With hindsight, the pace of reform in the first decade may have been too tentative. In particular, the cost of postponing the inevitable liquidation and restructuring of public enterprises was high: persistent inflation and low growth. Critical momentum came when the financial sector was opened up; this provided both much-needed discipline to public enterprises and financing for the renascent private sector, and it immediately made monetary policy more effective. Equally important was the establishment of sound public institutions. A modern tax system and disciplined strong revenue administration gives Tanzania a domestic resource base to finance government priorities. Stronger PFM ensures more effective use of public money. Although there is ample scope for further improvement, particularly on PFM, sound public institutions were surely essential for Tanzania's success.

Nevertheless, Tanzania is still poor. The critical challenge, therefore, is to sustain the momentum gained over the past decade and the levels of economic growth that allow the country to address its development priorities. At the same time, the international environment is likely to be more challenging for some years to come. And in this regard, the current global financial turmoil presents an unprecedented challenge for Tanzanian policymakers.

Tanzania is well-placed to meet these challenges. In the short term, a relatively sound financial system and some room for flexibility in macroeconomic policies should help cushion the impact of the global financial crisis.

However, sustaining the reform effort today in spite of the crisis will require perseverance. For the coming years three economic priorities stand out:

- Public finances will need to balance higher levels of public investment, notably in much-needed infrastructure, with more efficiency in public spending and a sustainable level of public debt. Further expanding the domestic revenue base, sound public financial management practices, and better public debt management practices will be critical.
- Access to financial services must expand, supported by a prudential supervision that ensures continued financial sector soundness.
- Legal and regulatory reforms will be needed to promote robust expansion of the private sector. In the long run, only the private sector can generate economic growth and create jobs.

Broadening the Revenue Base, Making Public Spending More Efficient, and Improving Public Debt Management

Foreign assistance will remain important, at least in the immediate future, because Tanzania's needs far exceed its domestic financing capacity, but in the long term, reducing aid dependency must be a priority for economic policy. And, although Tanzania has done a great deal to consolidate its public finances, as it raises spending in coming years to address critical social and infrastructural needs, public finances will face three critical challenges.

First, the revenue base must be broadened even further. Despite modern tax laws and tax administration, Tanzania still brings in relatively little tax revenue. Raising the tax-to-GDP ratio to 20 percent, as the TRA's five-year corporate plan envisages, is the right objective. To achieve it, reinforcing tax administration by, e.g., reducing tax exemptions, and moving into undertaxed areas like natural resources, should be priorities.

Second, to ensure that increased spending yields results on the ground, public spending must become more efficient. Current efforts to strengthen public financial management must be accelerated. More generally, Tanzania needs to upgrade its civil service and government institutions to ensure that public services are adequate. Reforms must therefore encompass the government as a whole, especially line ministries and local government, whose share of spending is increasing.

Finally, innovative financing for large infrastructure projects, perhaps through public-private partnerships or financed on commercial terms, will require an enhanced capacity to assess fiscal risks, disciplined public procurement, and strengthened public debt management.

Extending Financial Sector Reform

Thanks to far-reaching reforms of the financial sector over the past decade, Tanzania now has a diversified banking system and a small but growing capital market. Bank supervision standards meet international norms, and the banking sector is considered sound.

Nevertheless, despite rapid growth in recent years, the financial sector remains small. Expanding access to financial services will be critical for both economic growth and poverty reduction. Major bottlenecks are the legal framework, particularly for land ownership and use of land as collateral, and an inadequate court system. The amendment of the Land Act and the Condominium Law now being drafted are steps in the right direction. Finally, gradual capital account liberalization should help attract longer-term sources of savings.

As financial deepening accelerates, prudential regulation and financial sector supervision will need to be tuned to oversee a fast-growing and diversifying financial system. Further progress toward risk-based supervision is therefore important, as is tighter regulation of the rapidly growing NBFIs, especially pension funds. Because financial integration within the EAC, which is proceeding apace, will reduce the room for its member countries to maneuver, regional harmonization will be particularly important.

Accelerating Private Sector Development and Reducing Bottlenecks to Growth

Private sector development will be critical to not just sustaining but raising long-term growth prospects. What continues to undermine investment and private sector activity in Tanzania are lack of adequate physical infrastructure and lack of skilled labor at the vocational and managerial levels. These will take time to address. However, other shortcomings that increase costs and risks for business can be addressed expeditiously. Two areas stand out: streamlining regulation and harmonizing trade reform, especially within the EAC.

Despite some improvement in the business environment in recent years, dealing with the plethora of regulatory and licensing bodies that finance themselves through the fees they impose—in effect, nuisance taxes—is a major burden, particularly on small and medium-sized enterprises. The new Land Law is being implemented only slowly, especially in rural areas, and foreclosing on land collateral upon default remains difficult. The creation of commercial courts has improved the dispute resolution system, but the courts remain understaffed and ill-equipped. Inability to enforce contracts in a business-friendly and timely manner is thus discouraging bank lending and private investment. And determined efforts to combat corruption and strengthen governance will also be critical to improving the environment for private investment, both domestic and foreign.

Tariff barriers have dropped dramatically in recent years, but nontariff barriers—customs and administrative procedures, regulations and licenses, and labor mobility—are still raising the cost of doing business and hampering trade in the region. Priorities for the EAC will be to harmonize investment codes and rules of origin; introduce uniform cargo clearance procedures; and standardize regulations, metrology, and product quality standards. However, overlapping memberships in the SADC and COMESA trade groupings will complicate harmonization; common standards across different regional groupings in Africa should be pursued.

Achieving Lasting Poverty Reduction

Economic growth alone cannot ensure sustained development or lasting poverty reduction, but it is an essential prerequisite. The keys to Tanzania's success over the past two decades have been perseverance and ownership. Indeed, persevering with good policies despite initially slow progress has been possible only because Tanzania has been able to generate widespread ownership of the reform process.

Looking ahead, however, this ownership may face challenges in the face of a more difficult global environment and mixed progress domestically on poverty reduction. Renewed commitment to sustain reforms will be key. The need to maintain ownership puts a premium on priority spending, particularly infrastructure investment and agricultural development, which are both critical for rural economic development. The challenges are significant. But thanks to the work done, Tanzania is well placed to meet them.

APPENDIX

1 IMF Involvement in Tanzania

IMF involvement in Tanzania's economic transformation and programs has evolved in three phases: liberalization, 1986–95; macroeconomic stabilization and structural reform, 1996–2006; and consolidation of reforms and policy support since 2006 (Table A1).[30]

The major challenge for Tanzania at the outset of Fund engagement with the country was to stabilize the economy. Once this objective was met, the overarching challenge was to accelerate growth and reduce poverty by emphasizing private sector development and reorienting public expenditure toward social and infrastructure priorities. The Fund-supported programs generally met their objectives: the economy was stabilized by the end of the 1990s, and significant structural and fiscal reforms created a virtuous cycle of high growth and poverty reduction, financed by increasing FDI and development partner support.

Throughout, IMF-supported programs in Tanzania have had a significant technical assistance component, which was crucial for building the capacity to implement successful and durable reforms. These programs were also instrumental in Tanzania's obtaining debt relief under the HIPC and MDRI initiatives.

Liberalization and Partial Reforms, 1986–95

In the first period the Fund committed financial support of $445 million to programs to reduce inflation, contain the budget deficit, and restore the balance of payments equilibrium by transforming the economy to be more market based. However, actual drawings were only $284 million because the programs were not fully implemented.

[30]Between 1975 and 1985 the IMF's Executive Board approved two standby arrangements, but because reform moved slowly over that period, the programs went off-track and the approved loans were only partially disbursed.

Table A1. Tanzania: History of IMF Programs
(US$ million)

Facility	Date of Arrangement	Date of Expiration or Cancellation	Amount Approved	Amount Drawn	Amount Outstanding
PSI	Feb 16, 2007	Feb 15, 2010	n/a	n/a	n/a
PRGF	Aug 16, 2003	Aug 15, 2006	29.1	16.7	17.4
PRGF*	Apr 04, 2000	Aug 15, 2003	175.9	182.4	210.1
ESAF/PRGF*	Nov 08, 1996	Feb 07, 2000	232.4	222.1	172.5
ESAF	Jul 29, 1991	Jul 28, 1994	260.2	122.4	0.0
Structural Adjustment Facility	Oct 30, 1987	Oct 29, 1990	106.3	106.3	0.0
Standby Arrangement	Aug 28, 1986	Feb 27, 1988	78.5	55.6	0.0
Standby Arrangement	Sep 15, 1980	Jun 30, 1982	229.1	31.9	0.0
Standby Arrangement	Aug 21, 1975	Aug 20, 1976	12.3	0.0	0.0

Source: IMF.
*The approved amount was disbursbed; the discrepency is due to exchange rate fluctuations.

Table A2. Tanzania: Key Program Policy Objectives and Reforms in 1986–95

Key Objectives (1986-1995)	Outcome (end of period)	TA Focus
Macroeconomic objectives		
Real growth rate of >4%	GDP growth 4.5%	Statistics: Government finance statistics; balance of payment; external debt; money and banking; prices; production; and national accounts
Tight monetary policy; reduce inflation to > 10%	Inflation 25%	
Balance of payment sustainability	Achieved	
Fiscal deficit reduced to 6% of GDP	Achieved	
Structural reforms		
Interest rate liberalization	Achieved	Monetary: banking supervision, Policy implementation; operation of forex and T-bill auction; bank supervision
Exchange rate unification	Achieved	
Elimination of price controls	Largely achieved	
Improvement of price incentives for export crops	Partially achieved	
Reform of the crop marketing boards and National Milling Corporation	Partially achieved	
Financial sector reform; increased competition and entry of foreign and private banks	Implemented	
Parastatal reform: designing a privatization plan and refraining from financing unviable companies	Initiated	Fiscal: Tax system and administration; Public expenditure management; VAT
Restructuring of public sector banks	Not done	
Sales tax reform	Initiated	
Civil service pay reform	Implemented	
Improve revenue collection	TRA established	

Source: IMF.

At that early stage some major reform measures were implemented, notably unification of the exchange rate; liberalization of banking sector interest rates; and reform of public finance by increasing government savings, shrinking the budget deficit, switching to noninflationary financing mechanisms, and initiating parastatal and financial sector reforms (Table A2).

Macroeconomic Stabilization and Core Structural Reforms, 1996–2006

In the second phase of reform, IMF-supported programs aimed at consolidating previous achievements, fostering macroeconomic stability, and launching the economy on the path of sustainable high and broad-based growth that was necessary for reducing poverty. To this end successive PRGF programs focused on further restructuring parastatals and the financial sector to create conditions conducive for investment and private development (Table A3). Financial sector development and improving the business environment were given considerable attention. A comprehensive program of financial deepening was drawn up based on the joint IMF–World Bank Financial Sector Assessment Program, and determined efforts were made to improve economic governance.

The Fund provided analytical support for macroeconomic and structural policy development; deepened its technical assistance for capacity building; and extended concessional financing of about US$400 million, which catalyzed donor support and was instrumental in Tanzania's obtaining HIPC and MDRI debt relief. With IMF support Tanzania reached the enhanced HIPC completion point in 2001, unlocking debt relief of over US$2 billion in NPV terms. In 2007, under the MDRI, the IMF cancelled 100 percent of the remaining debt, which amounted to $336 million.

The PSI Era

As aid inflows surged, Fund financing became far less critical for Tanzania than assistance in the formulation of policy, first to anchor macroeconomic stability and then to provide a basis for sustaining growth and improving the efficiency and competitiveness of the economy. With the PSI the Fund continues to provide policy advice and signaling to development partners and the market to help Tanzania achieve a virtuous cycle of faster growth and poverty reduction based on higher public spending supported by FDI and donor inflows.

The PSI, which supports Tanzania's continuing efforts to attain high and sustainable broad-based growth and speed up poverty reduction, has three core themes: (1) mobilizing more public resources and making spending more efficient; (2) increasing the financial sector's contribution to growth and the effectiveness of monetary policy; and (3) improving the business environment to encourage private investment.

Table A3. Tanzania: Key Program Policy Objectives and Reforms in 1996–2006

Key Objectives (1996-2006)	Outcome (end of period)	TA Focus
Macroeconomic objectives		
Real growth rate > 6%	GDP growth >7%	Statistics: monetary, balance of payment, price, and national accounts
Contain inflation at 5%	Inflation at 6%	
International reserves at 4-months of imports	Achieved	
Maintain fiscal discipline	Achieved	
Structural reforms		
Financial sector reform and financial deepening: Increased competition from foreign and private banks; restructuring and privatization of public banks; legal reform to use land as bank collateral	Restructuring NBC; partial privatization of NMB; insurance sector liberalization; stock exchange establishment; FSAP and second generation reforms; amendment to the Land Act	FSAP; banking supervision; credit reference database; prudential regulations
Parastatal reform and privatization	Achieved; over 100 public companies were removed from government control	
Improving public expenditure control	Improved cash management system; PFM and public audit bill enacted	Public expenditure management; budget execution; cash management system; duty draw bank system; fiscal decentralization; fiscal transparency and reporting according to Observance of Standard and Codes system (ROSC); tracking poverty-reducing spending
Domestic revenue mobilization and tax reform	VAT introduced; harmonization of import tax between Zanzibar and mainland; TRA corporate plan; Large tax payer department established; new income tax law	Tax policy; tax administration; VAT tax; income tax review; mining taxation; macro-fiscal analysis; income-tax law
Civil service reform	Reduced public sector employment and pay system reform;	
Trade liberalization	EAC and SADC membership	EAC tax harmonization; customs administration;
Improving governance and the investment climate	On-going; NACSAP; PCCB	
Improving monetary policy operations	On-going; New BoT act	Monetary: Monetary management and policy instrument; forex and T-bill operations; domestic debt-market development; BoT accounting and organizational structure; central and commercial bank legislation reform; foreign exchange act; national payment system bill

Source: IMF.

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