

**ECONOMIC AND SOCIAL RESEARCH FOUNDATION
(ESRF)**

**Investment, Foreign Aid and Self Reliance in
Tanzania: A State-of-the-Art Review**

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ESRF Discussion Paper Series No. 001

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(ESRF)
51 Uporoto Street (off Ali Hassan Mwinyi Road)
Ursino Estates
P. O. Box 31226
Dar es Salaam.

Desktop publishing by A. A. Kasango and V. N. Mwanukuzi.

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PREFACE

A study of Investment, Foreign Aid and Self Reliance is one of the six major themes in the ESRF Research Programme.

Since the mid-1980s Tanzania's economy has been growing at 3-4% per annum. During 1993 the growth of the GDP rose to 4.1%. However, these growth achievements are still below the target growth rate of 4.5% per annum and much below the target of 6% envisaged by 1997. A more fundamental question is whether a higher rate of growth can be attained and be sustained in the absence of a corresponding growth in investments. Of particular concern is that the period of economic reforms has been characterized by the failure to recover investment. For instance, during 1992 and 1993 investment (capital formation) declined by 3.5% and 3.2% respectively. This suggests that the growth of the economy may have been achieved through the more efficient use of existing capacities rather than through the creation of substantial additional capacities. While this source of growth may appear to be appropriate in the short run, it is not likely to be sustainable in the medium and long term. In the past (especially during the 1970s) emphasis was placed on high levels of state-led investment paying little attention to the productivity of those investments. More recently, (from the mid-1980s) growth seems to have recovered without being accompanied by a corresponding increase in the level of investment. This recovery of growth may have originated from the more efficient utilization of existing investments (through rehabilitations and availability of intermediate inputs). This shift from capacity expansion to capacity utilization in itself is not likely to lead to sustainable growth. For sustainable growth to be attained, priority needs to be given to the question of encouraging and stimulating investment recovery in parallel with the creation of a balance by enhancing the productivity of those investments.

The rather ambitious state-led investment programme which was implemented particularly in the 1970s outstripped the domestic capacity to accommodate it in terms of domestic savings, foreign exchange and the budget. One approach that Tanzania adopted to close these three gaps (in domestic savings, foreign exchange and in the budget) was through attempts to mobilize foreign aid resources from various donors. These foreign resources were supposed to facilitate the attainment of self reliance presumably in the not-too-distant future. The dynamics of aid and the role of donors seem to indicate that self reliance itself is itself in danger. The role of aid in the mobilization of domestic, financial, human and natural resources has been put to question. The relationship between aid and self-reliance has been changing and perceptions of this relationship are changing. Donor fatigue is one response to this perception. There is need to understand more deeply the relationship between aid and donor activity on one hand and the role of domestic development agents in achieving self reliance on the other.

Policy research on investment will cover the following sub-themes: studying the mechanisms for domestic resource mobilization; policies for creating conditions to encourage and stimulate all forms

of investment (domestic and foreign, formal and informal, public and private); investment policies and the need for striking a balance between various forms of investment; the possibilities, options and implications of promoting investment by indigenous entrepreneurs; the role of policy in influencing the content and pattern of investments; the relationship between aid and self-reliance and the new role of aid in complementing the policy reform process.

ESRF engaged Bartholomew M. Nyagetera of the ERB, University of Dar es Salaam, to undertake a state-of-the-art review on Tanzania's experience in foreign investment and domestic mobilization experience since independence. This study also identifies knowledge gaps which require to be addressed as possible research areas.

Prof. S. Wangwe
EXECUTIVE DIRECTOR

1. INTRODUCTION

In understanding Tanzania's economic growth performance an analysis of the role of investment, foreign aid, and domestic savings mobilization is vital. This paper undertakes a review of current knowledge on the experience of investment, foreign aid and domestic savings mobilization in Tanzania. It also identifies knowledge gaps which require to be addressed as possible research areas.

2. INVESTMENT TRENDS AND POLICIES IN TANZANIA

2.1. Investment Effort

The investment effort recorded in Tanzania as measured by the ratios of gross fixed capital formation to GDP and gross capital formation to GDP has been considerable, although the size of this effort has varied over most of the independence period as can be noted from Table 1.

In examining Tanzania's economic performance, the approach of period categorization is found to be quite useful. This approach has been adopted by Nyagetera (1993), Ndulu (1994) and Adam, *et al* (1994) among others. Ndulu (1994) categorized Tanzania's economic development experience into two main periods, namely: 1961-1980, a period of economic modernization and structural transformation, and 1980-1992, a period of economic crisis and responses to emerging resource gaps. Adam, *et al* (1994) have categorized Tanzania's macro-economic performance into three distinct periods, namely: the pre-crisis, the crisis, and the reform periods. The pre-crisis period (1967-1978), ends in 1978, the year of the collapse of the coffee boom. The crisis period, 1979-1985, begins with the war with Uganda and the second OPEC oil price shock in 1979 and ends with the resignation of President Nyerere in 1985. The reform period, 1986-1992 begins with the adoption of the Economic Recovery Programme (ERP) in 1986 and continues to the present time. Nyagetera's (1993) period categorization conforms more closely with the issues at hand, and this categorization is adopted in examining saving and investment trends. Nyagetera (1993) has identified the following period categorization of investment experiences in Tanzania between 1965-1993 period to be the initial investment push (1965-1969), sustained investment expansion (1970-74), investment slowdown (1975-79), investment crisis (1980-84), and investment revival (1985-93) periods¹.

The period of initial investment push began with the implementation of the First Five-Year Plan's investment programmes. As a result of these programmes, the ratio of gross fixed capital formation to GDP averaged 21.5% annually while in real terms, the gross fixed capital formation grew at an average annual rate of 9.9% p.a. during 1965-69.

¹. See Nyagetera (1993)

The period of sustained investment expansion (1970-74) which was also the period of the Second Five Year Plan indeed witnessed an unprecedented expansion of investment. In real terms, the gross fixed capital formation grew at an average annual rate of 10.9% p.a. and the ratio of gross fixed capital formation to GDP averaged 27.2% p.a. during this period, a result mainly of the implementation of relatively large projects, such as TAZARA.

Table 1: Investment Effort Trends in Tanzania (Annual Averages)

(At 1976 Prices)	1965-69	1970-74	1975-79	1980-84	1985-90	1991-93
GFCF (Tshs Mill)	2,835	4,631	5,456	5,481	7,836	10,107
GCF (Tshs Mill)	3,174	5,130	6,027	6,000	8,310	11,749
GFCF/GDP (%)	21.5	27.2	25.2	23.5	29.3	30.9
GCF/GDP (%)	24.0	30.2	27.9	25.7	31.0	35.9
Growth Rate of: GFCF (% p.a)	9.9	10.9	7.0	1.6	3.9	4.4
GDP (% p.a)	3.7	4.5	4.5	0.8	3.7	4.3
Investment Productivity (%)	23.3	19.8	11.5	4.4	14.2+	

Sources: (1) Nyagetera (1993) [Investment data (1965-1976) have been computed by Nyagetera (1993) by revising National Accounts investment data series during the pre-1976 period to bring about comparability with National Accounts investment data series in the post-1976 period). Post-1976 data are from the Bureau of Statistics, National Accounts of Tanzania].

(2) Ndulu (1994), investment productivity rates.

Note:

GFCF - Gross fixed capital formation

GCF - Gross capital formation

Investment productivity rate:- the ratio of the change in real GDP (net of depreciation) over fixed capital formation.

+ - refers to 1986-92.

The period of investment slow-down (1975-79), coming after the completion of such large projects as TAZARA, and reeling from the impact of such adverse factors as the first and second oil price shocks, drought, the collapse of the East African Community and the Uganda-Tanzania War, resulted in a slow-down of investment. The brief positive coffee price boom of 1978 somewhat mitigated the slow-down, leading to a rise in investment at the end of the period. Thus, the period 1975-79 recorded an overall deceleration in the average annual growth rate of real gross fixed capital

formation to 7.0% p.a. Consequently, the ratio of the gross fixed capital formation to GDP declined to an annual average of 25.2%.

The period of investment crisis (1980-84) was also a period of severe economic depression as a result of the severe production and a foreign exchange crisis which afflicted the Tanzanian economy and which was accompanied by steep declines in domestic and national saving rates, resulting in a deceleration of investment activity. Consequently in real terms the gross fixed capital formation grew at an average annual rate of 1.6% p.a. The ratio of gross fixed capital formation to GDP thus declined to an annual average of 23.5%.

The period of investment revival (1985-93) has been one in which the institution of policies of reform and economic liberalization have transformed the period into one of economic recovery. During this period, the ratio of the gross fixed capital formation to GDP rose to an annual average of 29.3% during 1985-90 and 30.9% during 1991-93.

Nevertheless, the growth rates of the real, gross fixed capital formation during the perceived investment revival period (1985-93), show that the revival was fragile since its foundation was not based on an increased mobilization of domestic resources, but hinged on uncertain large foreign savings inflows instead (see Tables 1 and 7).

Adam *et al* (1994) also show that investment as a share of GDP (in current prices) declined from 23% during the pre-crisis period (1970-78) to 20% during the crisis period (1979-85) and has since risen to 35% during the reform period (1986-92). However, data in current prices overstate the reform-period boom in expenditure aggregates since they are heavily weighted in favour of traded goods, a result of the large and real depreciation of the Tanzanian shilling since 1986. Data in real terms at 1976 prices show however, that the fixed gross investment as a share of GDP amounted to 22.1% during 1970-78, rose slightly to 22.3% during 1979-85, and went higher to 26.3% during 1986-92. The increasing shares of investment even during the crisis period are attributed to the impact of the Basic Industries Strategy (BIS) which began in 1976. The boom in investment resulting from the BIS thus persisted even after the decline in external flows between 1981-85. The continued boom in investment after 1985 is on the other hand associated with the large external inflows which were a result of the positive donor response to the implementation of reforms during this period. An investment boom which is dependent on the continued influx of large external inflows which are donor-driven funds, however, is not sustainable.

2.2. Investment Structure, Composition, Patterns and Productivity

An analysis of the structure, composition and pattern of investment made in conformity with the period categorization of investment experiences recorded in Tanzania and summarized in Table 2 reveals the following:

- (i) During the period of the initial investment push (1965-69), the contribution of parastatal enterprises was quite low, averaging 20.2% of the gross fixed capital formation, while the private sector's contribution amounted to 54.7%. In terms of the structure of economic activities, secondary economic activities accounted for 70.7% of the gross fixed capital

formation, while tertiary activities accounted for 18.2% and primary production activities 11.1%. In terms of asset composition during this period, machinery and equipment accounted for 43.8%, followed by buildings with 32.9%. This period also recorded the highest investment productivity rates at 23.3%.²

- (ii) The period of sustained investment expansion (1970-74) witnessed the reversal of roles between the public and private sectors. The public sector achieved dominance in investment activity, accounting for 69.2% of fixed gross capital formation, with the contribution of parastatal enterprises rising to 48.1%. This resulted from the combined effects of nationalization, the establishment of new parastatal projects and enterprises, and the inflow of foreign aid, a substantial proportion of which went to the parastatal sector. At the same time, the private sector share declined to 30.8%. This period saw the intensification of secondary economic activities, whose share rose to an all time high of 78.0%, while the shares of tertiary activities and primary production declined to 14.2% and 7.8% respectively.
- (iii) On the other hand, the shares of machinery and equipment as well as buildings declined to 38.6% and 22.1% respectively, while that of other works rose significantly to 38.3% signifying the increasingly important role of transport, storage and communications in the overall investment effort during this period. The principal thrust of fixed investment during 1965-74 was modernization and commercialization of the economy.³ Nevertheless, investment productivity rates declined to 19.8% during this period. The decline in investment productivity during this period is attributed to the impact of the dominant parastatal sector whose average investment productivity rates were below those of the private sector. Thus, the changing of dominance from the private to the public sector led to the decline in average productivity reflecting the dominant role of the parastatal sector in aggregate investment.

². Ndulu (1994)

³. Ibid., p. 4.

Table 2: Capital Formation in Tanzania: Structure and Patterns (Annual Averages in %)

Gross Fixed Capital Formation (Current Prices)	1965-69	1970-74	1975-79	1980-84	1985-90	1991-93
a) By ownership	100.0	100.0	100.0	100.0	100.0	100.0
i) Public sector	45.3	69.2	56.7	50.7	46.8	34.8
Government	25.1	21.1	21.8	23.7	9.2	10.9
Parast. Enterp.	20.1	48.1	34.9	27.0	37.6	23.9
(ii) Private sector	54.7	30.8	43.3	49.3	53.2 ^a	65.2
(b) By Economic Activity	100.0	100.0	100.0	100.0	100.0	100.0
(i) Primary Production of which: Agriculture, etc. ¹	11.1 9.7	7.8 6.2	8.4 7.8	10.5 9.7	5.3 4.9	4.9 4.6
(ii) Secondary Activities of which: Manufacturing Transport, etc. ²	70.7 14.9 35.8	78.0 13.7 43.6	67.4 24.4 30.2	62.8 23.4 22.5	84.6 25.6 34.0	81.4 23.3 31.6
(iii) Tertiary Activities of which: Public Admin. etc. ³	18.2 6.2	14.2 3.0	24.2 12.6	26.5 17.7	10.1 6.2	13.6 6.5
c) By Type of Asset	100.0	100.0	100.0	100.0	100.0	100.0
(i) Buildings	32.9	22.1	19.2	23.3	10.8	9.7
(ii) Other works	19.7	38.3	26.8	24.6	20.5	18.0
(iii) Machinery and Equipment	43.8	38.6	54.0	52.1	68.7	72.3
Transport equipment	17.2	12.3	19.1	19.4	37.8	29.2
Other equip. & Mach.	26.6	26.3	34.9	32.7	30.9	43.1
(iv) Other ⁴	3.6	1.0	-	-	-	-

Source: Nyagetera (1993)

- Notes:
1. Agriculture, Hunting, Forestry and Fishing
 2. Transport, Storage and Communications
 3. Public Administration and Other Services
 4. Other: Dairy and Breeding Cattle.

The periods of investment slow-down (1975-79) and crisis (1980-84), witnessed the beginning of a decline in shares for the public sector and parastatal enterprises in particular. Thus, the contribution of parastatal enterprises to gross fixed capital formation fell to 34.9% during 1975-79 and to 27.0% during 1980-84, and the overall public sector contribution declined to 56.7% and 50.7% during 1975-79 and 1980-84 respectively. This was a result of the impact of rising oil prices, food shortages due to the drought, the war with Uganda, the collapse of the East African Community and falling foreign aid inflows which put a severe squeeze and strain on resource availability to the public and parastatal sectors. Consequently, the contribution of the private sector rose to 43.3% and 49.3% during 1975-79 and 1980-84 respectively. Similarly, the shares of secondary economic activities declined to 67.4% and 62.8% during 1975-79 and 1980-84 respectively. Paradoxically though, the share of manufacturing in total investment rose to 24.4% and 23.4% during 1975-79 and 1980-84 respectively, mainly due to the impact of entrepreneurial parastatal activities.

The share of tertiary activities rose substantially during these periods to 24.2% during 1975-79 and 26.5% during 1980-84 mainly on account of public administration and other services which rose to 12.6% and 17.7% respectively. The predominance of machinery and equipment in the asset composition was re-asserted during these periods, reaching 54.0% and 52.1% during 1975-79 and 1980-84 respectively. This indicated again the paradoxical situation, whereby despite the slow-down and crisis conditions affecting the economy, with substantial capacity underutilization of existing machinery and equipment, investment in machinery, plants and equipment continued to dominate investment activity. Moreover, investment productivity rates fell precipitately to very low levels during this period, to 11.5% and 4.4% during 1976-80 and 1981-85 respectively. The principal explanation for this intensification of investments which occurred despite the existence of substantial underutilization of the capacity of the existing machinery, plant and equipment during 1974-85 is found to be due to the emphasis placed on the structural transformation of the economy during this period, whereby an expanding manufacturing sector was considered a prerequisite for this transformation.⁴ The goal of structural transformation was reflected in the implementation of the Basic Industries Strategy (BIS) during this period which put heavy reliance on new manufacturing plants and equipment.

Another contributing factor to the dominance of machinery and equipment in a period of crisis can be traced to the increased investments by the private sector. New investments by the private sector largely involved investment in new machinery and equipment, all of which contributed to raising the share of machinery and equipment in fixed investment. At the same time, a big proportion of the parastatal sector stagnated due to the decline in external inflows. Moreover, since the physical capital equipment was operating way below capacity in most parastatals, parastatal investments during this period tended to be largely aimed at rehabilitating and facilitating the fuller utilization of the existing capacities.

The period of investment revival (1985-93) has been characterized by a continued decline in the contribution of the public sector in the total fixed investment to 46.8% and 34.8% during 1985-90 and 1991-93 respectively, mainly on account of the precipitated fall in contributions from the government in the total fixed investment. The share of the private sector has consequently risen to levels similar to or exceeding those attained in the early 1960s. The share of secondary

⁴ See, Wangwe (1983), Ndulu and Semboja (1993) and Ndulu (1994).

economic activities which declined during the periods of slow-down and crisis has shown a reversal in direction and risen to 84.6% and 81.4% during 1985-90 and 1991-93 respectively. Similarly, the share of machinery and equipment in the asset composition has continued the general upward trend, rising to 68.7% and 72.3% during 1985-90 and 1991-93 respectively. These shares exceed by over one and a half times the shares recorded during the periods of investment push and investment expansion (1965-74).

Investment productivity rates have also reversed direction. From the declining trend which had characterized them since the early 1970s, the investment productivity rate rose from the low point of 4.4% recorded during 1981-85 to 14.2% during the period 1986-92. The decline in investment productivity since the early 1970s can also be attributed to the falling growth rate of real GDP which was much lower than the growth of real fixed capital formation. The improvement in investment productivity during the 1985-93 period has in turn been caused by the rising growth rates of GDP during this period which have increased relatively faster than the increase in real fixed capital formation.

2.3. Policies Affecting Investment in Tanzania

Government policies have been a critical factor affecting investment in the Tanzanian economy. Government policies in the area of investment have included: nationalization, limiting areas for investment by the private sector, limiting private sector access to credit, foreign exchange and sources of raw materials, price control, exchange control, limiting firm access to the domestic market (especially by the private sector), and import and export licensing procedures which have largely been cumbersome and bureaucratic. All these have crucially affected incentives for private sector investment. Government policies have generally been interventionist in character especially after 1967. Such intervention policies have affected all aspects of the economy inclusive of investment.

Between 1961 and 1967, government policies favoured the promotion of economic growth and private investment. For instance, to promote the latter and engender business confidence, the Foreign Investment Protection Act of 1963 was enacted.

However, government sympathy for the private sector was short lived. A stream of policies hostile to local and foreign private investment ensued from February 1967 starting with the "Arusha Declaration" which entailed the nationalization of both domestic and foreign investments covering almost all sectors of the economy. The nationalizations continued until the 1970s touching not only large enterprises, but also small scale trade such as butcheries in towns and small shops in villages, as well as buildings and agricultural estates. The Foreign Investment Protection Act of 1963 which continued to operate until 1990 was essentially toothless and ineffective.⁵

The investment policy pursued by the government until 1990 arising from the "Arusha Declaration" can be described as one which aimed at ensuring that the major means of production, distribution and exchange were under government ownership and control. The investment policy defined the major means of production, distribution and exchange as the land, forests, mineral resources, water, oil, electricity, communications, banks, insurance, import-export trade, wholesale businesses, the steel, machine-tool, arms, motor-car, cement and fertilizer factories, the

⁵. See, Nyagetera (1993).

textile industry and any other big industry upon which a large section of the population depends for their living, or which provides essential components for other industries, and large plantations, especially those which produce essential raw materials. Nevertheless, three categories of ownership for all investments were envisioned by the investment policy, namely:

- (i) Purely public controlled investments;
- (ii) Partnership between government-owned enterprises and/or co-operatives, and local or foreign private investors; *and*
- (iii) Privately owned investments by local and/or foreign private investors.

Activities falling under the major means of production, distribution and exchange as defined above were reserved by the investment policy for purely public controlled investments. Activities not considered as major means of production, distribution and exchange were envisaged to be undertaken either as partnerships or as purely privately owned investments. The following industrial sectors were reserved predominantly for partnership between public and private investors: manufacture of food, beverages and tobacco; manufacture of wood and wood products including furniture; manufacture of paper and paper products, printing and publishing; manufacture of industrial chemicals and miscellaneous products of petroleum and coal; and manufacture of fabricated metal products, machinery and equipment. On the other hand, the following industrial sectors were predominantly reserved for private investors: textile, wearing apparel and leather industries; manufacture of other chemical products; manufacture of non-metallic mineral products, with the exception of petroleum and coal products and other manufacturing industries.

Thus, the overall thrust of the investment policy was towards government ownership and control and hence the promotion of public investment and a very lukewarm provision for private investment.

A number of other ruling party and government actions and other policies also had a negative bearing on private investment in Tanzania⁶. These include, for instance, the 1967 Party Leadership Code whose restrictions had the effect of precluding educated African public servants from entering into business ventures or engaging in private investment. Moreover, African participation in private investment was given further discouragement not only by the nationalizations and the active discouragement of the private sector in general, but more strongly by the rapid emergence of the public sector as an employer of the first resort (and the similarly rapid elimination of alternative employment of similar status in the private sector) for educated and capable Africans whose entrepreneurial talents were then developed towards a wholly bureaucratic direction and environment.

Other negative practices include lengthy and bureaucratic business licensing, registration regulations and practices, viz. the Licensing and Registration Act 1967 and the Business Licensing Act 1972, which made entry into private enterprise very difficult by increasing bureaucratic regulations as well as opportunities for bureaucratic 'discretion' -- and corruption. For instance, a private entrepreneur seeking an industrial licence to establish a small scale industry had to submit his licence application successively to 6 different central and local government offices after

⁶ . See, also Nyagetera (1993), Bagachwa (1992) and Mennonite Economic Development Associates.

having first registered the business by filing memorandum and articles of association and other documentation which on their own require approvals from several government offices. Such procedures increase and engender uncertainty, which acts to limit private sector participation in business and investment.

In 1973, the ruling party decided on a policy of small scale industries under which it was prohibited for private individuals to establish and run small industries in Ujamaa villages. In 1975, the Villages and Ujamaa Villages (Registration, Designation and Administration) Act 1975 placed all lands in the villages under the ownership and control of Village Councils, and also made it impossible for private individuals to hold legal title to land. These two measures ensured that private enterprise and investment were disrupted in the rural areas.⁷

The macro-policy environment engendered by the government was, until the early 1990s operated to restrict the development of the private sector and ensure the dominance of public sector investment. First, the political/ideological environment weighed heavily against private sector investment, and particularly against that by indigenous investors. Second, policies of price control weakened the investment climate, reducing the profitability and the efficiency of investment in most investment projects. Third, policies of exchange control and foreign exchange rationing which operated particularly against the private sector for most of the period negatively affected both the profitability and the capacity utilization of existing investments and the desire, particularly by foreign investors, to engage in new investments. Fourth, credit rationing particularly against the private sector reduced its capacity for undertaking new investments and ensuring a high rate of capacity utilization in existing investment projects. Fifth, interest rate regulation while assuring relatively low lending rates, nevertheless subjected the private sector to the highest lending rates in the economy, affecting their relative profitability viz-a-vis public-sector investments. Sixth, the insecurity of private investment and the unpredictability of the macro-policy environment affecting the private sector discouraged it from taking a long-term view of the financial risks inherent in long-term investment. Consequently, private investors have shunned long-term investment and preferred short-term commercial and/or rent seeking activities with high returns.⁸

In recognition of the negative effects of some of these measures on investment, the government has introduced policies designed to reverse these negative effects since the mid-1980s and particularly following the introduction of the Economic Recovery Programme in 1986/87.

A crucial first step among the policies adopted by the government in promoting private sector investment has been the change in the attitude of the government towards the private sector. This is exemplified by the reversal of the government's negative view of the private sector, due to the Arusha Declaration, and its replacement with a view which considers private sector development as being crucial to the achievement of sustainable economic development. Deliberate measures have as a result been taken by the government to promote and encourage private sector development. These measures, which include the liberalization of agricultural marketing and elimination of price controls in the mid-to-late 1980s allowed private sector participation.

⁷. See, Nyagetera (1993), op. cit.

⁸. See, Bagachwa (1992) and Nyagetera (1993).

Further measures which are important include:

- (i) the enactment of the National Investment (Promotion and Protection) Act 1990 and the formation of the Investment Promotion Centre in 1990 charged with, among others, the promotion of private investment;
- (ii) the enactment of the Banking and Financial Institutions Act 1991 which among others allowed the establishment of private banks in 1991; and
- (iii) the enactment of the Foreign Exchange Act 1991 which, among others, allowed private individuals to own convertible currency and establish private Bureaux de Changes in 1992.

The ruling party (CCM) in 1992 also reviewed and reversed the Party Leadership Code in what has been called the "Zanzibar Resolution" to lift restrictions on the earning of more than one official income by Party and Government officials. The Government also announced measures in 1992 aimed at reforming the parastatal sector, which among others encourages private sector participation. The government has also finally recognized the legitimacy of small scale and micro-enterprises of the informal sector. This has given impetus to the rapid expansion of businesses and micro-enterprises within the private sector. Nevertheless, expansion of private sector investment may also be constrained by the declining investment in the development of human resources as shown by the declining share of educational funds in the government budget.

In spite of the changing attitude of the government towards the private sector, the attitude and perceptions of the private sector as regards the changes in the investment climate have not really changed. It is apparent that the private sector does not consider that the attitude of the government towards the private sector has undergone any fundamental shift from an essentially negative stance towards a fundamentally more positive one. The private sector has thus more or less adopted a "wait-and-see" attitude. Consequently, private investors still do tend to shun long-term investment particularly involving production activities, and prefer short-term investments particularly involving import trading activities. The shift from direct production to trading activities and the implied shift from long-term investments (physical capital assets) to short-term investments (inventories) has an impact (mostly negative) on the overall investment in fixed capital formation and the long-term growth rate of the economy.

The policies adopted by the government in the promotion of public investment in the parastatal sector hinge on both the privatization and transformation of parastatal enterprises into efficient and profitable units. Policies of privatization aim at removing the government and government bureaucrats from commercial and business, or entrepreneurial decision-making through the sale of assets, joint ventures and management contracts. The objective of profit-orientation has been sought by the government through joint ventures and management contracts as well as measures designed to increase autonomy and assure a progressive movement away from administrative regulation and a commanded economy towards a market-oriented one. These measures have included the decontrol of domestic prices, devaluation of the shilling, cutting of parastatal subsidies, and a reform of the parastatal entrepreneurial sector in order to allow enterprises to manage, have autonomy and be independent in decision-making as well as to allow the private sector to participate in ownership and management. The measures currently being introduced

which involve the establishment of domestic capital market institutions are designed, among others, to assist parastatal enterprises to eventually improve their equity capital by tapping domestic long-term funds from domestic equity market sources.

2.4. Issues Requiring Further Research

Following from the above discussion of the issues, experiences and policies affecting investment in Tanzania, the following areas emerge as requiring further research:

- (i) The causes for the lacklustre investment revival during the post-1986 period despite the adoption of economic liberalization policies.
- (ii) Has the macro-economic environment improved for investment revival, and are the incentives in the Investment Promotion Act adequate, comprehensive and/or relevant for both foreign and local investors (in terms of their width, depth, coverage and types).
- (iii) The policy mix impacting on investment in terms of consistency, adequacy and desired balance (e.g. policy inconsistencies, sudden policy shifts and contradictions, adequacy for raising investment levels, balance between foreign and local, and/or between indigenous and non-indigenous).
- (iv) The mechanisms for the acceleration of parastatal sector reform and their impact on the overall investment.
- (v) The potential of privatization as both an investment strategy and a means for attracting new investments.
- (vi) The role and impact of the informal sector on overall investment, as well as the links between the informal and formal sectors.
- (vii) The impact of the policies of liberalizing the financial sectors and the monetary restraint policies (viz. rising lending interest rates and credit squeeze) on investment.
- (viii) The lessons and relevance of South East Asian experiences in attracting foreign investments to Tanzania.
- (ix) The type, quality, adequacy, relevance and extent of current foreign investment inflows to Tanzania and their size in relation to investment by local investors.
- (x) The enabling environment for investment in Tanzania (its essential factors and features), and the type of financial and non-financial incentives (their role, adequacy and relevance) necessary for promoting both the overall and specific types of investments desired for significant recovery, growth and employment objectives.

- (xi) **The impact on parastatal management effectiveness of the patronage environment existing between politicians/civil servants and parastatal executives/managers.**
- (xii) **The complementarities between public and private investment and between local and foreign investment in Tanzania.**
- (xiii) **The extent, adequacy and relevance of investment incentives and protection offered to local investors.**
- (xiv) **The institutional mechanisms and incentive arrangements for the promotion of small investments particularly by indigenous entrepreneurs.**
- (xv) **The extent, role and adequacy of investment in the development of human resources and its impact on overall investment in Tanzania.**
- (xvi) **How Tanzanian investors make investment decisions and their attitude towards risk.**
- (xvii) **The productivity of investments in Tanzania and the impact of the current taxation policies on investment.**

THE ROLE AND IMPACT OF FOREIGN AID IN TANZANIA

3.1. The Role of Foreign Aid

At independence in 1961, the principal goal of the new government was to attain a higher standard of living for its people. This was to be attained through higher national income growth rates, which were to be obtained through higher investment rates. On account of an assumed low domestic saving rate, both the Three Year Development Plan (1961/62-1963/64) and the First Five Year Plan (1964/65 - 1968/69) had placed the dominant role in resource mobilization for investment on foreign sources. The major source for foreign resources was also envisaged to be accounted for by private foreign investment. In order to promote and encourage the inflow of foreign private investment, the Foreign Investment Protection Act 1963 was put in place. Official development assistance from foreign governments and international organizations and agencies was also envisaged to be the principal source of finance for the development of the economic and social infrastructure in the two plans.

The performance of the financing sources, however, fell completely short of and was opposite to the expectations; domestic financing sources dominated foreign financing sources by a ratio of 3:2⁹. As a result of the short-fall in foreign finance inflows, coupled with a better than expected performance in domestic finance mobilization,¹⁰ the Tanzanian government concluded that a policy of self-reliance which placed emphasis on domestic resource mobilization and only minimal reliance on foreign aid was not only imperative and necessary but was also the only realistically available option. These conclusions played a major role in the formulation of the "Arusha Declaration", which was introduced in February, 1967.

Despite the existence of the "Arusha Declaration", the ensuing period particularly from the 1970s saw the intensification of dependence on foreign aid rather than intensification of self-reliance.¹¹ Indeed, Tanzania is classified as one of the largest recipients of foreign aid.¹² When foreign aid is defined to include all types of loans, then the ratio of foreign aid to GDP (in %) is shown to have risen to 35% by the late 1980s.¹³ Moreover, the average annual growth rates of total foreign aid and foreign grants to Tanzania were found to be 17% and 20% p.a. respectively during the second half of the 1980s.¹⁴

⁹ . Calculated from Table 2.2.1 in Nyagetera (1993).

¹⁰ . See, Nyagetera (1993).

¹¹ . See, Collier (1987), Likwelile, et al (1994), Falck (1992), Mjema (1994), Adam *et al* (1994) and Doriye, White and Wuyts (1993).

¹² . See, World Bank (1991a), and Collier (1987), *op.cit*.

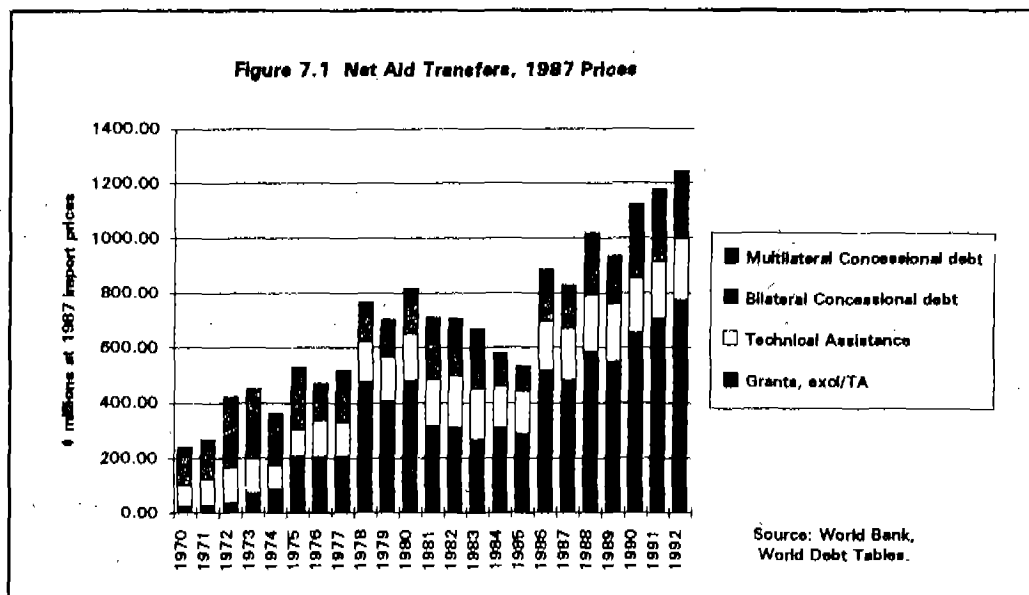
¹³ . See, World Bank (1991b) and Falck (1992).

¹⁴ . See, Danielson, et al (1994).

The experience of aid inflows to Tanzania shows four distinct periods: 1961-1970, 1970-1980, 1980-1985, and 1986-1990s. Doriye, *et al* (1993) and Adam, *et al* (1994) identify two periods of aid boom: 1970-1980 and the post-1985 period, and one period of aid slump: 1980-1985, during the period after 1970. Fig 1a and 1b show the pattern of aid inflows to Tanzania from 1970.

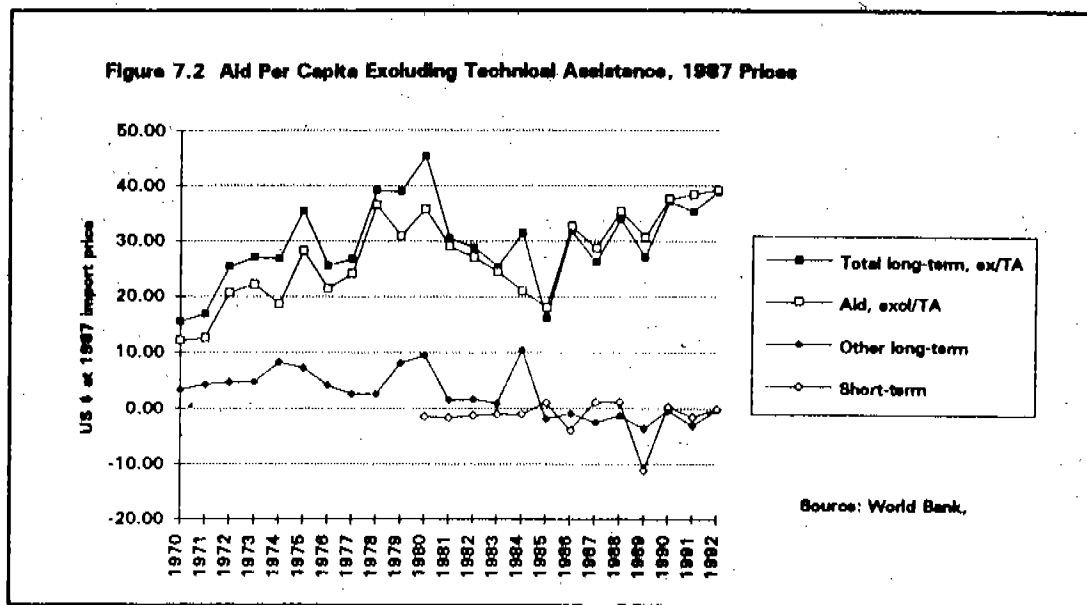
The period 1961-1970 was characterized by unfulfilled aid expectations and low aid inflows resulting from the withdrawal of Tanzania's major bilateral donors such as Britain and West Germany as well as the lukewarm aid response from the USA, a result mainly of foreign policy disagreements. As mentioned earlier, the low aid inflows and unfulfilled aid expectations played an important role in the formulation of the "Arusha Declaration".

Fig. 1a: Net Aid Transfers to Tanzania, 1987 Prices



Source: Adam *et al* (1994), Fig. 7.1, p. 71

**Fig. 1b: Aid Per Capita to Tanzania, 1987 Prices
(Excluding Technical Assistance)**



Source: Adam *et al* (1994), Fig. 7.2, p. 71.

The period 1970-1980 experienced sustained aid inflows resulting in its being classified as the period of the first aid boom¹⁵. During this period, donors drawn to Tanzania's new ideological path to development, with its emphasis on rural development, limit on social differentiation and inequality, search for poverty alleviation and desire for self-reliance led to major aid support particularly from the Scandinavian, and other countries (such as China), and multilateral agencies such as the World Bank. Most aid funds during this period were in the form of project aid, particularly for financing expansions to the capital stock. Fig 1a and 1b demonstrate in both volume and per capita terms the steep rise of the first aid boom during the 1970s which peaked in 1980.

The period 1980-1985 experienced a major decline in foreign aid inflows, mainly the result of major economic policy disagreements with most of the donors, particularly the international financial institutions; the IMF and the World Bank. These protracted disagreements between 1979 and 1985 with these two world bodies produced and stimulated a rapid decline in aid inflows from almost all major donors. This is also demonstrated in Fig. 1a and 1b where the steep decline in aid inflows between 1980 and 1985 is shown. Indeed, aid inflows fell by about US \$30 million per year during this period.¹⁶

The period beginning in 1986 and extending into the 1990s has experienced substantial aid inflows, resulting in its being classified as the period of the second aid boom.¹⁷ The second aid

¹⁵ See, Doriye *et al* (1993) and Adam *et al* (1994).

¹⁶ See, Adam *et al* (1994), p. 71.

¹⁷ See, Doriye *et al* (op. cit) and Adam *et al* (op. cit).

boom was triggered by the agreement with the IMF and the World Bank in 1986 on a structural adjustment programme. Tanzania's adoption and implementation of the Economic Recovery Programme (ERP) and subsequently its extension into the Economic and Social Action Programme (ESAP) also known as ERP-II has seen a rapid increase in aid inflows greater than those experienced during the first aid boom. This is demonstrated in Fig. 1a and 1b.¹⁸

The magnitude of foreign aid inflows to Tanzania has by most measures been quite high. Table 3 indicates that in per capita terms, net inflows to Tanzania more than trebled between 1970 and 1992. While for instance, during the 1980s net aid inflows to Tanzania averaged over US \$35 per capita, net aid inflows to other sub-Saharan African countries averaged US \$17 per capita during the same period, and was below US \$5 per capita for other low income countries¹⁹.

Table 3: Net Aid Inflows Per Capita to Tanzania (Excluding Technical Assistance)

Annual Average	1970-78	1979-85	1986-92	1992
US \$	11	26	35	39

Source: Adam *et al* (1994).

Other indicators of the increased importance of foreign aid to the Tanzanian economy are the shares of foreign financing to government's total and developmental expenditure, and of parastatal enterprises' fixed capital formation as shown in Table 4.

Table 4: Foreign Financing¹ (As % of:)

Period	Total Development Expenditure	Total Govt. Expenditure	Parastatal Fixed Capital Formation
1965-69	30.4	7.1	23.5
1970-74	41.0	13.0	23.5
1975-79	45.5	18.5	30.4
1980-84	33.5	13.4	46.5
1985-90	48.0	24.6	51.7
1991-93	48.0	8.9	25.6

Sources: (1) URT, Economic Surveys (various issues)
 (2) URT, Analysis of Accounts of Parastatal Enterprises (various issues)
 (3) Nyagetera (1993).

Notes: 1. Excludes import support.

¹⁸ See also Fig. 2.1 and 2.2 in Doriye *et al* (1993) for a demonstration of the pattern of aid inflows between 1970 and 1991.

¹⁹ See, Adam *et al* (1994), p. 72.

Thus, foreign financing has continued to finance an increasing proportion of both the government's total government expenditure and developmental expenditure of parastatals, particularly until the late 1980s. While foreign financing had been particularly significant in financing the fixed capital formation particularly until the late 1980s, its share has, however, fallen substantially in the post-1990 period. This indicates that there is a decline in the role foreign aid plays in financing investment activities within parastatal organizations.

Nevertheless, the important role played by foreign aid to the Tanzanian economy is shown by the relatively more generous and easy loan terms and conditions to which Tanzania has been subjected. These terms and conditions (Table 5) show that Tanzania received the highest average maturity and grace periods on loans as well as the lowest average interest rate on loans. Table 6 below demonstrates even more generous terms and conditions for public given to Tanzania.

Table 5: Loan Terms and Conditions to Tanzania (TZ) vs Sub-Saharan Africa (SSA) and the Less Developed Countries (LDCs).

Period	AMP			AIR			AGP		
	LDCs	SSA	TZ	LDCs	SSA	TZ	LDCs	SSA	TZ
1961	20	25	30	4	6	4	5	6	10
1970	18	18	30	5	6	4	5	6	10
1974	16	17	29	6	5	4	5	6	10
1978	14	16	30	7	6	4	4	4	7
1982	14	18	28	10	8	4	4	4	7
1985	13	17	24	8	7	4	4	4	7
1988	12	14	21	8	7	4	4	4	7
1990	11	12	17	9	8	4	4	4	6

Source: Mjema (1994).

Key: AMP - Average maturity period (years)
 AIR - Average interest rate (% p.a.)
 AGP - Average grace period (years).

Table 6: Terms and Conditions of Public Borrowing: Tanzania (TZ) Vs Sub-Saharan Africa (SSA)

Period	AMP		AIR		AGP	
	TZ	SSA	TZ	SSA	TZ	SSA
1970	40	27	1.2	3.1	11	8
1983	29	29	3.9	3.4	5	7
1988	41	21	0.8	5.3	10	6
1989	34	21	2.1	4.0	8	4
1990	37	20	0.9	4.5	10	4
1991	41	20	1.9	4.7	12	4

Source: Danielson, et al (1993)

Key: AMP - Average maturity period (years)
 AIR - Average interest rate (% p.a)
 AGP - Average Grace period (years)

Nevertheless, it should be noted that foreign aid inflows may not adequately capture the extent to which a country is dependent on the mobilization of foreign resources for its development. A major reason for this is the restrictive definition of foreign aid which excludes many foreign resource components.²⁰ A much more encompassing indicator of the extent to which a country mobilizes and uses foreign resources may be shown by foreign savings. The foreign savings rate defined as the ratio of foreign savings to GDP presents one such measure of the extent of a country's mobilization and use of foreign resources. A comparison of the ratios of foreign aid to GDP and foreign savings to GDP indeed shows that the former has almost always been significantly below the latter (Table 7). Foreign savings, as a percent of GDP, were shown to have risen to significantly high levels particularly from the mid-1980's following the implementation of the ERPs.

²⁰ One such restrictive definition of foreign aid is given in Likwelile *et al* (1994) as "...all transfers from abroad that have a grant element".

**Table 7: Foreign Aid and Foreign Savings Inflows to Tanzania
(As % of GDP)**

Period	Foreign Aid	Foreign Savings
1965-69	1.6	1.2
1970-74	6.0	9.2
1975-79	8.0	10.7
1980-84	4.9	9.9
1985-90	7.1	34.6
1991-93	9.9	57.9

Sources: (1) Likwelile, *et al* (1994).
(2) Nyagetera (1993).

3.2. The Impact of Foreign Aid

The impact of foreign aid on the Tanzanian economy may be examined by evaluating its impact on saving, investment, economic growth, fiscal performance, exports and the real exchange rate appreciation.

3.2.1. The Impact of Aid on Saving, Investment and Economic Growth

Foreign aid and more particularly foreign savings tend to fill the gap in domestic savings. Generally, foreign savings are said to limit the effort in domestic savings. Nyagetera (1993) indeed finds the existence of such a negative relationship between foreign savings and domestic savings in Tanzania, which suggests that foreign savings displace domestic savings, and thus Nyagetera (1993) discourages it. Mjema (1994) also finds a negative relationship between foreign capital inflows and domestic savings in Tanzania. Mjema attributes this negative relationship to what he perceives as the positive association between periods of increased foreign capital inflows with periods of economic crisis. This explanation is not, however, entirely borne out by the facts, since periods of crisis such as 1974 and 1980-1985 were also periods of reduced foreign aid inflows as can be seen from Fig. 1a and 1b.

The high foreign saving rates have substantially contributed to the achievement of high investment rates in Tanzania. Indeed, the investment rates achieved in Tanzania are high by international standards. The World Bank Report (1994a:38)

observes that investment rates in Tanzania have been more than double the average share of 16% for the whole of Sub-Saharan Africa. Adam *et al* (1994) also note that the contribution of foreign aid to the achievement of such high investment rates has been very high, particularly in financing the foreign exchange components of investment. This is also confirmed by Mjema (1994) who found that foreign capital inflows had a positive impact on investment in Tanzania.

In examining the impact of foreign aid on economic growth, it is usually assumed that high aid inflows resulting in high investment rates should generate high rates of economic growth. This has, however, not been the case in Tanzania. The poor rates of economic growth achieved in Tanzania have by all accounts been phenomenal, suggesting that foreign aid quite possibly either has a negative effect or no effect on economic growth in Tanzania. Mjema (1994) found a positive but weak relationship between foreign capital inflows and the growth rate of national income in Tanzania. Mjema attributed this weak relationship to the fact that the productivity of most foreign financed investments was not sufficiently high as to positively affect income growth. He also attributed the low productivity of these investments to the persistence of the economic crisis which resulted in foreign exchange shortages and the resultant under-utilization of capacity of most firms. Likwelile *et al* (1994) nevertheless argue that while foreign aid inflows to Tanzania show an increasing trend, real per capita income has been declining, indicating therefore, that there is no reason to argue that foreign aid has led to economic growth.

Tanzania's poor economic growth performance is, indeed, a paradox in view of the high investment rates achieved. It is clear that the poor economic growth performance cannot be attributed to low levels of investment, since investment rates have been quite high. It is apparent that the issue is one of quality rather quantity, i.e. most investments have low productivity²¹. The low quality of investment during the pre-crisis period is attributed to the highly distorted macroeconomic environment, while during the crisis period it is attributed to the government's persistent pursuit of the Basic Industries Strategy (BIS) at a time of severely constrained foreign exchange availability. The implementation of the BIS supported by donor financing of capital expenditures at a time when donors were unwilling to finance recurrent expenditures led to a strangulation in the importation of intermediate goods and a decline in (industrial) capacity utilization rates to below 30% during the early 1980s.²² The low productivity of investment is also attributed to the dominance of the public sector in credit allocation from the banking system²³. The parastatal sector faced a soft budget constraint throughout the 1980s and consequently passed on the huge losses incurred to the government budget and the banking system²⁴. Adam *et al* (1994) also observed that without

²¹ . See, Adam *et al* (1994), p. 87.

²² . Ibid, p. 87.

²³ . Ibid.

²⁴ . See, Eriksson (1993).

hard budget constraints, changes in relative prices are unlikely to create major resource reallocations or lead to major productivity gains. This is because the parastatals are able to pass on the major portion of the relative price changes they face to either or both the government budget and/or the banking system in form of financed losses through the soft budget constraint (system). Indeed, this is what has happened in Tanzania.

The observed negative relationship between aid and economic growth in Tanzania is also discussed by Doriye *et al* (1993). They note that the first aid boom which provided investment support in the form of project aid, contributed significantly to the generation of the subsequent economic crisis experienced during the early 1980s. They argue that while on one hand foreign aid eased the budget constraint on investment and capital goods imports, on the other hand, the constraint on recurrent imports (consumer and intermediate goods) hardened substantially, partly as a result of the aid boom itself. Consequently, "... the drive for capacity creation undermined its utilisation, particularly in industry, while the multiplier effects of investment shifted relative prices in agriculture in favour of food crops and away from cash (export) crops. Coupled with the steep rises in the price of oil, the consequent fall in export volume eroded the sustainability of economic growth".²⁵

The negative impact of foreign aid inflows on overall economic growth in Tanzania can also be attributed to the fact that agriculture which is by far the most dominant and large impact sector has relatively received a very small share of foreign aid in comparison to other sectors due to the foreign aid policy which placed emphasis on other sectors. These foreign aid-favoured sectors which by comparison contributed only negligibly to the overall growth, were also poor performers. Thus, since aid flowed to low impact sectors, the lack of adequate aid flows to such high impact sectors as agriculture contributed to the generally poor overall economic growth.

3.2.2. The Impact of Aid on Fiscal Performance

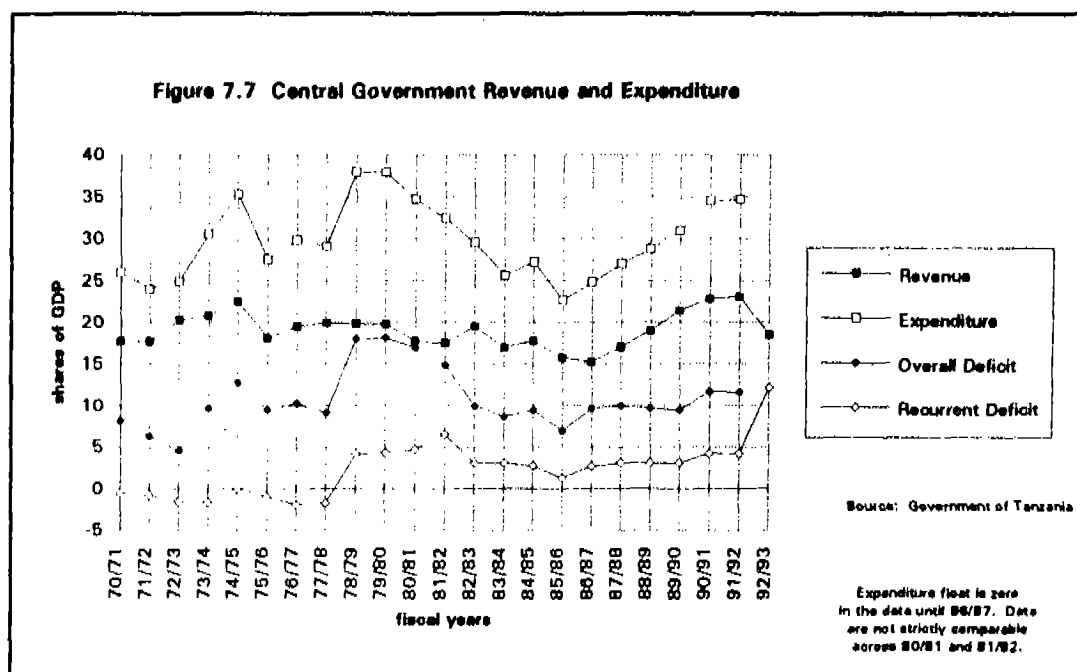
So long as foreign aid inflows accrue to the government budget, there is a strong likelihood for it to displace of tax revenue, and thus lead to a reduction of taxation. Mjema's (1994) analysis, however, contradicts this view. His analysis does not point to a reduction in the tax effort as the factor contributing to the substitution of domestic savings by foreign capital inflows in Tanzania. Indeed, Lipumba and Osoro (1990) have observed that in Tanzania the tax effort arose during periods of increased foreign aid inflows, suggesting that the relationship between the two is a positive one.

Fig 2. shows that both government revenue and expenditure as a share of GDP closely follow the general pattern eked out by foreign aid inflows to Tanzania. This indicates that foreign aid has a close and positive relationship with both government revenue and expenditure. Fig. 2 also shows no obvious evidence of

a discouraging effect of aid inflows on tax effort.²⁶ Moreover, evidence of a direct positive link between foreign aid inflows and government revenue is strikingly provided in Fig. 3 where this link is generated by the dependence of government revenue on the import base which is itself very much dependent on foreign aid inflows.

Another impact of foreign aid (loans) on Tanzania's fiscal performance is given by the effect of foreign debt servicing on the government budget. When government recurrent expenditure is decomposed into discretionary expenditure and debt servicing as shown in Table 8, then it is observed that while during the 1986-91 period, the overall recurrent budget recorded a deficit of about 7% annually. In contrast, however, the discretionary recurrent budget was in surplus by an average of almost 15% annually²⁷. This indicates the impact of debt servicing on the recurrent budget, and thus also the impact of foreign aid loans on the same.

Fig. 2: Tanzania: Central Government Revenue and Expenditure

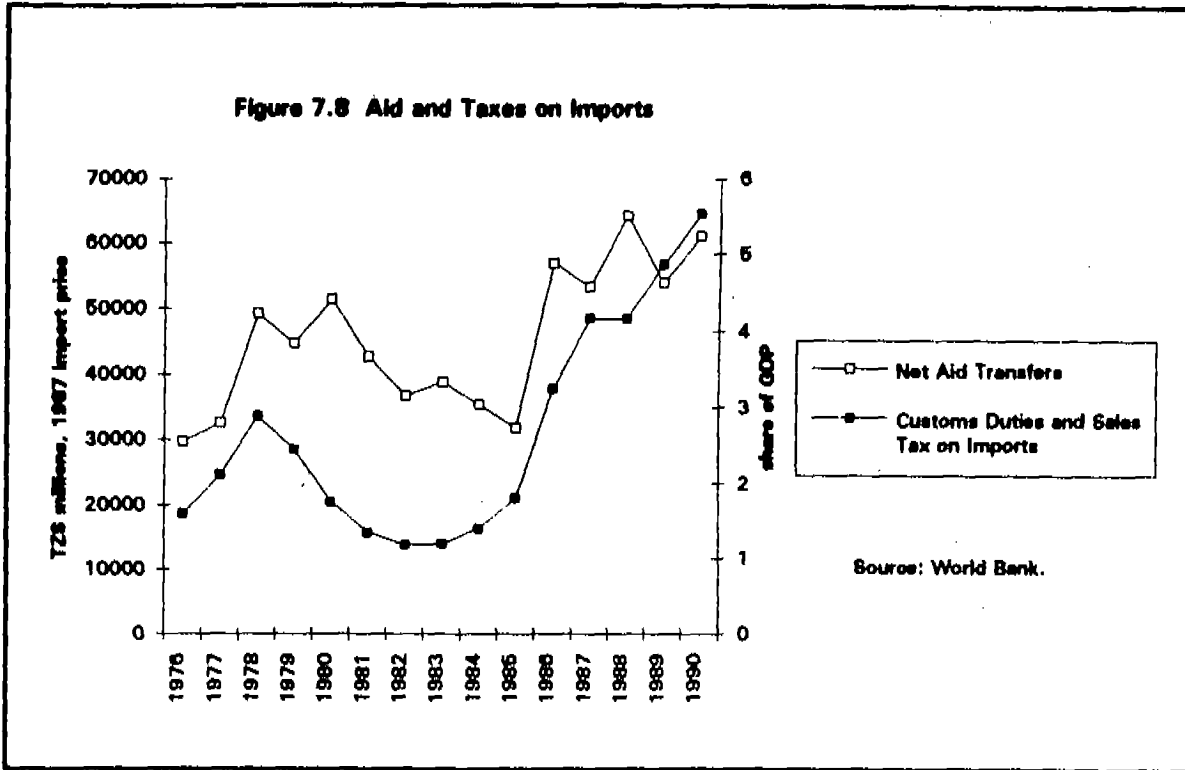


Source: Adam *et al* (1994), Fig. 7.7, p. 92.

²⁶ See, Adam *et al* (1994), p. 91.

²⁷ See Doriye *et al* (1993) p. 84.

Fig 3: Aid and Taxes on Imports in Tanzania



Source: Adam *et al* (1994), Fig. 7.8, p. 93.

Table 8: Effects of Debt-Servicing on the Tanzania Government Recurrent Budget

Year	Recurrent Revenue (a)	Recurrent Expenditure		Surplus/Deficit			NCPI Deflator	
		Including Debt Service (b)	Excluding Debt Service (c)	Including Debt Service (b)		Excluding Debt Service (c)		
				Shs.Mill.	As % of (a)			Shs.Mill.
1976/77	5794	5022	4427	772	13.3	1367	23.6	100.0
1977/78	6714	5258	4583	1456	21.7	2131	31.7	110.6
1978/79	6056	5969	5009	87	1.4	1047	17.3	128.6
1979/80	5588	5672	4069	-84	-1.5	1519	27.2	158.6
1980/81	4281	5208	4385	-927	-21.7	-104	-2.4	200.2
1981/82	3778	5182	4598	-1404	-37.2	-820	-21.7	249.0
1982/83	3768	4369	3977	-601	-16.0	-209	-5.5	333.9
1983/84	3368	3976	3408	-608	-18.0	-40	-1.2	401.0
1984/85	3341	3862	3718	-521	-15.6	-377	-11.3	557.8
1985/86	3078	3335	2838	-257	-8.3	240	7.8	715.8
1986/87	3094	3649	2988	-555	-17.9	106	3.4	947.7
1987/88	3833	4533	4056	-700	-18.3	-223	-5.8	1288.8
1988/89	4438	5158	3049	-720	-16.2	1389	31.3	1586.8
1989/90	5161	5895	5895	-734	-14.2	-734	-14.2	1896.2
1990/91	5994	7096	5117	-1102	-18.4	877	14.6	2287.2

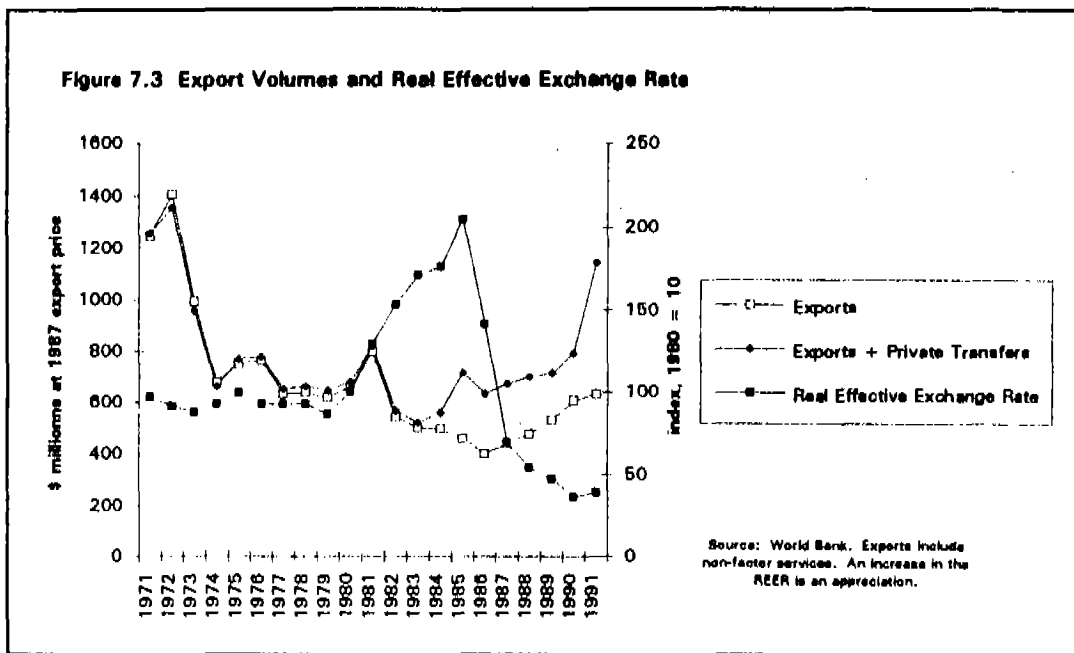
Source: Doriye *et al.* (1993), Table 4.4, p. 83.

3.2.3 The Impact of Aid on Exports and Real Exchange Rate Appreciation

The impact of aid on exports in Tanzania may be examined through its effect on the real exchange rate and then also through the effect on export sector reforms.

The exchange rate affects export performance through its effect on competitiveness. Exchange rate overvaluation reduces the competitiveness of export commodities and thus retards export growth. Foreign aid inflows played a major part in delaying the use of the exchange rate as a policy variable in place of foreign exchange and imports rationing. Consequently, despite rising inflation, adequate depreciation of the exchange rate was not considered until the onset of the ERP in 1986. The exchange rate consequently became seriously overvalued. Such overvaluation of the exchange rate reduced the competitiveness of Tanzanian exports, which declined seriously until the latter half of the 1980s. Fig. 4 which relates export performance and the real effective exchange rate (REER) in Tanzania shows that REER depreciation has been associated with rising export performance, while REER appreciation has been associated with declining export performance. To the extent that foreign aid inflows delayed exchange rate realignment and thus prolonged exchange rate overvaluation, this means also that foreign aid inflows promoted declining export performance.

Fig 4: Exports and the Real Effective Exchange Rate in Tanzania



Source: Adam *et al* (1994), Fig. 7.3, p. 80.

Foreign aid inflows also prolonged delays in undertaking export sector reforms in Tanzania. Producer pricing policies, the government's support of monopolies in export crop marketing, the associated rising margins in marketing and the heavy effective protection of the import-substituting industrial sector all resulted in prices turning negatively against the agricultural sector producing for export. All these constraints on export producers led to a decline in export growth.

The reform period (post-1986) and the accompanying second-aid boom has seen rising export performance. However, this has been primarily due to the tying of aid inflows to the implementation of export sector reforms and an exchange rate depreciation both of which have acted to improve export incentives and thus stimulate export growth.

Nevertheless, such large aid inflows as those experienced by Tanzania tend to produce negative effects on the economy, and such negative effects usually known as the "Dutch Disease" effects operate through the real exchange rate. It has been argued that large aid inflows similar to Tanzania's substantially augment the economy's income and result in an increase in domestic spending on both traded and non-traded goods. However, since the direct supply effect is only on traded goods, there is a resultant excess demand for non-traded goods. This raises the prices of the latter relative to the former and produces a resource movement effect (of labour and other factors of production) from the traded to the non-traded goods sector. This process produces a real appreciation of the exchange rate. Such real appreciation of the exchange rate becomes the "Dutch Disease" when the resulting decline in the domestic production of tradables is excessive.

Falck (1992) has contended that foreign aid inflows to Tanzania have given rise to the "Dutch Disease" through appreciation of the real exchange rate. Identifying the agricultural sector as the traded goods sector, he argues that cash crop production in the agricultural sector has been reduced by the operation of "Dutch Disease" resulting from foreign aid inflows. Adam *et al* (1994) however argue that the induced movement out of tradables in Tanzania as a result of real exchange rate appreciation has not been excessive, and thus the appreciation of the real exchange rate has not been of a magnitude which enables the resulting resource movement effects to be classified as "Dutch Disease". Firstly, they observe that some movement of resources from traded goods production may be a desirable response to a substantial aid inflow as was the case in Tanzania. Secondly, such a movement may be desirable if domestic production of tradables has been inefficient and unduly propped up by protection. Finally, they observe that the "Dutch Disease" in the sense of real exchange rate appreciation need not be cured by aid cuts but rather by appropriate policy interventions. Thus, the "Dutch Disease" in its Tanzanian manifestations is essentially different from that induced by natural resource endowments, and can therefore be merited with a much reduced significance.

3.3. Issues Requiring Further Research

Following from the above discussions on the role and impact of foreign aid in Tanzania, certain issues emerge as meriting further research:

- (i) Why the chosen set of foreign financed investments in Tanzania have low productivity.
- (ii) Options for the optimal use of foreign resources availed to Tanzania.
- (iii) Foreign aid and the "Dutch Disease" in Tanzania.
- (iv) Options under which utilization of foreign aid cannot give rise to "Dutch Disease" effects.
- (v) Options for reducing the share of foreign debt service in Tanzania's export earnings.
- (vi) The impact of changes in foreign aid policy on new fixed investment.
- (vii) The factors explaining Tanzania's experience with foreign aid which has been accompanied by a decline in real per capita earnings, domestic savings and export growth rates.
- (viii) The relationship between aid and poverty in Tanzania.
- (ix) Who are the final recipients of foreign aid in Tanzania?

4. DOMESTIC RESOURCES MOBILIZATION IN TANZANIA

4.1. Domestic Saving Effort and Saving Patterns

Saving efforts can be portrayed by the domestic saving rate, the foreign saving rate, and the savings gap. The domestic saving rate is defined as domestic savings expressed as a percentage of GDP. The foreign saving rate is also defined as foreign savings expressed as a percentage of GDP, while the savings gap is defined as the difference between the gross investment rate and the domestic saving rate, with the gross investment rate being defined as the gross capital formation expressed as a percentage of GDP.

Table 9: Saving Effort Trends in Tanzania (in %)

Period	National Saving ¹ Rate	Domestic Saving ² Rate	Foreign Saving ³ Rate	Savings Gap ⁴
1966-69	20.3	21.4	1.2	0.2
1970-74	21.3	21.3	9.2	8.9
1975-79	17.5	17.8	10.7	10.3
1980-84	11.1	11.5	9.9	9.5
1985-90	-5.1	0.6	34.6	28.9
1991-93	-0.9	7.3	57.9	49.7

Source: Nyagetera (1993)

Notes:

1. National Savings = Gross Capital Formation less Foreign Savings
2. Domestic Savings = National Savings less Net Factor Income from Abroad.
3. Foreign Savings = Imports of Goods and Non-Factor Services less Exports of Goods and Non-Factor Services less Net Factor Income from Abroad.
4. Savings Gap = Gross Capital Formation less Domestic Savings.

The pattern of saving effort in Tanzania as shown in Table 9 has been determined by Nyagetera (1993) to have displayed the following characteristics:

First of all, both the domestic saving rate and the national saving rate have been on a declining trend between 1966 and 1990. The domestic saving rate stabilized at around 21% between 1966 and 1974 and fell significantly to 17.8% during 1975-79, to 11.5% during 1980-84, and to 0.6%

during 1985-90. The declining trend of the domestic saving rate between 1966 and 1990 is principally associated with the falling growth rate of the GDP. Between 1991-93, the domestic saving rate is shown to have started a rising trend, rising to 7.3%, as a result of the significant increase in the growth rate of the GDP which rose by 4.3% p.a. during this period.

Secondly, the foreign saving rate is shown to have generally displayed a rising trend since 1966, although the period 1970-84 was generally stable, averaging 9.9%. The period 1985-93 has displayed a significant increase in the foreign saving rate, rising to 34.6% during 1985-90 and 57.9% during 1991-93. The large increase in the foreign saving rate is attributed principally to the widening gap between imports and exports, itself a result of imports growth being far in excess of exports growth.

Thirdly, the declining trend of the domestic saving rate has brought about a rising trend in the savings gap throughout the period 1966-93. Table 9 shows that the period 1985-93 has actually seen a significant widening of the savings gap. Thus, the pattern displayed by the savings gap in Table 9 provides evidence of the inadequacy of the domestic saving effort in Tanzania.

Evidence also shows that the dominant source of domestic savings in Tanzania has almost always been the private sector.²⁸ The factors contributing to the inadequacy of the domestic saving effort have been identified to be the existence of financial repression, an underdeveloped financial system, low levels of per capita income, and the negative effects of foreign saving inflows.²⁹ The negative influence of foreign saving inflows on domestic savings in Tanzania has already been discussed in section 3.2.1

4.2. The Role of Domestic Money Markets

Domestic money and capital markets provide the institutional basis for a country's financial self-reliance. The domestic money market is essentially a market for locally-held short-term funds, or put in another way a market for local currency denominated financial assets or liabilities with short maturity. Such local currency denominated financial assets or liabilities with short maturity periods in Tanzania are essentially constituted of deposits with the banking system and non-bank financial intermediaries. These institutions include the banking system, viz-a-vis the central bank and the commercial banks, and the thrift institutions which are constituted of the Post Office Savings Bank (POSB), the Tanzania Housing Bank (THB) and the Diamond Jubilee Investment Trust (DJIT). These money market institutions which are part of the financial system also dominate the Tanzania financial system. For instance, both the banking system and the thrift institutions have on average accounted for about 85% of the total financial assets of the financial system since 1966, with the thrift institutions, however, accounting for only about 3 - 4%.³⁰ The financial system has thus been dominated by the banking system, with the commercial banks alone

²⁸ See, Nyagetera (1993).

²⁹ Ibid.

³⁰ See, Nyagetera (1991).

accounting for over 50% of total financial assets until 1984. Since then the central bank has substantially increased its share.³¹ The Tanzanian financial system has thus remained quite narrow throughout the period 1966-93.

The importance of both the banking system, particularly the commercial banks, and the thrift institutions stems from their role as depository institutions which provide facilities for the mobilization of public deposits. Such deposits are important sources of financial savings and provide the base for lending to ultimate borrowers. An increase in such public deposits in real terms indicates financial growth and improvement in the status of domestic self-reliance over time. Various measures may be used to assess financial growth, viz. the deposits to money ratio (TD/M2), the quasi-money ratio (QMR), the bank loanable funds ratio (M3/GDP), and the financial savings ratio (FSR). An assessment of financial growth in Tanzania is made in Table 10.

The deposits to money ratio which relates public deposits with commercial banks to broad money supply indicates the relative growth of public deposits. The growth of public deposits is shown to have occurred between 1966 and 1979. Between 1979 and 1984 there was a relative stagnation followed by decline until 1990. From 1991 there has been a sluggish rise. The deposits to money ratio thus shows a picture of poor to mixed performance particularly during the post-1984 period.

The quasi-money ratio traces financial development and the spread of financial habits, with interest-earning financial assets gaining in importance in the portfolio mix of asset-holders as economic development proceeds. While the development of this ratio had been relatively poor up to 1984, the post-1984 period has witnessed a substantial and significant increase, indicating that asset holders do respond to changes in interest rates in Tanzania.

Table 10: Measures of Financial Growth in Tanzania

Period	TD/M2	QMR	M3/GDP	FSR
1966-69	0.67	0.31	0.26	0.05
1970-74	0.69	0.44	0.37	0.12
1975-79	0.72	0.31	0.38	0.13
1980-84	0.72	0.37	0.50	0.15
1985-86	0.67	0.45	0.37	0.18
1987-90	0.65	0.44	0.44	n.a
1991-93	0.69	0.62	n.a	n.a

Source: Nyagetera (1993).

Key: TD/M2 - the ratio of total deposits with commercial banks to M2
 QMR - the ratio of quasi-money to M1
 FSR - the ratio of the change in total financial assets to GDP.
 M2 - M1 plus quasi money
 M3 - M2 plus public deposits of non-banks.

³¹ See Nyagetera (1993).

The bank loanable funds ratio, which includes the public deposits of non-banks, and shows the growth of the real lending capacity of the financial system, also presents a picture of relative stagnation between 1970 and 1986 and a relative growth during the post-1985 period. This is also confirmed by the financial savings ratio which increased by an average of 11.8% every 5 years between 1970 and 1984, compared to an increase of about 20% during the post-1985 period. However, Kimei (1994) has shown a picture of stagnation in the bank loanable funds ratio particularly during the post 1984 period despite the improvement in financial asset returns during this period.³² However, Kimei's findings result from his restrictive definition of M3 which in his case includes only the banking system and the Tanzania Housing Bank (THB). A more correct definition should also include, in addition to the banking system and the THB, public deposits from other deposit-taking financial institutions such as the Post Office Savings Bank (POSB) and the Diamond Jubilee Investment Trust (DJIT).

The causes for the stagnation and relatively poor growth of Tanzania's financial system have been identified by various authors³³. A common thread running through these authors' findings of the causes is detailed as follows:

- (i) The financial system was characterized by monopoly which led to the lack of drive towards product innovation and customer orientation. Thus, for instance, private entry was prohibited, the diversification of the menu of financial assets was deterred, and there was a deterioration in the quality of financial services and adherence to banking ethics.
- (ii) Government control of financial institutions and its continual interference in the management decisions of financial institutions affected the mobilization of deposits and the allocation of credit. Thus, for instance, following government pressure, banks opened branches irrespective of viability resulting in bank losses and a reduced growth of deposits. Similarly, government pressures in credit allocation resulted in a substantial proportion of the loan portfolio being made up of non-performing assets and significantly worsened bank solvency.³⁴
- (iii) There was a Government preference for administrative allocation mechanisms rather than market mechanisms, involving administrative fixing of interest rates and exchange rates, and administrative allocation and control of credit and foreign exchange through the Annual Finance and Credit Plan and the Annual Foreign Exchange Plan. Thus, for instance, with regard to credit, financial institutions could not be expected to compete for resources and their allocation when they could neither influence the prices (interest rates) nor the quantities (credit volume) as both interest rates were set by the government through the Bank of Tanzania and credit volume allocation was made by the government through the Bank of Tanzania in the Finance and Credit Plan. Moreover, given the rigid and fixed interest rates characteristic of the pre-1984 period, the prevailing inflationary conditions resulted in severely negative real interest rates and a decline in the mobilization

³². See, Kimei (1994), p. 213, Appendix 9.1

³³. These include the Presidential Banking Commission (1990), Nyagetera (1991, 1992, 1993), and Kimei (1993, 1994).

³⁴. See, for instance, Kimei (1994), p. 147, and Presidential Banking Commission (1990)

of financial savings. Administrative fixing of exchange rates and exchange control resulted in currency overvaluation, an excessive demand for foreign exchange, capital flight, unsustainable foreign borrowing and the dollarization of the shilling.

The solutions proposed in the Presidential Banking Commission (1990) to address the above problems have started being implemented. These include the Banking and Financial Institutions Act 1991 (BFI) and the Loans and Advances Realization Trust Act 1991 (LART). The BFI Act allows entry of private domestic and foreign banks, removes barriers to competition, enables market forces to play a more decisive role in mobilization and allocation of resources, and establishes capital adequacy and prudency rules. The Banking and Financial Institutions Amendment Act 1993 made further improvements in this regard. The LART Act 1991 provided the mechanisms for dealing with non-performing assets of financial institutions as a means for cleaning up their balance sheets and enabling existing banks and financial institutions to continue operations on a sound financial footing.

The Foreign Exchange Act 1991 also eased the entry and participation of the private sector into the foreign exchange market and has enabled market forces to play a more decisive role. In this respect, the establishment of *bureaux de changes*, allowing the opening of private foreign accounts and private acquisitions and holding of foreign exchange, and the introduction of foreign exchange auctions, have brought about significant and continuing changes in the operation of the foreign exchange market in Tanzania. The government has also taken a number of measures to reform and restructure the country's financial sector and improve the enabling environment at large to ensure unimpeded development and growth of the financial sector. Among the measures for the development of the money and capital markets include the introduction of treasury bill auctions, steps to develop a secondary market for government bonds, and the enactment of legislation for the orderly creation, management and development of markets of equity and securities.

Despite the clearly unprecedented measures adopted by the government, it is still correct to state that, first of all, the measures have not gone the whole way or far enough to assure the achievement of the intended results.³⁵ For instance, interest rate adjustments have not been sufficiently significant, as a result of which real interest rates on short-term deposits have continued to remain negative even after 1990. The spread between commercial bank deposit and lending rates represented by average interest rates on 12-month deposits and short-term loans for the same period has continued to be quite large.³⁶ Such a wide spread between deposit and lending rates signifies high intermediation costs.

Second, exchange rate adjustments have not been sufficient to eliminate the overvaluation of the Tanzania shilling. Consequently, the parallel premium is still quite large and the exchange rate adjustments have not been sufficient to bring about the unification of the official and parallel foreign exchange markets.³⁷

Third, both the segmentation of the financial sector and the problem of monopolistic financial institutions have been addressed only fleetingly. For instance, within the commercial banking

³⁵ . See, Nyagetera (1993).

³⁶ . See, Nyagetera (1993) op. cit.

³⁷ . Ibid.

sector, the National Bank of Commerce which alone accounts for over 85% of the total commercial bank assets continues to remain dominant and monopolistic. Its monopolistic status can only be eliminated if, to start with, the NBC is broken down into several essentially equal smaller banks each accounting for 20-25% of commercial bank assets, and secondly if 100% government ownership is replaced by dispersed ownership which includes the private sector.

Fourth the selective credit system has not been entirely dismantled and the public sector continues to receive preferential access to credit.

Fifth, the payments system, especially the formal cheque clearing system is still poor and inefficient and needs to be overhauled and rehabilitated to improve its efficiency and increase its turn-over.

Sixth, more effort needs to be put in the development of the financial markets viz. the money market and the capital market, in order to improve resource mobilization and allocation, and enhance monetary control and the liquidity of debt instruments.

4.3. The Role of Domestic Capital Markets

The domestic capital market is essentially a market for long-term funds. Such a market incorporates a market for securities and a market for stocks and shares. The market for securities involves the market for government bonds and other government securities, as well as the market for commercial debt such as debentures. The market for stocks and shares essentially revolves around the stock exchange. The domestic capital market plays a very important role in raising domestic long-term funds and facilitating the process of investment, since investment generally involves a medium or long-term frame.

The domestic capital market has in its broadest sense essentially been non-existent in Tanzania. Indeed, it has almost been synonymous with government securities.³⁸ The menu of government bonds in Tanzania is, however, quite narrow, being confined to Treasury stocks with a maturity of 5, 10, 15 and 20 years. Treasury Notes with a maturity of 2 years which started in 1980, and Treasury Reserve Certificates with a maturity of 3 years from 1986.³⁹ The level of interest rates on government bonds has generally been uniformly above the interest placed on deposit instruments until relatively recent times.⁴⁰ This was designed to encourage the flow of long-term financial savings to the government. Government securities are predominantly held by financial institutions (averaging over 90% since 1978)⁴¹ and thus financial institutions have directed a substantial share of mobilised funds to the government.

Specialized financial institutions in Tanzania particularly falling under the category of development financial institutions have also been participants in the market for medium and long-term funds. However, in practice this 'market' has been limited. While they have been relatively more successful in mobilizing foreign savings, their performance in the mobilization of domestic

³⁸ . See, Nyagetera (1993).

³⁹ . See, Nyagetera (1993), op. cit.

⁴⁰ . Ibid.

⁴¹ . Ibid.

savings has been quite dismal.⁴² They are all almost entirely a product of government tinkering in the financial sector, as a result of which they are characterized by monopoly, segmentation, government control and intervention in credit decisions, and the large proportion of non-performing assets in the loan portfolio. Consequently, the importance of specialized financial institutions in fostering the development of the capital market in Tanzania through the mobilization of long-term domestic funds has been quite dismal or negligible. Indeed, these institutions have not tried to establish a market for long-term commercial debt instruments such as debentures.

The market for stocks and shares has also almost entirely been non-existent, and this was a result of the long held "Arusha Declaration" view which equated the development of a market for shares with the development of capitalism. Since capitalism was considered an anathema, obviously the development of a shares market was also considered the same way until 1991. This mainly explains why a stock exchange has been completely absent from the Tanzanian financial landscape. An important reason had also been the dominance of parastatal enterprises for almost three decades and the absence of large and relatively strong private enterprises with public share subscriptions.

The importance of a stock exchange and the market for stocks and shares stems from its ability to facilitate the improvement of the financial leverage of enterprises through the raising of equity funds which enable an enterprise to improve its credit rating.

The government currently has the view that a stock exchange is essential for business development. Consequently, the Capital Markets and Securities Act 1994 has been enacted. This has been followed by the establishment of a Capital Markets and Securities Authority charged with the regulation and supervision of the market and its participants. The Capital Markets and Securities Authority has already initiated a number of steps which are expected to lead to the establishment of a stock exchange, initially in the form of an Interim Stock Trading Facility⁴³.

Other institutional developments involving the capital market include the launching of the Tanzania Venture Capital Fund (TVCF) in 1993 to facilitate the formation of joint ventures between foreign and local entrepreneurs through the provision and mobilization of equity funds. The TVCF began with a fund of US \$6.61 million, and by July 1994, had contributed US \$1.65 million to eight projects with a total equity investment of US \$5.5 million⁴⁴. However, the size of the TVCF is small and its impact is yet to be felt. Moreover, this is the only venture capital fund in Tanzania, thus creating in place an environment which facilitates the establishment of similar venture capital facilities would clearly be a positive contribution.

⁴² . Ibid.

⁴³ . See, Kibola (1995).

⁴⁴ . Ibid.

4.4. Issues Requiring Further Research

From the above discussion on the issues affecting domestic savings mobilization in Tanzania, the following emerge as areas for further research:

- (i) Causes for the continued fall of the domestic saving rate and the associated rise of the savings gap, and the options for raising the domestic saving rate.
- (ii) The impact of macro-economic adjustment on the rate of domestic savings.
- (iii) The impact on household savings of the deepening marginalisation of the rural and urban population.
- (iv) The impact of informal sector savings on the rates of domestic savings.
- (v) The relationship between foreign aid and domestic savings in Tanzania.
- (vi) The relationship between credit availability to savers and the growth of financial savings with financial institutions in Tanzania.
- (vii) How to eliminate segmentation and monopoly in the Tanzanian financial system.
- (viii) How to solve the problem of the wide spread between deposit and lending rates and the implied problem of high intermediation costs in Tanzania.
- (ix) How to integrate the conflicting goals of rising deposit and lending rates in Tanzania.
- (x) How to bring about the unification of the official and parallel foreign exchange markets.
- (xi) The mechanisms for assuring the efficient operation of the payments system, particularly of the formal cheque clearing system.
- (xii) How the process of selling shares to the public has proceeded so far before a stock exchange or share-sale rules have been established, and whether this process has proceeded in a manner which eliminates the potential and possibility of 'ponzi schemes'.
- (xiii) The modality under which a securities market which incorporates both government securities and commercial debt may be established in Tanzania.
- (xiv) The modality for the establishment of a stock exchange catering for both parastatal and private enterprise share trading in Tanzania.

5. CONCLUSIONS

This paper sets out to undertake a review of the current knowledge available on the experience of investment, foreign aid and domestic savings mobilization in Tanzania in order to identify the current knowledge gaps which may be addressed as possible research areas. Such possible research areas in investment, foreign aid, and the mobilization of domestic savings have been identified in Sections 2.4, 3.3 and 4.4 above.

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