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Small Scale Industries, Transaction Costs and Reform: The Case of Tanzania

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PREFACE

This study was undertaken within the frame of a research project on ”Small-scale industries in Africa: Lessons from the Asian experience”, which is carried out jointly with the multi-disciplinary teams of the International Labour Organisation in Addis Ababa, Harare and New Deli, with financial assistance from the Swedish Agency for Research Co-operation with Developing Countries (SAREC). It is one of a series of studies focusing on the development of small scale industries in economies undergoing transformation towards market economies from socialism and central planning in Asia and Africa. The focus of these studies is on an analysis of the development of small-scale industries in the wake of economic liberalisation and institutional reform and on the importance and implications of the institutional environment and macro-economic policies for the development of small-scale industries.

The present study provides an analysis of the broad linkages of small scale industries with a country’s institutional framework, in terms of transaction costs. An attempt has been made in explaining the experiences of small firms in Tanzania in this regard.

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Abbreviations

BIS	Basic Industry Strategy
BoT	Bank of Tanzania
CCM	Chama Cha Mapinduzi
ERP	Economic Recovery Programme
ESAP	Economic and Social Action Programme
NBC	National Bank of Commerce
NSIC	National Small Industries Corporation
NMC	National Milling Company
SAP	Structural Adjustment Programme
SIDO	Small Industry Development Organisation
SIP	Sister Industry Programme
SSE	Small Scale Enterprise
SSI	Small Scale Industry
TAA	Tanganyika African Association
TANU	Tanganyika African National Union
TAS	Tanzanian Shilling

SMALL SCALE INDUSTRIES, TRANSACTION COSTS AND REFORM:

The Case of Tanzania*

1 Introduction

Tanzania has been described as 'one of Africa's economically most distressed, socially most innovative, and politically most controversial countries'.[1] It has been rated one of the poorest countries in the world by the World Bank, and it has attracted international attention for its experiment with African socialism. Undoubtedly the charismatic leadership of Julius Nyerere, Tanzania's President for over twenty years, and his forefront position in the fight for African liberation has helped to put Tanzania on the global map. In the late 1970s and early 1980s, Tanzania experienced a for the country unprecedented economic crisis with increasing budget deficits and detoriating current account positions, all combined with a heavy reliance on foreign aid. Parallel to this development the country endured a rapid growth in its population. Since 1986 has Tanzania in large followed a structural adjustment programme under the sponsorship of the World Bank.

Without any doubt, Tanzania may be labelled a *transition economy*; it is moving away from its attempt at socialism, which lead to a high level of bureaucratic co-ordination of resource allocation, towards the implementation of an economic system based on market forces, where market co-ordination is allowed to play an increasingly larger role.[2] As a result, Tanzania's search for macro-economic stability has been faced with a set of challenges peculiar to these types of post-socialist economies. One main challenge for countries undergoing transition is the inherited institutional setting, which most likely is not well equipped to meet the demands of the new economic order. Furthermore, the institutional setting of most socialist countries was biased against certain types of economic activities, private small scale entrepreneurship being one of them. These biases may be expected to result in a structure of transaction costs which affect the environment of the economic agents and, subsequently, also their decisions and behaviour.

* An earlier version of this paper was presented at the 'ILO Seminar on Macro-policy Framework for Small Scale Industries Development in Africa and Asia', Nairobi, Kenya, 26-29 March 1996.

[1] Yeager (1989) p. 1.

[2] Kornai (1992) pp. 91-92, describes the characteristics of these two basic and polar co-ordination mechanisms. *Bureaucratic co-ordination* is a vertical relationship between subordinates and superiors in a multi level hierarchy. These vertical linkages are asymmetrical as the subordinates depend more on the superiors than the reverse. Thus, the command, i.e. an order which the subordinate has to follow, becomes the typical flow of information. *Market co-ordination,* on the other hand, are horizontal linkages between legally equal partners. The motivating factor for transactions is financial gains, and the price mechanism is used.

This study starts from two basic assumptions, the first being that small industries are *sine qua non* for the overall industrial development of any country. The development of a healthy formal small scale industrial sector - including the dynamic element of growth in firm size - is taken to be both in line with the global development, and a facilitating element in the transition period Tanzania is undergoing. The other assumption is that the outcome of macro-economic management is affected and influenced by the structure of transaction costs prevalent in a certain economy. Attempting to specify existing and potential sources of high transaction costs is here seen as one first step to 'move beyond the debate over the advantages and adverse affects of structural adjustment programmes'.[3]

Thus, the main focus of the paper lies with the institutional framework of Tanzania, and on possible ways this framework has affected transaction costs facing formal small scale industries operating in its economy. The paper uses a historical perspective and it puts particular emphasis on policy making and general factors which have influenced Tanzania's internal economic environment. Finally, as the study is based on secondary data and adequate information about Zanzibar proved hard to find, its scope has been limited to a discussion of mainland Tanzania only.

The remainder of the paper is organised as follows: Section 2 summarises Kornai's model of the classical communist system, as well as it introduces the basic concepts of institutions and transactions costs, and their relationship. Section 3 briefly outlines the economic history of Tanzania since its independence in 1961. Section 4 analyses the institutions setting of the country using a transaction cost approach, while section 5 explores the situation for small scale industries in Tanzania and introduces some important supporting institutions. Finally, section 6 links the situation for small scale industries to the analysis of the institutional setting, as well as it summarises some general implications for transaction costs and small scale industry development in Tanzania as found in this paper.

2 Basic Models and Concepts

2.1 A Socialist Economic System Prototype

2.1.1 What is a Socialist Economic System?

As Tanzania has been identified as a transition economy one natural point of departure is to outline some basic features of the socialist economic system itself. Unfortunately, no general agreement as to what constitutes a socialist economic system has been reached. Traits such as self-declaration on the part of official leadership, state control of the commanding heights of the

[3] Ronnås & Sjöberg (1996) pp. 23, 24.

economy, a high degree of central planning, nationalisation of land and strategic industries, and the primacy of political objectives over economic ones have all been used to distinguish socialist economies from other economic system. However, the one system which is seen as embodying all these traits is the ”classical socialist system” which has been thoroughly investigated and clearly outlined by Kornai.[4]

Kornai argues that the socialist system constitutes a broad but clearly identifiable class of social-political economic systems; countries within it share common phenomena and properties, i.e. there are traits which are system specific. In particular, the socialist system rests on a peculiar structure of power, ideology, property and co-ordination mechanisms.[5] *Power* refers to the one-party system with the undivided political power of the ruling Party along with suppression of any force which depart from, or oppose, the Party’s policy. *Ideology* refers the official ideology adopted by the ruling party which in fact forms its sole; the Party’s organisational existence and its ideology form an indivisible entity. Ideology work both as a codification of values of those in power, and a back-drop on which to legitimise the existing social order. *Property* under the classical system takes the form of preponderance of state ownership, or a situation where at least the key positions (the commanding heights) are under state ownership. This follows on the need to vest control with the ruling party and on the fact the rationale for state ownership and control is given by the prevalent ideology. As to *co-ordination mechanisms,* the system specific constellation is dominated by bureaucratic co-ordination, while all other mechanisms (such as market co-ordination, self-governing co-ordination, ethical co-ordination and family co-ordination) play supporting or secondary roles, or wither away.

Kornai sees the classical socialist system as characterised by a main line of causality, which starts from its political structure. The undivided power of the ruling Party imbued with its specific ideology is seen as the prime factor which induces the other system-specific phenomena. The political structure then brings about the property form it deems desirable, i.e. the dominant role of state ownership. Finally, once these characteristics are in place, they give rise to the prevalence of the mechanism of bureaucratic control. Kornai concludes that classical socialism, although being

[4] Kornai (1992). Kornai uses the undivided power of the Communist party as the sole criterion of a socialist country, and the official leadership’s declaration of the system as socialist as the criterion for nature of economic system. It is worth pointing out that, following these criteria, Tanzania does not fall in the group of countries investigated by Kornai; the leadership in Tanzania adherted to African Socialism not Communism, and although the power of the leading party was undivided, this party did not claim to be Communist.

[5] See Kornai (1992) Part Two, especially chapters 3-6.

repressive and inefficient, constitutes a coherent system which is unable to renew itself (undergo reform) internally as to prove viable in the long run. In the end, transition will come.[6]

2.1.2 Tanzania, the Prototype and the Challenge of Transition

Kornai's model of the classical socialist system should be regarded as a socialist system in its ”pure, laboratory form”, and is therefore somewhat limited in its application. Nevertheless, it points to certain important factors and insights to consider when analysing an economy in the process of transition. While Tanzania does obviously not fit fully in to this particular mould, it is interesting to note that some of the main features of the classical socialist system also appeared in Tanzania. In particular had the ruling party under African Socialism similar claims on power and ideology, but also bureaucratic co-ordination, soft budget constraints[7] and extended shortages emerged as traits of its economic system. This should not be taken to far, however, as the system in Tanzania neither applied central planning nor experienced some of the other system specific phenomena mentioned by Kornai.

The important implications for this study are, first, that a different set of priorities as to political and economical goals than what is usually assumed in economic theory, existed during an extended period of time in Tanzania. This has had bearing on the formation on the institutional structure of the country. Second, however irrational this system may seem, it did in fact constitute a economic-political system of its own which may prove difficult to move away from. Major concretises these points when he states that economic efficiency in a command economy is greatly affected by the efficiency of its political regulation - the latter referred to as ”the system's institutional efficiency”. [8] Institutional efficiency refers to how information is generated by economic agents, how information is transmitted in the system, and how different signals trigger responses to the ruling bodies. Major's argument shows two important things: First, that low institutional efficiency will result in high transaction costs in an economy, and second, that costs incurred due to institutional inefficiency during the transition period constitutes one of the main challenges to economies undergoing transition.

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[6] Kornai (1992) Chapter 15.
[7] A soft budget constraint is a non-binding budget constraint that does not restrict the behaviour of the firm.
[8] Major (1994) p. 332 ff.

2.2 Institutions and Transaction Costs[9]

2.2.1 Definitional considerations

Firms make decisions about organisational form, mode of operation and product mix within a framework of factors which are endogenous as well as exogenous to them. The political, social, legal and economic systems may be examples of such exogenous factors. The nature of institutions and co-ordination mechanisms in a particular economy helps to define the ”rules of the game” and the environment in which firms make its choices. Following North, institutions can be defined as rules which constrain behaviour. These rules can be of a formal nature (such as statues) or an informal nature (such as norms), and they can also be divided in to effective rules (with emphasis on enforcement) and nominal rules.[10] As this paper is concerned with the behaviour of formal small scale industries, formal effective rules become highly relevant, as do government, quasi-government and private non-government organisations or agencies.

Entrepreneurial or economic activities rely heavily on gains from ”exchange” or ”transactions”. The non-existence of perfects markets, with equal access to accurate information by all agents, give rise to the concept of transaction costs. No clear cut definition of transaction costs exist, however, two major definitions are transaction costs as ‘the cost of running the system’ and ‘the costs of measuring the valuable attributes of what is being exchanged and the costs of protecting rights and policing and enforcing agreements’.[11]

Common to most definitions is that they in one way or another relate transaction costs to the cost of acquiring information about exchange. However, Eggertsson points out that the concepts of information costs and transaction cost are not identical as information costs can be incurred without any exchange taking place. According to the same author, ‘when information is costly, various activities related to the exchange of property rights between individuals give rise to transaction costs’.[12] Furthermore, he provides the following list of transaction cost generating activities:[13]

1. The search for information about the distribution of price and quality of commodities and labour inputs, and the search for potential buyers and sellers and for relevant information about their behaviour and circumstances
2. The bargaining that is needed to find the true position of buyers and sellers when prices are endogenous

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[9] Unless otherwise stated this section draws on Ramamurthy & Ronnås (1995). Both the present paper and Ramamurthy & Ronnås’ paper were undertaken as parts of the same research project on ”Small Scale Industries in Africa: Lessons from the Asian Experience” (see the preface to this study). For a more detailed discussion of the theoretical concepts referred to here, please also see section II in Ramamurthy & Ronnås (1995).

[10] North (1991). Another useful distinction between *institutions as social constraints* (such as rules habits, law and conventions) and *organisations as agents* (such as households, firms and state agencies) is done in Khalil (1995). In the present report the term ”institutions” is used to cover both of Khalil’s concepts. In other words, ”institutions” will refer to both rules, regulations, and norms in Tanzania, as well as to the physical organisations which enforce them. Nevertheless, the analysis done generally tries to reflects even Khalil’s, highly relevant, dimension.

[11] Williamson and Ouchi (1981) p. 388, and North (1990) p. 270, respectively.

[12] Eggertsson (1990) p.15.

[13] Ibid.

3. The making of contracts
4. The monitoring of contractual partners to see whether they abide the terms of the contract
5. The enforcement of a contract and the collection of damages when partners fail to observe their contractual obligations
6. The protection of property rights against third party encroachment ....

Eggertsson's list indicates that transaction costs can be incurred both before the exchange takes place (ex ante transaction costs) and after (ex post transaction costs). Costs for information typically occur as ex ante transaction costs, while monitoring and enforcement costs typically take the form of ex post transaction costs. Nooteboom has summarised this as transaction costs arise in three stages of the transaction: the stages of contact, contract and control.[14] Thus, total operational costs for a firm include transportation costs, production costs and transaction costs.

Transaction costs are inevitable to the firm, but cost minimising economic agents will try to economise also on transaction costs. This may be done by 'replacing market transaction, in part or in full, by direct governance within the firm'[15] a process referred to as "internalisation".

2.2.2 The relationship between institutions and transaction costs

The strength of the institutional setting in an economy may be expected to affect the amount of transaction costs incurred by a firm. Eggertsson states that high transaction costs are often associated with weak institutions (weak public enforcement of rules), but argues that high transaction costs can also be associated with strong institutions that leave the agent with few rights. However, this is not to be understood as institutions being the sole cause of high transaction costs. The same author mentions other factors - such as technology of measurement and monitoring, the physical characteristics of assets and the nature of the exchange - as affecting the costs of transacting.[16] Two different perspectives are generally used to explore the relationship between institutions and transactions costs. One states that firms react to a given institutional set-up based on the structure of transaction costs this set-up implies. The other sees measurement and enforcement costs themselves as sources of social, political and economic institutions. Clearly, this indicates that there is a two-way reinforcing relationship between transaction costs and institutions.

For the purpose of this study, the former of the two perspectives will be used. Accordingly, the institutional setting will be regarded as exogenous to the firm; the possibility of large scale enterprises and collectives of small firms actively trying to induce institutional change in Tanzania - however interesting this may be - is considered to be beyond the scope of the present paper. Furthermore, the focus will be on the nature and level of transaction costs in the Tanzanian

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[14] Nooteboom (1993) p. 285.
[15] Williamson (1975) pp. 20-21 and (1981/82) p. 548.

economy which will be inferred from the formal economic system as it developed after independence in 1961. Thus, any transaction cost effects of other non-institutional factors are left out. In other words, the Tanzanian small scale firm will be regarded as adapting to both components of institutions and transaction costs, in an environment where the institutional setting of the country is one of the main determinants of the prevalent structure of transaction costs.

2.2.3 Transaction costs and firms of small size

Nooteboom argues that while small firms often have behavioural advantages (such as entrepreneurial drive and risk taking, motivation, little bureaucracy and proximity of management to customers and to the shop floor) most of their disadvantages lie in material resources.[17] This includes high costs due to lack economies of scale, of scope, experience and learning. Moreover, according to the same author, some generic effects of firms size tend to raise transactions costs for small firms. First, threshold costs[18] arise regardless of the size of the transaction, and, thus, weigh more heavily for the typically smaller transactions associated with small firms. Second, since small firms typically have less resources than large firms to gather information and to internalise external transactions, their rationality is more bounded[19] than that of larger firms. When rationality is bounded, there is scope for opportunistic behaviour among economic agents. Third, firms small in size typically have fewer transaction partners than large firms, and, thus, are more vulnerable to opportunistic behaviour of a single transaction partner. In addition, small firms may be less attractive as contractual partners as the risk of opportunistic behaviour on their part is perceived as higher: 'small and in particular new firms may generate suspicions of their possibly being ”fly-by-night” operations, who are in for a quick ”hit and run”'.[20]

Ramamurthy and Ronnås summarises by stating that in general, the factors causing high transaction costs to small firms are: i) information bottlenecks, ii) an unfavourable policy environment and iii) the nature of the activity of the small business itself.

Small firms may try to avoid, or reduce, high transaction costs through better exploitation of any internal strength they posses, through collective action and lobbying, through linkages with larger firms (subcontracting) or through network building with other, often small, firms. Another option is to develop linkages with the informal sector, which may involve such diverse activities as lending from friends or family or indulge in illegal activities of some sort.

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[16] Eggertsson (1994) p. 22.
[17] Nooteboom (1993) p. 287 ff.
[18] In this context, threshold costs refers to a minimum capacity required for any small amount of output produced. The concept stems from the indivisibility of people, machines and facilities.
[19] Bounded rationality arise from the scarcity of, or cost of, information, and limited capacity for information processing.
[20] Nooteboom (1993) p. 291.

3 Tanzania's Economic Development Since Independence

3.1 Colonial Legacy

Contemporary mainland Tanzania had at the time of independence in December 1961 been under European colonisation since the 1890s, first under German rule and from the end of World War I under British. Colonialism has put its mark on Tanzanian society and its economy in a number of ways, of which only a two shall be mentioned here. Firstly, colonialism in Tanzania had created an economy based on plantation agriculture and on production of cash-crops for exportation to the European market. Secondly, an administrative systems and an economic reward system alien to traditional structures and institutions, as well as a socio-economic structure divided along racial and ethnical lines had been introduced. The Germans had introduced a hierarchical system of government which put Europeans, Arabs and coastal Africans in charge of local headmen. The British administration on their part had applied ”indirect rule” under ”native authority” which in summary referred to letting African officials implement colonial directives and customary law. This system implied that local chiefs and centrally appointed persons received a higher position than the traditional council of elders.[21] This historical legacy has been reflected in the development of the country's political and economical agenda since independence.

3.2 The Search of an Economic Strategy: 1961 to 1967

At the time of independence in 1961 there were a mere 220 industrial establishments employing 10 persons or more and having fixed assets exceeding 20,000 shilling (TAS) in Tanzania. The manufacturing sector contributed about 4 percent to GDP and supported about one percent of all households in the country.[22] After independence a three year development plan (1961-1964) was launched with the prime target to achieve rapid economic growth. The basic structure was that of a free-enterprise economy. The new government actively sought to attract investment in industry by designing a favourable tariff and tax incentive structure, making existing investment opportunities public, establishing industrial estates and guaranteeing foreign investors against nationalisation.[23] The First Five Year Plan (1964-1969) continued this strategy, and it identified market size and availability of capital to be the main constraints to industrial development. Changes of rules of trade and protection of the home market were strategies chosen to address the market constraint, while encouragement of private investment (including foreign) along the lines of import substitution was to lessen the capital constraint.[24] Tanzania experienced a rapid growth in industry

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[21] Yeager (1989) pp. 10-15.
[22] Hedlund & Lundahl (1987) p. 15.
[23] Rweyemamum (1979) p. 71.
[24] Skarstein & Wangwe (1986) pp. 4-5.

during this period. In 1965, there were 596 manufacturing establishments employing 10 persons or more, an increase by almost 160 percent in four years. The vast majority of these investments were channelled to the country's four major urban centres.[25] Available figures on output show considerable increases in most industrial products for the same time period, along with an increase in the share of manufacturing in GDP from 3.6 percent in 1961 to 8.4 percent in 1967.[26]

In essence, Tanzania's economy was mainly governed by the same set of principles as had been adopted under colonial rule. The outcome was an economy heavily dependent on foreign loans and grants, along with a pattern of investment and income distribution that continued to favour a small number of farmers, urban wage earners and non-African entrepreneurs. In addition, a number of internal and external disturbances occurred between 1964 and 1967. The violent revolution on Zanzibar in early 1964 and the subsequent unification of the two states to form the United Republic of Tanzania in April the same year may is one example. Another is the loss of support by Tanzania's largest donor countries (UK, USA and West Germany) due to international political disputes during the same time period.[27] The latter effectively pointed out Tanzania's heavy reliance on foreign assistance and its vulnerability to changes on the international arena.

3.3 The Inward Looking Phase: 1967 to Late 1970s

In the 1960s, a political strategy referred to as ”African socialism” was launched by President Nyerere. This approach was tightly linked to Nyerere's interpretation of traditional African culture and it put emphasis on *ujamaa* (familyhood). It aimed at the creation of a country less dependent on foreign actors in which the state would act as the unifier and provider for the masses. This ideology of socialism and self-reliance was explicitly stated in the policy document signed in Arusha in 1967, in which specific guidelines for a transition to African socialism and ”one-party democracy” were stated. These guidelines were also incorporated into the Second Five Year Plan (1969-1974). The plan aimed for Tanzania to become self-sufficient in terms of the basic needs of the people (food, clothing and housing) and an outspoken import substituting agricultural and industrial strategy was formulated.[28] *Ujamaa* villages were introduced as the basic economic and social unit in rural areas, the idea being to stretch out the tradition of the African extended family to embrace the larger unit of the village. After 1973, a villagisation programme resulted in forced resettlement of scattered population in rural areas, and legal status was given to the villages.[29] In accordance with the Arusha Declaration, the public sector was recognised as the official economy, and the ”commanding

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[25] Rweyemamum (1979) pp. 70-76.
[26] Skarstein & Wangwe (1986) pp. 5,10.
[27] Yeager (1989) pp. 65-71.
[28] Hansson *et al.* (1983) p. 92.

heights" of the economy (such as banking, major industries and plantations, import and export trade, land and major buildings) were nationalised.[30] In addition to the Third Five Year Plan (1976-1981), a long-term basic industry strategy (1975-1995) was adopted. It focused on the development of industrial activities producing to meet the basic needs of the people, and on those producing inputs for domestic agriculture and manufacturing using local resources.[31] The Arusha Declaration constitutes a watershed in Tanzania's economic history and it has dominated the development of the Tanzanian economy from the late 1960s until the early 1980s.

The inward looking period was characterised by substantial improvement in the social sector, e.g. increased life-expectancy rates and adult literacy rates, combined with a gradual deterioration of the productivity of the economy. Economic indicators for the time periods 1967-73 and 1982-84 show a decline of growth in GDP per capita from a positive 2.5 percent to a negative 2.9 percent; increase in inflation from 8.5 percent p.a. to 30.6 percent p.a.; and a sharp increase in the debt to exports ratio level from 120.6 to 513.1 respectively.[32] Emphasis was put on food production instead of on cash-crops for exports which, in combination with an over-valued shilling, severely affected the country's ability to earn foreign currency. Restructuring of the industrial sector according to the basic industry strategy resulted in an increase in Tanzania's dependency on imported intermediate and capital goods. The goal of self-reliance in effect transferred resources from agriculture to industry. The role of prices in the allocation of resources was reduced, and price controls were introduced to most sectors of the economy. The villagisation programme and the introduction of state run marketing boards and distribution systems did not succeed in increasing agricultural productivity. Furthermore, investment in production capacity was not efficiently used and the state sector expanded rapidly.[33]

For a long time, this development was concealed by favourable world market prices of coffee and by a boom in foreign aid. Starting in 1979, however, a series of negative external chocks, e.g. a decline in terms of trade, increasing international interest rates, the expensive war with Uganda and a fall in aid flows, changed the situation. Finally, external pressure in the form a dispute with the International Monetary Fund (IMF) and the World Bank about Tanzania's price system and its exchange rate policy, forced the government to embark on the road of economic reform and of structural adjustment.[34]

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[29] Sarris & van den Brink (1993) p. 11.
[30] Eriksson (1991) p. 6.
[31] Skarstein & Wangwe (1986) p. 7.
[32] Hydén & Karlström (1993) p. 1397
[33] Hedlund & Lundahl (1987) pp. 4, 12-16.
[34] Hydén & Karlström (1993) pp. 1396-1397

3.4 Towards a Market Oriented Economic System: Early 1980s and Onwards

Although the economic crisis shaking the Tanzanian economy in the early 1980s was triggered by external factors, it was nevertheless a logical consequence of the development strategy followed since the adoption of the Arusha Declaration.[35] In response to the crisis, a number of economic recovery programmes have been launched. The first two, the National Economic Survival Plan (NESP) of 1981 and the Structural Adjustment Programme (SAP) implemented in 1983-1985, had both limited direct impact on the economy. During 1965-1985 official statistics show an average annual decline in real GDP per capita of 0.5 percent, while household surveys reveal a fall in real income per household of about 50 percent for the same period.[36] The SAP, however, did introduce some elements of systemic reform by initiating trade liberalisation, e.g. liberalisation of domestic trade in foodstuffs, the Own Funds Imports scheme and other partial eliminations of quantitative controls on imports. Trade liberalisation was generally coupled with price decontrols of the goods in question. In 1986 the Economic Recovery Programme (ERP) was launched, which introduced measures acceptable to the IMF and that later was incorporated in an agreement between the Tanzanian Government and the IMF. The focus of the ERP was on short-term macroeconomic stabilisation and on medium term structural adjustment and economic recovery. It targeted increased agricultural output, higher capacity utilisation within industry, improved physical infrastructure, tight fiscal and monetary policies and a more outward-looking trade strategy.[37] The dismantling of the price control system was to continue and liberalisation of both internal and external trade was to be expanded. Thus, the ERP signalled a shift in the direction of economic policy of the country and opened up for a massive inflow of external fund from international donors and from the World Bank. The ERP was followed by the Economic and Social Action programme (ESAP) covering 1990-1992, which basically continued along the same lines, but that put specific consideration on the development of the social sectors of Tanzania, which by the course of time had become neglected.[38]

Annual growth in official GDP ranged from 3.26 percent to 5.09 percent between 1986 and 1990.[39] The over-valuation of the Tanzanian shilling has gradually been reduced, the largest devaluations taking place in 1986 and 1987. There has been an expansion of both credits, mostly

[35] Eriksson & Lundahl (1993) p. 268.
[36] Hydén & Karlström (1993) p. 1399. This finding has been contra-argued in a survey done by Sarris and van den Brink, which put emphasis on the role of the second economy as income generator in Tanzania. They conclude that real income did declined somewhat for the urban middle class, but that the earlier reported serious decline during the 1970s and early 1980s should be questioned, especially as far as the rural, but also the urban, poor are concerned. See Sarris and van den Brink (1993) Chapter 6.
[37] Eriksson & Lundahl (1993) p. 269.
[38] Eriksson (1991) pp. 9-10.
[39] This paragraph draws on Eriksson (1993*a*) pp. 13-32.

benefiting the government-controlled marketing organisations in the agricultural sector, and money supply. Consequently, inflation has remained high, fluctuating around 30 percent in the mid-1980s but finally falling to about 19 percent in 1990. This has made it difficult for real interest rates to become positive. Foreign currency has only in part become subject to free allocation, but, in fact, the foreign trade sector constitutes the key to the entire recovery programme. The own-funded imports scheme and the open general licence system have been two of the driving forces in the recovery process. This system has made it possible to increase the availability of consumer goods (by some 95 percent on a national average between 1984 and 1988) and various inputs in Tanzania's economy. In addition, it has increased the scope and the relative size the private sector. Exports of non-traditional commodities, including petroleum products, minerals and manufactures, have shown the largest positive change, while the development for traditional agricultural exports, such as coffee and cotton, has remained weak. Non-traditional exports made up almost 50 percent of total official exports in 1990, up from some 32 percent in 1985. Furthermore, decontrol of prices has continued, the tax and tariff system has been revised, an Investment Code (defining areas open for private investment) has been introduced, as have a new banking law and bankruptcy legislation.

In essence, the economic programmes in Tanzania have implied both restructuring and reform measures, and a certain degree of change in the economic environment seems to have taken place. African Socialism has been abandoned in favour of a more market oriented development strategy and the role of the private sector has increased. Liberalisation measures have been partial and implemented gradually. In fact, some of them have officially recognised activities that previously were banned, resulting in an increase of informal market activities at the expense of parallel and black market activities, which have reduced their share of the economy of Tanzania.[40] It has been argued however, that, due to the lack of major reform of the state sector and a certain degree of ambiguity and inconsistency in the liberalisation process, the economic programmes have only partially reformed the economic system and that major rigidities still prevail.[41]

4 Institutional Setting

Following North's definition of institutions as formal rules (e.g. statutes) and informal rules (e.g. norms) this section maps some major institutions influencing economic agents in Tanzania. A picture of rules and norms operating in Tanzania's economy, and their corresponding organisational form is painted. These institutions are relevant for firms regardless of size, i.e. for firms of both

[40] Bagachwa & Naho (1995) Pp. 1393-1934. The authors identifies the *second economy* in Tanzania, which constitutes a large part of its economy but which is unrecorded in official statistics, as consisting of the *informal sector* (unregistered companies involved in legal activities), the *parallel market* (illegal production and trade of goods that are legal themselves) and the *black market* (production and trade in illegal and strictly forbidden goods).

large and small scale, although a particular interest in rules and regulations which have a significant effect on the economic environment of small scale firms is implicit in the discussion. The general impact of these institutions on transactions costs in the economy of Tanzania is also addressed.

4.1 Role of the Party

When looking at the role of the leading Party in Tanzania, there are three important, and highly interwoven, aspects that have to be considered. Firstly, the Party has been the ultimate shaper of the ideology which has permeated the political and economic life in Tanzania for almost three decades. Ideology has worked as the backbone on which various institutions have been formed in the country. Secondly, the Party has operated as the Party supreme in the one-party state created in the early 1960s, and, thus, as an organisation strongly influenced the structure of the political and economic systems. Thirdly, there is the effect of the first two aspects on transaction costs and the subsequent behaviour of firms in Tanzania.

4.1.1 The Party as Shaper of Ideology

By the time of independence in Mainland Tanzania, there was already a *de facto* one-party state under the Tanganyika African National Union (TANU) in place.[42] When it was formed in 1954, TANU had emerged from the Tanganyika African Association (TAA) and from a number of protopolitical interest groups. Opposition to colonialism combined with British harassment of African interest groups and TAA branches, had fuelled the speed with which even remote communities had joined TANU in the 1950s. In the national election to the Tanganyika Legislative Office in 1960, TANU had won all but one seat.[43] By the time of independence, TANU represented the unifying force that had succeeded in ending colonialism as well as it seemed to be the only political party of substance in Tanganyika. Thus, 'TANU felt that it had the duty to lead the country as its policies had already won the support of the people'.[44] In the years following independence, Julius Nyerere, President of Tanzania between 1964 and 1985, started to build an ideological base for TANU - and for Tanzania. It was a socialist approach based on the colonial experience, practices of pre-colonial African societies, Nyerere's education in Western political philosophy and the prevailing cold war politics. He concluded that an ideal society was 'based on human equality and a combination of freedom and unity of its members'.[45] At the heart of Nyerere's "African socialism"

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[41] See for example Eriksson (1991), Eriksson (1993*a*).
[42] Kweka. (1995) p.65.
[43] Yeager (1992) pp. 21-25.
[44] Kweka (1995) p.65
[45] Nyerere as quoted in Kweka (1995) p. 63.

was the creation of the ”new man”, an individual who would adhert to socialist values of hard work and to the moral obligation of contributing for the sake of development of the country.

4.1.2 Ideology as Shaper of the Political and Economic Systems

In terms of political systems and democracy, Nyerere regarded discussion, equality and freedom to be the essential characteristics of democracy and he saw these as being also the essential features of traditional African society. Furthermore, he argued that a Western style of democracy and a two party system were only justified in a society divided over fundamental issues. He did not find this to be the situation in Tanzania which had been unified in its fight for independence and that, according to him, needed to remain united in order to improve the situation of its people. In essence, Nyerere did not see any incongruity in speaking for equality and democracy, and at the same time argue for a political system based on one single party. The role of this party was to work as a two-way channel for ideas between the people and the Government; to secure grassroots participation and popular election of political candidates, while at the same time reduce bureaucracy and increase control of the Government.[46] In fact, voluntary participation and mass support can be regarded as the two legs on which Nyerere’s socialism stood.[47]

The formal introduction of ”one-party democracy” in 1965[48], was triggered by the revolution on Zanzibar and the following creation of the United Republic of Tanzania in 1964. It legalised a political structure that had already started to take form, in which TANU was the political supremacy. In 1963, the colonial native authorities were replaced by district councils, to which district TANU organisations were empowered to approve all candidates. Private trade unions had been merged into the National Union of Tanganyika Workers and co-operative societies had been transformed into the Co-operative Union of Tanganyika, both of which became formal affiliations of TANU. After 1965, policy decisions were made by the Party and merely ratified by the National Assembly. The National Executive Committee of TANU was given the parliamentary right to summon witnesses and subpoena evidence from both Party and Government leaders. In addition, the Preventive Detention Act of 1962 and subsequent legislation allowed for the arrest of TANU critics within the trade unions, and local inhabitants considered by the regional and area commissioners to be endangering peace and good order.[49]

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[46] Kweka (1995) Pp. 60-67.
[47] Hedlund & Lundahl (1989) p. 19.
[48] Nyirabu (1994) p.2. One-party democracy was incorporated in an interim constitution which actually allowed for two parties to be present in Tanzania: the Afro-Shiraz Party (ASP) on Zanzibar and TANU in Mainland Tanzania. In 1977, the two parties were merged to form the Chama Cha Mapinduzi (CCM).
[49] Yeager (1992) pp. 66-69.

Ideology has also had a significant impact on the economic system in Tanzania, where both the goal structure and the incentive scheme have been affected.[50] To help in creating the ”new man”, a set of non-material incentives based on the African tradition of the extended family was used: ‘the *carrot* of moral rewards for providing for your nearest relatives, and the *stick* of social disgrace for those who do not pull their weight’.[51] These ideas all came together in the Arusha Declaration of 1967, which finally incorporated a new economic system with the new state and the new ideology. In the Declaration, capitalism was declared the main enemy, foreign interests and the ”commanding heights” of the economy were nationalised, moral exhortation was to replace material incentives, the Leadership Code preventing TANU and Government leaders from engaging in economic activities outside the political system was introduced, and an explicit focus on agricultural development as the means to achieve self-reliance was formed. A second ideological milestone came in 1971 when the Party Guidelines were issued. This document aimed at restoring the Party and its socialist values, and attitudes towards domestic capitalist stiffened. One result was the loss of one-fifth of the country’s Asian population on 1971 alone, due to expropriation of private houses. To sum up, ideology in socialist Tanzania produced a goal structure centred around economic development which put emphasis on distribution and economic equality, not on economic growth. The resulting incentive scheme was complicated, mixing elements of central control with decentralised decision making within the framework of Governmental guidance, voluntary participation and moral exhortation.

In general, the role of the governing Party in Tanzania under African socialism was significant. In implementing its ideology (which was not always done successfully) it shaped a highly integrated political and economic system through which the rules of the game could be set. At present, this aspect of the Tanzanian socialist system finds itself in transition, a development that started with the 1991 Zanzibar Resolution. Here, the national committee of the Chama Cha Mapinduzi (CCM), in order to ”keep up with changing times”, reinterpreted the Leadership Code to allow for Party members to own shares in private businesses, and legitimised some economic activities previously labelled as ”capitalist activities”.[52] Finally, the introduction of the multi-party system in 1992 and the elections held in 1995 reflect the reshaping of the ideological environment in Tanzania.

[50] This paragraph draws heavily on Hedlund & Lundahl (1989).
[51] Hedlund & Lundahl (1989) p. 22.
[52] Nyirabu (1994) p. 11

4.1.3 Party, Ideology and Transaction Costs

The attitude towards capitalism and private enterprises under African socialism has not been conducive to private entrepreneurship in Tanzania. In fact, a sharp anti-market philosophy prevailed, which for instance could be seen in daily news commentaries which strongly discredited anything capitalist in the country.[53] The role of the private sector within the socialist framework in general has been ambiguous. As seen already, the public sector was declared the official economy under the Arusha Declaration. Furthermore, a number of Government Acts and Directives, have directly and indirectly discouraged private entrepreneurship.[54] As late as in the 1987-2000 Party programme, the private sector was only seen as fulfilling a role in the transition period from capitalism to socialism, after which it was to be abolished.[55] The distrust of private entrepreneurs, and the fear in the Party of an emerging economic and political elite, was manifested in the 1983 crackdown on ”economic saboteurs and racketeers”. This event was triggered by the belief that the shortage of goods in the formal sector and the rapid expansion of the second economy was due to deliberate hoarding with the aim to overthrow the Government.[56] After the introduction of the reform programmes in 1984, the situation for the private sector has changed somewhat. The most significant recognition of change, at least in symbolic terms, is the adoption of the Investment Code in 1990, which defines areas open for private, including foreign, investment.[57] Noteworthy is, however, that the mere need to define areas open for private investment underlines the ambiguous position this sector has had in the ideological framework in Tanzania.

In essence, both the institutional aspect and the organisational aspect of the Party, i.e. the ideology and the political system, have created a high degree of uncertainty among private economic agents in Tanzania. The official ideology has been alien to private entrepreneurship, and the development up until 1984 indicated increasingly harder restrictions under which these enterprises could operate. The combination of the 1983 crackdown and the introduction of economic liberalisation measures the following year, implied extremely fast changes in the policy framework of the country. The step-by-step approach of the reform process, the lack of an explicit commitment to transformation of the economic system and the occasional discrepancy between directives and their implementation, have resulted in uncertainty about in what direction the country is going.

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[53] Hydén & Karlström (1993) p. 1396

[54] Bagachwa (1995) p.24 Apart from the already mentioned Nationalisation Acts and the Leadership Code, which effectively excluded capitalists from engaging in politics, also the 1974 Ujamaa Village Act which excluded individuals from owning small industrial enterprises in villages.

[55] Eriksson (1991) p. 38

[56] For an extensive account of the 1983 crackdown, see Bagachwa & Maliyamkono (1990), pp. ix-xix.

[57] Eriksson (1991) pp. 36-37.

Thus, first and foremost, the Party has tended to increase overall transaction costs, by creating, and maintaining, uncertainty about what the rules of the games look like in Tanzania.[58] Lack of trust in the intentions of the political leadership implies that business commitments and investments decisions tend to be of short run nature, and of limited size. For example, search costs may increase as information about the behaviour of the potential partner, as well as price and quality of the product, has to be investigated and re-investigated thoroughly by own means before any decision about entering a contracts can be done. Furthermore, contracting costs become high as the contract, or the agreement between two parties to conduct business, has to include a number of possible scenarios. So do third party protection costs as the contract has to take into account possible encroachment by a third party, e.g. the Government in the case of nationalisation or in the case of economic activities in which the Government can be anticipated to show particular interest and which may become restricted to state enterprises.

Furthermore, following the adaptation of a redistribution oriented, as opposed to growth oriented, ideology, a number of regulations that affected transaction costs in Tanzania were introduced. Restrictions, for instance on certain commodities and credit arrangements favouring the state sector - the official economy - are likely to have increased transaction costs for those operating outside of it. The implication of these restrictions is that, for example, search costs and third party protection costs increased due to the ideology followed by the ruling Party in Tanzania. Some of these transaction costs may have decreased when liberalisation measures were introduced, e.g. liberalisation of domestic and external trade allowed for economic activities that previously were regarded as capitalist but that were carried out anyway, although under a great deal of uncertainty and risk.

It is worth pointing out, however, that as long as there is no explicit commitment to transformation of the economic system and the official ideology remains ambiguous in its relation to private economic activities, the threat of reversal of reform measures and a re-introduction of restrictions on private economic activities is always present. Recent changes in the political system, i.e. the introduction of a multi-party system, may have reduced this source of uncertainty, while at the same time have increased uncertainty about the political environment and the ideological base of Tanzania, at least in the short run. Thus, because of the transition process that the country is going through, transaction cost due to lack of trust would still seem to play an important role in the decision making of firms in Tanzania.

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[58] Eriksson (1991) pp. 37-39.

4.2 Role of Government

4.2.1 Government Organisation

Mukandala argues that under African socialism, the ruling Party had overall control of the state in Tanzania. The Government was either part of, or answerable to, the Party, and Government and Party functionaries overlapped to a high degree. Formulation of political policy was dominated by the Party, particularly by its National Executive Committee and its Central Committee, and the role of Government was mainly to implement these policies under supervision of the Parliament. In addition, the Parliament constituted a committee of the National Congress of the Party. As an effect, to distinguish between the roles of the Party and of the Government was in most cases troublesome.

Administration became the fastest growing sectors of the economy in the 1970s, and in the mid-1980s it made up just short of 30 percent of government spending.[59] In 1988, the public bureaucracy comprised 303,000 workers of which 142,166, or some 47 percent, were found in central government and the rest in local government or in other services.[60] In general, bureaucrats played a secondary role to politicians, something which was explicitly palpable in terms of policy making. However, this was often compensated for by a tendency among bureaucrats to 'leave policies that they did not like to die a natural death'.[61] The situation has changed somewhat in the 1980s, as policy decisions, due to internal pressure as well as to the involvement of international agencies such as the World Bank and the IMF, have tended to rely more on technocratic, as opposed to ideological, expertise. The economic crisis in the early 1980s, and the following decline in governmental resources, led to the bureaucracy having increasing difficulties in transferring information to its different branches. As a consequence, decentralising measures have taken place, for instance the introduction of popularly elected Executive Officer at the district level.

4.2.2 Fiscal Policy and Taxation

In the early years following independence, fiscal policy basically followed the policy adopted by the colonial administration, and was generally of a conservative nature. As the ideology of African Socialism took form in the 1960s, government budget deficits became regarded as a positive instrument in development policy.[62]

There seems to be a general consensus that the rapid expansion of the public sector that took place in the 1970s, in combination with a lack of appropriate policy responses to external shocks,

[59] Sarris & van den Brink (1993) p.25.
[60] Mukandala (1995) p. 66.
[61] Mukandala (1995) p. 67.
[62] Bukuku (1992) p.3.

have been main factors behind the economic crisis in Tanzania.[63] Overall, the Government aimed at managing economic difficulties by instituting tight controls and it was inclined to use the budget as its principal policy instrument.[64] Between 1976 and 1987, there was a public sector deficit ranging from 7.5 to 14.5 percent of GDP at market prices in Tanzania. Moreover, a sharp increase in the share of administration and services of the public debt of total expenditures took place in the 1980s, at the expense of the shares of education, health and economic services.[65] This development has constituted a large deviation from the basic needs approach to which the Government committed itself when adopting the Arusha Declaration.

Taxation was introduced in 1897 by the Germans as a mean to incorporate indigenous agricultural producers into the money economy. Today, consumption and excise duties plus income and personal taxes constitute the bulk of Government revenue; between 1967 and 1986 they made up 70 to 80 percent of total revenue.[66] Osoro argues that tax reforms since the end of the 1960s in general have been aimed at raising revenue to match the rapidly growing fiscal spending in the country. The reforms' single focus has been on base-broadening and rate-increasing measures, however, and the result has become a highly complex tax system which lacks in administration and enforcement.[67] Strömberg has looked in to the tax structure and collection procedure encountering small scale industries in Tanzania. Company tax for example, is levied on private and public corporate profits at 50 percent for resident companies. Company tax, along with tax on employees' wages; withholding tax; wealth based tax; and estate duty are paid once a year to the Income Tax Authority. Sales taxes are levied on locally manufactured goods, on imports and on a few services, and it has to be paid on a monthly basis to the Customs and Sales Tax Department. Import duty is paid at the port, and is usually administrated by the importer's agent. Finally, stamp and excise duties, along with various registration fees and licences fees, have to be paid to the Internal Revenue Department. These departments are all accountable to the Ministry of Finance and each has its own office in every region of Tanzania. In most cases, a company small in scale has to visit the different tax departments to pay the tax in cash.[68] Apart from administration, granting of generous exemptions have further reduced revenue productivity. There are a number of possible exemptions from sales tax, for example on industrial inputs and machinery, as well as on customs where 'the Minister of Finance has discretionary powers to exempt goods and individuals from full or partial

[63] See for example Ndulu (1988), Bagachwa & Maliyamkono (1990), Sarris & van den Brink (1993), Eriksson (1993*a*) and Hydén & Karlström (1995).
[64] Wagao (1992) p. 5.
[65] Sarris & van den Brink (1993) p.23.
[66] Sarris & van den Brink (1993) p.25.
[67] Osoro (1993) pp. 1-10.
[68] Strömberg (1995) p.64.

payment of duty'.[69] Furthermore, the tax structure could be accused of discriminating against production as compared to imports, and of having become a part of the soft budget constraints facing the parastatal sector in Tanzania.[70]

4.2.3 Monetary Policy

Under African Socialism prices were seen to have little or no role to play in the allocation of economic resources in Tanzania, and fixed nominal prices were seen as being important in their own right. This included unchangeable nominal exchanges rates as well as unchangeable nominal interest rates. 'Changes in nominal prices were seen as a symptom of profit making and thus of a capitalist mentality'.[71] This ideological standpoint has helped to shape the pricing system, with its emphasis on administrative price controls, as well as it has influenced both interest rate and exchange rate policy.

As pointed out by Caselli, the development of a well functioning money and stock market has not been in line with the official ideology. Instead mobilisation and allocation of financial resources were to take place through an appropriate organisational structure and, starting in the early 1970s, through financial and credit planning. The key monetary policy instrument has been control of credit. The powers of the Bank of Tanzania (BoT) have been extended far beyond the traditional of a central bank when it comes to credit control, and selective control of credits extended by commercial banks and other financial institutions have been possible.[72]

Ndulu points to 'the close relationship between the fiscal deficit, balance of payments and money supply process' in Tanzania.[73] Mainly due to underdeveloped financial and capital markets, financing of government deficits has been restricted to monetary expansion. As a result, Ndulu could find almost a one-to-one correspondence between growth in fiscal deficit and the expansion of money supply in Tanzania. Between, for instance, 1978 and 1981 net claims on government contributed to 90 percent of monetary base expansion.[74] Net claims of the banking system on the government increased by almost 20 percent annually in the late 1970s, and reached close to 30 percent annually for the first three years in the 1980s. During the peak of the economic crisis in 1980 to 1986, from 24 percent up to as much as almost 72 percent of the financing of the public deficit was in the form of bank borrowing. After 1986 this share seems to have been reduced quite

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[69] Osoro (1993) p. 23.
[70] Eriksson (1991) pp. 27. 41.
[71] Hydén & Karlström (1993) p. 1396
[72] Caselli (1976).
[73] Ndulu (1988) p. 3.
[74] Ndulu (1988) p. 4.

considerably, although loans to loss making parastatals through the banking system has continued, which in effect constitutes money creation.[75]

Inflation in Tanzania, after having fluctuated around 12 percent in the 1970s, jumped to 36 percent in 1980 and reached a peak of 43 percent in 1984. Between 1985 and 1989, inflation stayed close to 30 percent, after which it finally came down to 19 percent in 1990.[76] According to Ndulu, the inflationary process in Tanzania was fundamentally structural in that it was determined by supply-side constraints and channelled through increasing costs. The government exercised monetary accommodation of these pressures in the form of food subsidies, up until 1984, and, despite declining savings rates and lower productivity of investment, a continuation of high investment rates in industry. Between 1966 and 1981, savings varied from 8 to 10 percent of GDP, while net investment for the same period rose from 7 to 27.5 percent of GDP.[77] BoT reports a certain increase in deposits since the start of the reform process, as nominal interest rates have been raised to match inflation and taxes on savings have been reduced.[78]

For the first fifteen years following 1966 when the Tanzanian shilling was introduced, the exchange rate had remained unchanged at 7.143 TAS for one USD. By 1980, the TAS had depreciated by some 14.5 percent, and in the early 1980s the nominal value of the TAS was brought down somewhat more. This was counterbalanced by the high level of the domestic inflation rate, however, and in effect the TAS appreciated in real terms. Thus, the foreign exchange situation in Tanzania since the 1970s may be characterised by an accelerating overvaluation of the TAS.[79] Currency devaluation as a tool of balance-of-payment adjustment was a highly debated issue in the early 1980s. One of the main concerns from Tanzania’s side in the debate with the IMF was the threat of a inflationary spiral due to changes in the real exchange rate between tradable and non-tradable goods and expected slow responds in production of export crops to devaluations. Another concern was the effect on income distribution due to the extensive and rapid devaluation scheme suggested by the IMF. Minor adjustments of the exchange rate were done in 1983 and 1984 under the SAP programme. The large change in attitude came as Tanzania was finalising its agreement with the IMF in 1986. In accordance with the ERP the exchange rate has been adjusted on a monthly basis and by December 1990, it had reached 195 TAS per one USD.[80]

[75] Sarris & van den Brink (1993) p.31, 44-46.
[76] Eriksson (1993*a*) pp. 8, 31.
[77] Ndulu (1988) pp. 4-9, 46.
[78] Eriksson (1993*a*) p. 28
[79] Berglöf (1990) pp. 22-23.
[80] Bagachwa (1993) p.94.

4.2.4 Internal and External Trade Policy

The external position of Tanzania has been a major source of concern since the late 1970s. In 1976 the trade deficit amounted to some 2 percent of GNP, in 1978 it had jumped to about 15 percent, while in 1988 it had surged to 26 percent of GNP. Agricultural primary products, i.e. coffee, cotton, sisal, tea, tobacco and cashew nuts, are Tanzania's six top export earners. Together they account for about 60 percent of total export earnings, although the volume of all six has declined significantly since the mid 1960s. Capital and intermediate goods make up the bulk of imports, while food imports account for 40-60 percent of consumer imports. Before 1985, most of the financing of the current account deficit was through capital transfers. After 1985, an increasing amount has been financed by net external borrowing.[81] It is within the areas of trade policy and price deregulations, that the most comprehensive reform measures in the 1980s are to be found.

Under African Socialism, the pricing system, which stipulated administratively set prices for a number of goods and service, was an integral part of internal trade policy. In general, there was early on a separation between pricing on food items, which became more flexible in the mid 1970s to increase production of food, and non-food items, including production of export crops, which were subject to a higher degree of administrative prices. In addition, a pan-territorial pricing system was used which aimed at equalising producer and consumer prices in all regions.[82] In the early 1980s, more than 400 categories of goods were subject to price control, a number that had been reduced to only three by 1991. Prices for manufactured imports had been totally liberalised by then. Up until 1984, all domestic wholesale trade used to be confined to state agencies, which often exercised monopolistic powers. More than 50 categories of goods, including consumer goods, were subject to confinement. By 1991, there were only three items left.[83]

Most imports and exports were originally confined to state agencies. Despite subsequent de-confinement, monopoly has remained strong with respect to the major export crops. Foreign currency for trade purposes used to be allocated administratively, but this have since the mid 1980s changed significantly. The introduction of various export retention schemes since 1982, the Own Funds Import Scheme in 1985, the Open General Licence Facility in 1988 and the introduction of free foreign exchange auctioning in 1993[84] have all lessened the constraint on procurement of foreign currency by legal means. In 1988 the complex tariff structure was simplified as some

[81] Sarris & van den Brink (1993) pp. 19-20.
[82] Hansson *et al.* (1983) p. 98.
[83] Bagachwa (1993) p. 96.
[84] Eriksson (1995) p. 18.

specific duties were eliminated, and by 1990 tariff rates had been reduced to a four *ad valorem* rates. Export taxes are almost non-existent in Tanzania today.[85]

4.2.5 Industry Policy

As stated earlier, the industry policy adopted after independence was generally open to free enterprise, but considerable changes took place following the adoption of the Arusha Declaration. The second five year plan (1969-1974) reflected the ideology of socialism and self-reliance and argued for increases of domestic consumer goods production, along with that of intermediate and capital goods. The long term Basic Industry Strategy (BIS), adopted in 1974 and covering 1975-1995, has had a real effect on the industrial development in the country. Although agricultural development was the major focal point of the Arusha Declaration, and thus at the political centre, the BIS in effect helped to place agriculture in the economical periphery at the expense of larger-scale and capital intensive industrialisation.[86]

Skarstein and Wangwe clarify that under the BIS ‘exports of manufactured goods would be seen as an extension of the home market, i.e. the export market would develop after the home market had been fully developed and catered for. [The strategy of BIS] represented a significant shift towards the development of domestic resources to meet domestic needs whereby most of the materials required for industrial development would be produced in the country’.[87] The same authors point out that choice of technology has been constrained by e.g. the source of external finance and available technical managerial skills, and that, as an effect, industrialisation in Tanzania under the BIS has been marked by heavy dependence on imported inputs, machinery and know-how. In most cases the employment effect of the industrialisation effort has been rather limited, particularly in the rural areas. Thus, the implementation of the BIS has in most cases worked against the development as outlined the very same document, and against the objectives of socialism and self reliance.

According to the same authors, linkages played a pronounced role in the BIS as means to achieve structural change, although the emphasis was mostly put on inter-sectoral linkages (e.g. between industry and agriculture) and not on intra-industrial linkages (i.e. linkages within the manufacturing sector). The BIS identified a list of core industries which constituted the base of industrial production in Tanzania.[88] Studies have shown that typically these basic industries did

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[85] Bagachwa (1993) p. 96.
[86] Hedlund & Lundahl (1987) p. 11
[87] Skarstein & Wangwe (1986) p.35
[88] These were: iron and steel industries, metal working and engineering, industrial chemicals, paper, textiles, leather, construction materials and electricity.

show stronger backward linkages than the average, but that forward linkages in general not were above the average for all sectors in the economy. Moreover, the basic industries were shown to be highly import-intensive and to display low income effects. The linkages between, and the precise role of, small and large industries were vague and unclear in the BIS. In general, the planners seemed to have regarded small scale industries as connected with a number of ”sacrifices” in terms of cost, quality, consumer choice, speed and efficiency. In conclusion, the planners sent ‘a message of bias against the small scale of industries’.[89]

Rules on registration and licensing constitutes a part of the industry policy that directly affect firms in any economy. In Tanzania, enterprises are required to be registered (for small scale units) and sometimes licensed (for units with investments in buildings and machinery of above TAS 5 million). Failing to comply to these requirements in effect constitutes illegality. Bagachwa describes the process by which a company gets registered. Firstly, the company name has to be accepted by the Company Registration Office. Secondly, the articles of association have to be presented to the Company Registrar were registration is received for a fee. Thirdly, if the company is to be licensed, it has to apply to the relevant municipal authority, such as the City Council, where the application has to be approved by as many as six different authorities, ranging from the Health Officer to the Principal Assessor, for a fee. Fourthly, the licence has to be taken to the Trade Officer where it is lodged and the appropriate Ward number according to location is received. This fourth step can take up to three months. Finally, the enterprise has to register by the National Provident Office for employer’s insurance reasons.[90] In addition, the license has to be renewed each year, for a fee, which hinges upon the company first having received a number of clearances from various authorities.[91] In short, licensing and registration procedures are rather long-winded and costly affairs.

4.2.6 Government, Policy and Transaction Costs

Above, policies are identified as institutions which affect the behaviour and decisions by economic agents operating in Tanzania. The picture that emerges indicate that the Government did not consider lowering of overall transaction costs of the economy to be its major concern. Rather, policies and regulations were focused on redistribution, and development was to be achieved through a system of tight controls and active steering of the economy in a predetermined direction based on socialism and self-reliance.

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[89] Skarstein & Wangwe (1986) pp. 52, 169-190.
[90] Bagachwa (1993) p. 108.
[91] Levy (1993) p. 76.

Moreover, when looking at the organisation of government and of the political system in Tanzania, two interesting aspects emerge. First, the sheer size and scope of the political system which infiltrated most levels of the society. Second, the high degree of interaction and interdependence between the Party, the Government and the public sector. Given the integration of powers between the legislature (in effect the Party), the executive (in effect the Government and various parastatals) and the judiciary that prevailed in Tanzania, the political system to a high extent had to rely on self-enforcement of contracts. As a matter of fact, for most of the contracts agreed upon within the system, such as policy decrees, it had to rely on itself for monitoring and control. Thus, neither were there any checks and balances nor was there any powerful third party that could enforce contracts designed within the political system. In effect, the political system in Tanzania with its vast size and depth ought to have contributed considerably to the creation of high overall transaction costs. This particular situation is bound to change as a new political order under a multi-party system emerges, however.

As to rules and regulations, and the subsequent behaviour of firms, many mechanisms that may influence transaction costs emerge. Constantly present throughout, though, is the importance of ex-ante transaction costs, mainly in the form of costs for search for information about restrictions, as well as exemptions from restrictions. The time factor seems to be another predominant source of transaction cost. The examples of necessary procedures in the case of registration and submittance of taxes referred to above both indicate that any potential entrepreneur has to be well informed about a number of requirements and proper conduct. In addition, he or she has to possess a great deal of patience, and probably have an alternative income when the application is being processed by different authorities.

In short, the non-transparent nature of government policy, as well as the organisational structure supporting these policies, seem to impose significant transaction costs on registered and taxpaying (i.e. formal) enterprises in Tanzania. The result points to a number of small scale entrepreneurs in effect being pushed into operating in the informal economy, regardless whether they actually intended to or not. There is another side to the coin of taxation, however, which is tax evasion. As indicated above, the tax system in Tanzania lacks in enforcement. Administrative requirements of taxation are a source of high transaction costs to a company only as long as taxes are paid. Tax evasion is an effective mitigating strategy when tax enforcement is bad. As a consequence, the faulty taxation system in Tanzania may work as a disincentive for small scale enterprises to register, and to make ample investments to grow in size. Instead it may induce expansion of operations by means of addition of new, equally small enterprises to existing ones.

4.3 The State Sector

The state sector comprises majority owned state enterprises and institutions. In the case of Tanzania, majority owned state enterprises or other organisations are referred to as parastatals. Official financial institutions, which for the most part are fully state owned, have here been separated from other parastatals in order to highlighten their particular role in the economy. In accordance with the official ideology adopted after 1967, the state sector has been a significant part in the shaping of economic development in Tanzania. By its cheer size in some industries, and by its key position in others, the state sector must be regarded as one of the most important institutions affecting the economic environment in the country.

4.3.1 Parastatals[92]

4.3.1.1 Size and Scope of the Parastatal Sector

Eriksson shows that in the late 1980s, there were about 400 parastatals in Tanzania, of which more than 75 percent were commercial.[93] They were found in all sectors of the economy. There were agricultural parastatals, e.g. state farms and marketing boards, such as the National Milling Corporation (NMC), responsible for marketing of agricultural inputs and outputs as well as processing of certain farm produce. Parastatals were also engaged in industry and manufacturing, in domestic wholesale and retail trade, and in exports and imports. Mostly due to uncertainty about the reliability of official figures, the share of the state sector in the economy of Tanzania is somewhat difficult to gauge. Estimates show that parastatals have been more heavily represented in certain economic sectors that in others, manufacturing being one of them with contribution to industry value added of almost 50 percent from parastatals. In some industries, parastatals have experienced an almost monopolistic position (e.g. steel and basic metal production, fertilisers, pharmaceuticals, tyres and tubes, textiles, leather goods, shoes and paper products), which has also been the case within some parts of agriculture (e.g. wheat, rice, sugar and sisal production, marketing of cash crops). In addition, agricultural co-operatives in Tanzania bore a strong resemblance to state organisations after their reintroduction in 1984, and were formally subordinated to the Party.

It ought to be pointed out, though, that despite the ambiguous role of private ownership and the general emphasis put on the state sector, the Tanzanian economy has remained mixed. The private and the state sector have operated side by side, although private activities have been suppressed and barely acknowledged. In industries where private interests have not been excluded,

[92] Unless otherwise stated, section 4.3.1 draws on Eriksson (1991).

[93] *Commercial parastatals*, or parastatal enterprises, are parastatals supposed to generate revenue to the central government from dividends on profits. *Non-commercial parastatals*, or parastatal organisations, do not work along such commercial-like lines and include e.g. government run research institutes. See Bukuku (1992) p. 9.

parastatals have had priority over private enterprises in the eyes of the Party and of the Government. They have received preferential treatment in various ways, for example in allocation of inputs, of licenses, of credits and of foreign currency. There has also been a tendency among international donor organisations to channel aid through the official structure.

According to Eriksson, the reform process in Tanzania does not so far seem to have resulted in privatisation of state enterprises to any noticeable extent. A limited number of joint ventures have been established with existing parastatals, and few parastatals have been dismantled. Concerns have been raised as to the proper size of the public sector, the magnitude of a possible privatisation scheme for state enterprises, the timing of any such privatisation and, finally, to whom the chance of investment under a privatisation scheme should be offered.[94] There are some signs of changes within agricultural marketing, with NMC having closed branches and retail shops as well as having laid off 300 workers. Furthermore, the overall staffing level within the state sector has been frozen.[95]

4.3.1.2 The Decision Making Process

The decision making process for parastatals in Tanzania has frequently involved a number of levels and institutional bodies. Major decisions could be categorised as follows: (1) *Policy*: Decisions about the purpose and the nature of business of the parastatal were taken high up in the central hierarchy, i.e. by the National Assembly, the CCM and the Office of the President. (2) *Establishment and Investment*: Decisions on entry and exit, the approval of corporate plans and of investment plans were centralised, involving four to six institutions each, ranging from the Worker's Council to the Ministry of Finance and Planning. Major decisions on the location and size of a unit were initiated by the Central Committee or the National Executive Committee of CCM. (3) *Appointment Decisions*: Appointment of the general manager and of the board of directors was done by the parent Ministry of the respective parastatal in agreement with the President. In general, no leading position within parastatals or co-operatives were ever appointed unless the person had first been approved by the Party. In short, a nomenklatura like system was at work in Tanzania.[96] (4) *Operations:* In Tanzania, physical planning of the production of parastatals was never adopted, instead command and pressure from the Party and the Government influenced operations decisions. Although decisions on day-to-day issues were supposed to be decentralised to managers at the enterprise level, in reality, not even these decisions were taken without approval from different

[94] See for example Bukuku (1992) and Msambichaka (1992).
[95] Eriksson (1993*a*) pp. 13-17.

supervising organs. This included decisions on employment levels and wages, as well as the price of the produced commodities. In addition, since trade in most inputs and outputs was confined to state agencies, parastatals were not free in choosing their suppliers and customers.

Recently, there have been signs of the appointment process becoming more meritocratic as formal procedures have been introduced, and as the boards of directors seem to take more part in the appointment process. The changes have been very slow in materialising though. Nevertheless, liberalisation of domestic trade and of priced has increased the possibility for parastatal managers to make independent operational decisions.

4.3.1.3 Incentive Structure

Despite the fact that the bulk of parastatals in Tanzania are commercial, many of them are chronic loss makers.[97] The goal of profit making has in many instances been confused with other objectives, and parastatals 'are seen as objectives rather than means' to achieve certain goals.[98] In addition, other success criteria apart from profits have been present to commercial parastatals. Loyalty is probably the most important of them. In essence, no system that rewards and punishes on the basis of performance has been present within the state enterprises. Furthermore, given the low compensation levels in the public sector employees have been forces to divert time and effort to other income generating activities. Abuse as well as theft of public property, fraud and corruption have been reported on a number of occasions.

4.3.1.4 Soft Budget Constraints

Eriksson investigates the presence of soft budget constraints in Tanzania's economy. Under soft budget constraints, a firm does not operate under strict financial constraints. Thus, the budget constraint is not binding and 'cost over-runs are covered by some other organisation, typically the state'.[99] The budget constraint of parastatals in Tanzania has been soften by a number of mechanisms, including direct subsidies via the government budget, soft credits from the banking system, non-uniform and negotiable taxes, administrative prices set on a cost-plus basis, guarantees issued by the Government, and privileged or free access to import support form donor agencies. Mechanisms in use have varied between different sectors, as have probably the degree of softness. One important aspect of the soft budget constraint is that it influences the ex-ante behaviour of the firm since no particular attention has to be paid to cost awareness or prices, particularly on the input

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[96] *Nomenklatura* refer to the 'right of all levels of the Communist Party apparatus - from the central party committee down to the enterprise committee - to 'recommend' and 'approve' appointments for all managerial positions in the economic (and public) administration hierarchy, and managerial positions in enterprises' Winiecki (1991) p. 4.
[97] Eriksson (1993*b*) pp. 16-18
[98] Moshi (1990:2) as quoted in Eriksson (1991) p. 25.

side. Certain tendencies toward hardening of the soft budget constraints can be discerned since the reform process has started. This is particularly vivid within industry and commerce where parastatals are facing higher degree of competition due to liberalisation measures, and subsequently the Government seems to have become less inclined to bail out loss making parastatals.[100]

4.3.2 The Financial System

In the inland areas of contemporary mainland Tanzania, which has hosted agricultural kinship based societies since the dawn of mankind, money did not come in to use as means of exchange until the 19th century. The coastal areas on the other hand has a rather different history based on trade, and numerous archaeological findings of Roman, Arab, Persian and Chinese coins unveil a long tradition of use of money. When the Germans arrived in the 1880s, the Indian rupee was the prevalent currency in the area due to commercial connections with India and Indian immigration. The first commercial bank in Tanzania opened in 1905. During the years of British colonisation, Tanganyika became part of the East African Currency Board. After the central bank, the Bank of Tanzania (BoT), was formed in 1966, Tanzania has had an independent financial system.[101]

The bank sector was one of the industries which were nationalised in 1967. As has been indicated in various places in this paper, the financial system has been highly inter-linked with the government sector and it has played a major role in the economic development of Tanzania by being a tool for implementation of monetary policy. It has also been an operating device for the softening of the budget constraint facing parastatals; ‘banks have mainly fulfilled the task of accommodating the financial needs of the state sector’.[102]

The financial system in Tanzania consists of a dozen different financial organisations. Each of these have in practice enjoyed monopoly power in their respective areas of operation. A new banking legislation allowing for establishment of private and foreign banks was adopted in 1991, however, and by February 1993 at least two foreign banks had secured licences to operate in Tanzania[103].The Bank of Tanzania is directly subordinate to the Ministry of Finance, while the commercial banks are directly subordinate to BoT. Eriksson argues that the financial system in Tanzania over time developed to resemble, in some aspects, a ‘monobank’ system in the former socialist economies in Eastern Europe. She bases this on frequent political interventions in decisions

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[99] Eriksson (1993*b*) p. 1
[100] World Bank (1988) p.23
[101] Caselli (1975) pp. 21-25, 111 ff.
[102] Eriksson (1991) p. 28.
[103] Eriksson (1993*b*) p.41.

on credit allocation, along with other operational decisions, as well as to a tendency of lending being 'determined by government priorities rather than market criteria'.[104]

The National Bank of Commerce (NBC) is the major commercial bank in Tanzania, and it has been a major tool by which credit have been extended to the state sector. Formal lending criteria, as credit worthiness and collateral, were established for both the public sector and the private sector, although these were infringed on by other decision of priority to the state sector. In addition, interest rates were generally lower to state enterprises than to private. Recorded NBC lending since 1984 show a bias towards the parastatal sector at the expense of the private, and towards agriculture at the expense of industry. The overall share of the private sector in NBC lending has increased steadfastly, however, and by 1992 private sector recipients dominated in commerce and industry lending.[105] NBC has been accused of poor service, complex and time-consuming loan procedures as well as bad communication performance.[106] Finally, studies have indicated a high degree of disintegration within the NBC as consolidation of branch data at the head office was non-existent until the bank was computerised in 1991, and as there were signs of internal policies being 'neither understood nor followed in most of the branches'.[107]

4.3.3 Parastatals, Banks and Transaction Costs

First and foremost the above points to parastatals as well as having been a major obstacle to achieve allocative efficiency, they have also served to raise transaction costs in Tanzania. By being the high priority sector, backed up by an extensive regulatory framework, parastatals have in many cases excluded free access by other economic agents to resources, credits, foreign currency, distribution networks and markets. Mitigating strategies for non-parastatals imply activities and organisational structures that, although being probably the most efficient given the circumstances, could become even more efficient if not rules and regulations that constantly favoured parastatals were in place.

Furthermore, the structure and the operations of the parastatals, in combination with the negative official attitude towards private ownership, ought to result in difficulties for an outside private firm to either sell to a parastatal, or to become a subcontractor to one. The decision process outlined above, implies a high degree of integration within the parastatal sector and little power for local management to act independently. The structure of incentives and the soft budget constraint imply low accountability and low cost awareness on behalf of management. Thus, even if

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[104] See for example Eriksson (1991) p. 15 and Eriksson (1993*a*) p.41.
[105] Eriksson (1993*b*) pp. 43, 44, 85.
[106] See for instance the World Bank (1988) p. 24, Hyuha *et al.* (1993) p. 25 and Strömberg (1995) pp. 65-57.
[107] Eriksson (1993*b*) pp. 42, 45.

alternative competitive suppliers or subcontractors were available, parastatal managers would probably show little interest in them. First, there is no need to identify cost reducing activities for the parastatal manager since cost is not a constraining factor. Second, pushing for new arrangements does not seem necessary as managers are not held accountable for the financial outcome of the parastatal. Third, even if these first two actions were taken, the parastatal manager is in the end limited by, and subject to, the comprehensive decision making process of the parastatal corporation. Conceivable mitigating strategies on behalf of any agent in dealing with parastatals include networking and lobbying, but also embraces bribery and corruption. All of these are activities that raise transaction costs in the economy, particularly ex-ante costs like search and bargaining costs.

The parastatal sector and the financial system are two highly inter-linked institutions in Tanzania. This is so since financial institutions have allocated credits and foreign currency to parastatals, accumulated overdue parastatal commitments and diversified between private sector and state sector interest rates. Thus, the financial system has, first, affected transaction costs by implementing policies that them selves were transaction cost generating. Second, lack of credit in the private sector, due to preferential treatment of parastatals by the financial system, tend to put strains on private enterprises ability to invest in their operations. The solution may then be to turn to the informal sector for funding. Informal financing as a mitigating strategy may involve high interest rates in some instances, but low or non-existent interest rates in others. Nevertheless, informal funding is based on personal trust, and on considerable, often time consuming, investments in activities such as networking and reputation building. Furthermore, there is a limit in size of informal credit operations as monitoring costs tend to increase rapidly with number of entrants and with distance. In short, there is scope for a decline in transaction costs in the economy as a whole if trust is of a *general nature*, i.e. if economic agents put trust in a well functioning financial system and its procedures of operation, as opposed to of a *particular nature*, i.e. when economic agents put trust in a particular person or in a limited group of people.

This leads to the third and final point about transaction costs and the financial system in Tanzania, which is the low degree of financial integration. The description of the financial system in Tanzania implies potential investment resources not being channelled properly to profitable investments. Monetary policy has in general not been inducive to savings within the official financial system as real interest rates often have been low or negative. The banking system itself has in addition not been a good promoter of savings as such activities have been coupled with adverse administrative requirements. To open a savings account with the NBC for example, references were required and number of withdrawals per week was limited. Furthermore, high nominal interest rate (although still resulting in a negative real interest rate) was offered on the savings account up to a certain amount, after which capital had to be invested in short term certificates or in fixed term deposits at a lower interest rate. Finally, no interest rate was paid on current accounts, although parastatals were forced to maintain their current accounts with the NBC[108]. Other financial intermediaries, such as a functioning capital market, have, so far, been lacking or of moderate importance.

An example of both point number two and three above, is the disintegration of the Asian business community, which constitutes a substantial part of the private sector in economic terms, into the rest of the economy. This business community has in effect developed its own financial institutions. The underlying reason seems to be a lack of trust in governmental policy with regards to its position vis-à-vis private ownership, which spills over into lack of trust in the financial system[109]. Although this arrangement may lower transaction costs for the participants in the system, as compared to having to invest in complicated and time consuming application and feedback procedures, it is also the outcome of high transaction costs in the economy and in fact substitutes a suboptimal solution for the economy as a whole.

4.4 Property Rights

4.4.1 Private Property Rights

The Arusha Declaration of 1967 stated that ‘major means of production should be owned by the state on behalf of peasants and workers’[110], which was manifested in the subsequent nationalisation of the ”commanding heights” in the economy. Nationalisation did extend beyond that of core industries, however, and in the end included private rented buildings and farm estates as well as retail trade activities such as small butcheries and bakeries under private ownership.[111] The Government has tried to play down the threat of nationalisation by the introduction of the Investment Code law in 1990 which acknowledges the existence and importance of the private sector and which identifies areas open for private investments. In addition, the President has declared that the word nationalisation should be erased from the political vocabulary in Tanzania.[112] Still, the wording of the code implies that private property may still be nationalised in ‘due process of law providing for payment of full and fair compensation’.[113] How any such compensation is to be calculated is not stated in the law.

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[108] World Bank (1988) p. 24, footnote 22.
[109] Eriksson (1991) p.41.
[110] Skarstein & Wangwe (1986) p.17.
[111] Bagachwa (1993) p. 105.
[112] Mukandala (1995) p. 63.
[113] Eriksson (1991) p. 36.

Again, it is worth mentioning that, in general, the economy of Tanzania has stayed mixed, even after nationalisation was carried out. Private economic activities have been suppressed but have stayed important, mainly in agriculture, but also in manufacturing of household metal products, electrical equipment, soap, paints and plastics.[114] Retail trade and construction are other areas where the private sector has been important.[115]

Eriksson also points to the lack of legislation providing for bankruptcy and the unclear role of patent legislation in the country. Generally speaking, informal rules have had a higher status that formal legal rights in the history of Tanzania. Policies have often been backed by Government decree and not by formal legislation. The increased scope of private enterprise as implied by the trade liberalisation measures in the 1980s was not given a legal framework until the Investment Code of 1990. Also, the old legislation regarding confinement of goods to the state sector was still in force as late as 1991, although in real life much de-confinement had already taken place.[116]

4.4.2 Land Property Rights

In terms of land, Coldham explains that in 1961 virtually all land was held on right of occupancy, a system dating back to the period of British administration when all land was 'public land' vested in the Governor with the right to grant 'rights of occupancy'. Customary rights were incorporated into occupancy rights. After nationalisation, land was formally owned by the state, but villages had the right to cultivate it. The same author holds that the compulsory villagisation programme in the mid-1970s was basically a policy in absence of any legal framework to define land rights of both villages and villagers. Instead it was based on the assumption that land tenure could, and should, be handled by administrative means. As an effect, a number of disputes over land and land compensation have been filed 'in the more relaxed climate of the 1980s'.[117] However, in accordance with the 1991 Commission of Inquiry into Land Matters, land has been noticed to be of value and the development of private land ownership has been accepted. However, no enthusiasm to introduce a comprehensive programme of registration of individual land titles to owners has been shown. Eriksson states that customary law and the right to inherit land were basically not infringed upon in areas where cash-crops were intensively grown. In addition, long term leasing of land, or rather of what is built on it, was introduced in the 1983.[118]

[114] Skarstein & Wangwe (1986) pp. 19-20.
[115] Eriksson (1991) p.7.
[116] Eriksson (1991) pp. 35-36.
[117] Coldham (1995) p.231.
[118] Eriksson (1991) p. 17.

4.4.3 Property Rights and Transaction Costs

In accordance with the negative attitude towards private ownership that prevailed under African Socialism, private property rights have been poorly defined or undefined. The ideology regarded state ownership, and sometimes communal ownership, to be the means through which socialism and self-reliance were to be achieved. Over time, though, there seems to have been a certain mix-up between the goals and the means in terms of state ownership and parastatal expansion. In addition, informal rules have often been more important than formal rules in the historical context of Tanzania, something which has continued to be the case in certain areas of its economy. In sum, the private sector has been operating under dual legal systems in Tanzania; the formal system which has been weak in defining private property rights, and a customary system in which a set of rules based on norms has prevailed. The enforcement of property rights has in effect inter-linked the two systems to a certain degree. Bad enforcement of property rights by the formal system has lead to corruption and, thus, to bribery being accepted as an informal rule.[119]

Following Eggertsson, property rights are seen as fundamental to the issue of transaction costs since ‘transaction costs are the costs that arise when individuals exchange ownership rights to economic assets and enforce their exclusive rights’.[120] Badly defined and poorly enforced property rights ought to have increased overall transaction costs in the economy of Tanzania by increasing risk and uncertainty. Potential illegality of a contract has to be included in the bargaining of the terms of the agreement, and monitoring and enforcement of contracts have to be done by the respective partners since there is not an adequate legal framework to rely upon. Also, a perceived threat of nationalisation implies high third party protection costs. Poorly defined, protected and enforced property rights are likely to result in a reluctance on behalf of private entrepreneurs to engage in long-term and high cost investments. Land, apart from being an essential input in agricultural production, is also important as collateral for credits. As a result, uncertainty about property rights to land ought to have had an effect on the possibility for private entrepreneurs to receive formal credit, and thus, on transaction costs in the financial market.

[119] This has been pointed out by Eriksson (1991) p. 36.
[120] Eggertsson (1990) p.14.

5 Small Scale Industries in Tanzania

5.1 Definitions

5.1.1 Small Scale[121]

There is no coherent definition of small scale industries in Tanzania. Instead different institutions and organisations use their own classification as to what a small scale enterprise constitutes. The definition made by TANU in its Party Directive of 1973 was:

> Any unit whose control is within the capability of the people whether individually or collectively in terms of capital required or know how; it includes handicrafts or any organized activity based on the division of labour.

According to Bagachwa, the Small Industry Development Organisation (SIDO) has in principal embraced this highly flexible definition. However, in order to conduct surveys and statistical reports it has been forced to add its own categorisation. From 1994, SIDO defines small scale enterprises as ‘privately owned economic units with less than 50 permanent employees which have a minimum turn-over of USD 6.000 a year and a minimum investment of USD 400’. In terms of official figures, the National Accounts of Tanzania give an estimate of small scale production units within manufacturing which covers firms with 5-10 employees, along with an estimate of handicraft based on manufacturing firms engaging less than 5 persons. The Bureau of Statistics annually conducts a Survey of Industrial Production which defines small scale industries as establishments with less than 10 workers. Finally, the National Bank of Commerce (NBC) distinguishes between Small Scale Industries (SSIs) and Small Scale Enterprises (SSEs) based in its credit thresholds. In 1990 SSIs covered firms within a threshold level of TAS 20 million, while firms that went beyond this limit up to TAS 50 million were classified as SSEs.[122] NBC also requires any small scale business to be: (1) labour intensive; (2) export oriented; (3) import substituting; (4) predominantly based on local materials; and (5) demonstrating good potential to generate inputs into other industries, i.e. to comply to the general guidelines under the BIS.

5.1.2 Informal vs. Formal

There is an ongoing discussion among practitioners and the academia about the definition of informal and formal sectors in an economy. Some put a distinction between wage-earning and self-employment, and thus regard the informal sector as consisting of all income opportunities outside formal employment including both legitimate (e.g. activities such as self-employed artisans and

[121] Unless otherwise stated section 5.1.1 draws on Bagachwa (1995) pp. 9-10.
[122] Note that this definition does not follow the commonly held definition of SSI as a small firm engaged in industrial activities (e.g. manufacturing) and SSE covering small scale firms engaged in other activities (e.g. service activities).

shoemakers) and illegitimate (e.g. drug-pushing and petty theft) activities.[123] In the case of Tanzania, definitions of the informal sector ranges from being primarily based on size (equalising the informal sector with micro enterprises employing less than 10 workers), or function, (traditional crafts constituting the informal sector while modern small scale factories constitutes the formal) - or a combination of the two - to include access to organised markets, to credit institutions, degree of regulation and competitiveness of the market, family or non-family ownership, and access to formal schooling and training.[124] Whatever definition used, the category labelled the informal sector mostly tries to capture activities that are unrecorded in official statistics.

For the purpose of this study on Tanzania, a strict application of the judicial sense of the term has been used, i.e. the main focus of the paper is on small scale enterprises which are registered and/or licensed[125], and that exercise legitimate economic activities. This includes private sector employment as well as primary and secondary self-employment activities, as long as they are registered. The distinction along legal lines is found to be essential in the analysis of how institutions and transaction costs affect SSIs in Tanzania, as formal SSIs will operate within the structure of transaction costs set by the economic system itself. However, it also implies that previous empirical work done on SSIs in the country, formal or informal, has to be carefully interpreted.

5.2 Position of the Small Scale Sector in Tanzania

5.2.1 Role of Small Firms According to Policy and Law

The ideology of African Socialism has in principle not been negative to small scale economic units. On the contrary, small scale production was seen as an important mechanism by which self-reliance within rural areas, and equality between urban and rural areas, could be reached. Based on the low need of sophisticated know-how and capital, its potential as employment creator in rural areas, and its possible role as a carrier of technological change in rural areas, the 1973 Party Directive regarded 'Small Scale Industries as necessary for our country's development'.[126] Even though there seemed to be a general agreement about the importance of small scale enterprises at the time, the exact role of these enterprises in terms of industrial development was not explicit. The Basic Industry Strategy (BIS) regarded local small scale businesses as an important mean to spread economic activities and, thus, increase rural development and reduce transportation bottlenecks.[127]

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[123] See e.g. Hart (1973) p. 68.
[124] See e.g. Bagachwa (1993) p.107 and (1995) p.10, Bagachwa & Naho (1995) p.1388 and Strömberg (1995) p.4.
[125] See section 3.2.4 for licensing and registration requirements.
[126] SIDO (1984) p.2.
[127] Havnevik et al. (1995) p.62

As pointed out earlier, however, the BIS, although accepting the need for both large scale and small scale industries, was vague about the roles of the two, and was basically biased against small scale operations in its policy recommendations.

Furthermore, as pointed out by Bagachwa, in theory the industrial structure was supposed to combine small and large as well as centralised and decentralised. Large scale centralised industries were supposed to dominate at the national level, while development authorities were supposed to organise and assist medium- and small scale activities at the regional and district levels. Finally, village committees were supposed to organise and supervise rural industrial activities at the village level. In practice, however, large scale centralised enterprises came to dominate the national as well as the regional and district levels, and the development of village based SSIs was almost totally neglected.[128]

It is worth noticing that ”small” did not usually imply ”private” under these circumstances. The 1973 Party Directive also ‘required the Party, Government, Cooperatives, and Parastatals to be responsible for persuading, encouraging and supervising the establishment and running of small industries on socialist principles in villages and towns’.[129] This was interpreted to mean that there should be no room for individually owned small industries in Ujamaa villages, a policy that later was legally formalised into the 1975 Villages and Ujamaa Villages Act. Moreover, when selecting candidates for its projects, SIDO pays particular attention to ownership criteria and the applicant’s organisational structure. ‘Preference is given to sound industrial co-operatives, and small public organizations over partnerships and limited liability companies’.[130] In sum, small scale production was early on recognised as important in Tanzania, and the underlying assumption seems to have been that small enterprises should be means to achieve the goals of socialism and self-reliance and, therefore, not be under private ownership.

5.2.2 Small Firms in Practice

A number of empirical studies on Tanzania’s small scale businesses have been done in recent years. Many of them focus on the second economy[131] in one way or the other, and the important role it plays in the Tanzanian economy. For instance estimated Bagachwa and Naho the second economy in Tanzania to have made up some 15 percent of total (official + second economy) real GDP in the 1970s and more than 20 percent for most of the 1980s. The share of the second economy of official real GDP for the same time periods was estimated to have amounted to some 15 to 20 percent and

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[128] Bagachwa (1993) p.101.
[129] Havnevik *et al.* (1995) p. 259.
[130] SIDO (1984) p. 14.
[131] See the definition of the second economy made in footnote 40.

25 to 30 percent respectively.[132] Tripp has calculated that a minimum of 80 percent of urban household income has to come from activities in the informal sector.[133] Finally, Bagachwa shows that small scale industries are less capital intensive than parastatals, and that average labour productivity within the informal sector is higher than for parastatals in both rural and urban areas.[134]

As most studies conducted in order to estimate the role of the small scale sector in Tanzania has had their prime focus on the informal sector, the exact role of the formal small scale sector can be rather difficult to survey. Nevertheless, the picture that emerges indicates that small scale business in general, regardless of form, is, and has been, an important factor in the Tanzanian economy. They generate income and employment opportunities along with much needed inputs and consumer products. In particular, most sources on Tanzania, for instance the studies referred to above, indicate the small becoming increasingly important in practical terms during the economic crisis in the early 1980s.

5.3 Supporting Institutions for Small Scale Industries

This section addresses the two supporting institutions for small scale industries in Tanzania which are in fact an integral part of the institutional framework outlined above, namely SIDO and NBC. Apart from these, there are a number of domestic and international NGOs that operate to support SSIs in the country. These will not discussed here, however, mainly due to lack of sufficient information regarding these organisations.

5.3.1 The Small Industries Development Organisation[135]

In 1966 the National Small Industries Corporation (NSIC) was established to promote development of small scale industries in Tanzania. Following the 1973 Party Directives, the Small Industries Development Organisation (SIDO), a parastatal under the Ministry of Industry, replaced the rather malfunctioning NSIC.[136] The principal obligation of SIDO has been to promote SSIs and to co-ordinate all policies and programmes towards SSIs in the country. It is interesting to note, though, that SIDO's small industry development plans have not been incorporated in to the national development plans, and that the Small Scale Development Plans have tended to lag behind the national plans. Furthermore, SIDO receives limited financial support from the Government, a trend which has accelerated since the early 1980s both in terms of absolute numbers and as share of SIDO's total development budget. Between 1974 and 1984, 56 percent of SIDO's total development

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[132] Bagachwa & Naho (1995) pp. 1393-1395.
[133] Tripp (1989) p. 9.
[134] Bagachwa (1995) pp. 20-22.
[135] Unless otherwise stated, section 5.3.1 draws on SIDO (1984).
[136] Havnevik *et al*. (1985) pp. 64-65.

budget was covered by domestic resources, the rest was contributed for by foreign allocations.[137] Eriksson has calculated that SIDO each year between 1981 and 1992 reported losses losses exceeding TAS 5 million; as a matter of fact, five times during this period it belonged to the top ten loss making parastatals in Tanzania.[138]

The primary function of SIDO's *industrial extension service* is to provide small entrepreneurs with information about industries suitable for immediate establishment as well as required production techniques in these industries. For this, SIDO has a network of Regional Extension Offices which is supposed to conduct economic surveys, prepare techno-economic profiles and feasibility studies and assist small enterprises in procurement of raw materials and marketing. Selection of industries that are to be promoted is done according to the priorities set in the BIS and by the Government, and there is a possibility to mix projects proposed by entrepreneurs (tailor-made projects) and projects initiated by SIDO (open projects). Between 1976 and 1983, SIDO conducted 60 industry prospect studies, 819 feasibility studies, 698 technical profiles and it held 141 technical seminars. Bagachwa reports that SIDO prepared 609 feasibility studies, 565 technical profiles and 82 market surveys between 1985 and 1989. Most of these industry extension services have been carried out in urban areas.[139]

Under the *hire purchase scheme*, SIDO takes the responsibility to procure machinery, equipment and tools and to rent them to SSIs on a hire purchase basis at interests rates below the commercial. After the last instalment has been paid, ownership of the property is transferred to the SSI. Between 1974 and 1984, TAS 53.3 million had been approved in hire purchase loans to the rural area while TAS 256.5, or some 83 percent of total funds for the period, had been approved for urban areas. Between 1985 and 1989 a total of 203 projects amounting to TAS 287 million were financed under the hire purchase scheme.[140] Investigations have shown extreme delays or non-delivery of machinery in some cases, while on the other hand, cases of delivery of machinery without SIDO having received the required down payment from the entrepreneur, as well as SIDO having disbursed loans exceeding approved amounts, also have been reported.[141]

Through the *industrial estate programme* SIDO provides basic infrastructure, i.e. roads, water, sewage, power and telecommunication for factories inside its industrial estates. In 1983, a total of 124 sheds were in operation in 14 estates, in 1985 the number had increased to 154 sheds in 16 estates. SIDO is the owner of all the sheds in an industrial estate, while the entrepreneurs pay rent

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[137] Havnevik *et al*. (1985) pp. 125, 267-270.
[138] Eriksson (1993*b*) p.68
[139] Bagachwa (1993) p.103.
[140] Bagachwa (1993) p.102.
[141] Havnevik *et al.* (1985) pp. 210-213.

for using them.[142] Bagachwa identifies a number of problems encountered by the programme such as ‘intermittent supply of water, power interruptions, lack of raw materials, scarcity of experienced entrepreneurs and low recovery rental incomes (estimated to be 10 percent)’.[143] Furthermore, reviews have showed that projects inside the industrial estates exhibit higher unit costs, lower levels of capacity utilisation and higher machine intensity than industries outside of them.

Finally, to provide proven technology and to minimise ‘entrepreneur’s expenses on research and product development’[144], SIDO runs *transfer of technology* undertakings. One of its major programmes has been the Sister Industry Programme (SIP). Under the SIP, Swedish small scale enterprises (senior sisters) provide Tanzanian SSIs (junior sisters) with know-how, supply of machinery, start-up raw materials and initial training for entrepreneurs, managers and workers. The senior sisters also assist in plant installation. The programme stated in 1976 and is funded by the Swedish International Development Co-operation Authority (SIDA). Up until 1990, 34 ventures employing some 1400 people had been established under SIP at a cost of USD 75 million (1990 constant prices).[145] SIP projects have been found to be quite capital intensive and highly import dependent, and to have had rather limited employment generating effects. As a result of the foreign exchange shortage many SIP industries have been operating below capacity level, although, in some cases, the foreign exchange constraint has resulted in backward linkages as the SIP enterprise has been forced to find local suppliers. Managerial constraints have been identified to constitute the major threats to the survival and development of SIP industries.[146]

Moreover, SIDO has various programmes for entrepreneurial development which cover both basic skill development and upgrading of skills by entrepreneurs, managers and workers. Finally, SIDO also targets the handicraft sector with technical and economical services as well as with training and marketing assistance.

5.3.2 The National Bank of Commerce

In 1981, the NBC established the NBC Term Finance Unit to deal with SSI and SSE[147] financing, under which it provides medium- and long-term loans along with consultancy services and seminars to this sector. A maximum of 80 percent of an investment could be borrowed for up to ten years at commercial interest rates. According to Bagachwa, 116 SSE projects had received loans worth TAS 508 million as of June 1990. However, as pointed out by the same author, funding of

[142] Havnevik *et al.* (1985) pp. 164-175.
[143] Bagachwa (1993) p.101.
[144] SIDO (1984) p. 35.
[145] Bagachwa (1993) p. 112.
[146] Carlsson *et al.* (1988) pp. 71-77.
[147] See section 5.15.1.1 for NBC’s distinction between SSIs and SSEs.

small scale operations from NBC has suffered from substantial delays; on average some 79 weeks between submission of the loan application and the disbursement of the loan itself, but cases of delays up to three years have been reported. Procurement of equipment and tools by NBC in Dar es Salaam and the subsequent distribution of these has been an additional source of delay for small scale clients.[148]

Strömberg has investigated the loan procedure adopted by the NBC. In order to receive a loan from the NBC, a small scale industry entrepreneur has to have two references and he/she has to deposit TAS 100,000 into a savings account with the bank. Furthermore, a feasibility study, the memorandum of association, the corporation certificate and a resolution to borrow have to be presented, along with financial statements covering the last five years of operation which should have been audited at least once during this period. The NBC also requires real property or fixed assets as pledge for the loan, which has to be fully secured. Since 1991, the situation for micro-enterprises[149] has been somewhat different as lending without collateral for this group then was introduced[150]; small scale units in this category only need to deposit TAS 30,000 into a servant account and present a project profile (for which help is offered by the Community Development Officers) to be entitled to a loan from NBC. NBC uses the servant account as security, and it has the right to auction the project machinery if the loan is not repaid in due time. In 1995 NBC was reported to have less than a 50 percent recovery rate on its loans to small scale units, and to have frozen all lending facilities to this sector. The freeze did not apply to micro-enterprises, however, as these loans were backed up by foreign currency funds provided by international aid organisations.[151]

5.3.3 Small Scale Supporting Institutions and Transaction Costs

When investigating supportive institutions for small scale industries in Tanzania, a particular interest has to be put on SIDO since it is the implementing as well as the co-ordinating body for policies targeting small scale industry development. In this respect, it is interesting to note, as has been done earlier, the disintegration of SIDO's Small Scale Industrial Development Plans with the National Development Plans, as well as the low level of financial resources provided by the Government. Apart from being an outcome of the hardening economic terms facing Tanzania in the

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[148] Bagachwa (1993) p. 103 and Bagachwa (1995) p.35.
[149] Strömberg actually refers to these enterprises as the ”informal sector”, but since she does not follow the same legal distinction of informal and formal as done in this paper, the usage of this particular term was found to be inappropriate. All other evidence in Strömberg's paper indicate that the term ”micro-enterprises”, regardless of legal form, is a more accurate description of the circumstances referred to in the passage. However, it is not clear if Strömberg is also referring to the distinctions between SSIs and SSEs done by NBC, i.e. if ”micro-enterprises” (or ”the informal sector”) mean SSIs as defined by NBC's threshold level, and if the term ”small scale industries” also is applicable to SSEs as defined by the lending threshold of NBC.
[150] Bagachwa (1995) p. 35.
[151] Strömberg (1995) pp. 65-67.

early 1980s, this may constitute a further manifestation of the vaguely defined role of the small scale industries as outlined above. To fully explore in what way, and to what extent, activities that SIDO conduct generate or reduce transaction cost, a full evaluation of SIDO's operations needs to be done. However, this is beyond the scope of the present paper, although some general implications are presented below.

In general, most of SIDO's support programmes would result in reduced transaction cost for small scale industries, if implemented properly. For instance, the idea behind the industry extension service seems to be to reduce information asymmetries and high search cost facing small scale industries in the economy of Tanzania. Easy access to information about foreign and domestic market demand, new technologies, potential suppliers and emerging subcontracting opportunities would significantly lower ex-ante transaction costs for many SSIs. Furthermore, improved access to tools, machinery and equipment at a reasonable cost under a purchase hire scheme, as well as access to physical infrastructure in an industrial estate, would reduce costs in terms of time and money spent in trying to secure operations in an economy marked by shortages, as in the case of Tanzania. In practice, however, SIDO seems to have experienced operational problems, due to e.g. lack of a clearly defined set of priorities, poor communication between the headquarters in Dar es Salaam and the regional offices, as well as between the industrial estates and the regional offices, and a shortage of staff with the high level of technical and economical competence required. As a result, feasibility studies have often been weak and projects have suffered from badly specified technical requirement. Furthermore, numerous sources of delays within the SIDO framework seem to have emerged due to mainly organisational problems[152]. Thus, the experience of exemplifies the distinction between institutions and organisations done by Khalil; the weak support provided by SIDO seem to stem mainly from its organisational problems (the organisation as an agent), and not from its underlying set of norms, rules and regulations (the institution as social constraints).[153]

For the individual SSI, this would imply that much of the transaction cost reducing effect of the SIDO programme has been lost, since it may not have been able to bypass information and distribution bottlenecks by entering the programme. When entering a SIDO programme, the SSI might have expected to avoid transaction cost increasing activities such as search for adequate information about markets and suppliers, and to reduce insecurity and high monitoring and enforcement costs. However, the SSI has instead entered a contract with SIDO which has to be monitored and enforced, a situation which not necessarily implies the SSI having a stronger position vis-à-vis SIDO that vis-à-vis any other contractual partner. As a result of problems experienced

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[152] Havnevik *et al.* (1985) chapter 5.

when dealing with SIDO, such as extensive delays and poor quality of implemented infrastructure, entrepreneurs in Tanzania may lose faith in SIDO's ability to promote their business activities. It is also worth noticing that a major share of SIDO's development budget has been used to support manufacturing units in industrial estates. This implies that a substantial share of SIDO resources may have reduced transaction costs for a rather limited number of SSIs operating inside its estates.

Lack of access to credit is often identified as one of the most binding constraints by the SSIs themselves, particularly when undertaking new business investments.[154] NBC could thus play a substantial role in reducing transaction costs for small scale industries in Tanzania. In particular ex-ante transaction costs could be reduced if NBC was able to provide SSIs with easily accessed information about availability and cost of credits, as well as if it exercised simple and fast application procedures. As with rules of registration and licensing, the time factor seems to constitute a major source of transaction costs for SSIs in dealing also with NBC. A time lag of on average almost 79 weeks - or some one and a half years - between application and disbursement of a loan implies the SSI having to turn to alternative sources of funding for many of its financial needs. This can be done by turning to the informal financial sector, or by securing funds by allowing partners in to the business. Both strategies would be expected to result in rather moderate amounts of funds being borrowed, and, most possible, on a short time basis.

When it comes to simple application procedures it should not be forgotten that, in accordance with good banking practice, NBC has to adopt a certain degree of formality when dealing with loan applications from businesses of any size. However, these requirements tend to imply higher transaction cost for small scale units than for large scale. Apart from the possibility of various fees, necessary to get the required document or certificates, constituting a larger share of the total budget of an SSI than of a large company, most SSIs have a limited ability to internalise administrative functions and to employ financial managers with the skills and time to deal with financial institutions. Instead, SSIs have to rely on external services for tasks as accounting and auditing, which, in general, ought to imply search, bargaining and monitoring costs on behalf of the SSI; assuming that the market for such producer services is not fully efficient. Furthermore, it may be expected that time has to be taken away from other profit generating activities in order to deal with NBC.

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[153] See footnote 10 for a brief description of the distinction, or Khalil (1995) for a more thorough investigation.
[154] See e.g. Levy (1993) and Parker *et al.* (1995). In Levy's study, lack of access to finance was identified as the principal constraint by all the surveyed small scale industries within the furniture sector in Tanzania. In the study made by Parker *et al.*, access to finance was not regarded as a primary constraint on *current* operations as 37 percent of the sampled enterprises had just received a loan, while 90 percent of the firms cited cost of credit and 50 percent cited access to credit as major constraints for undertaking of *new* investments.

Finally, it is interesting to note that when dealing with NBC, and maybe also with SIDO, there seems to be an advantage in being *very* small, as opposed to just small. As long as a company belongs to the category of ”micro-enterprises” many of the transaction costs generating rules and requirements can be avoided, and access to credit may actually be made easier. As the micro-enterprise grows, and ”graduates” into an SSI, the requirements facing it stiffens. Requirements of collateral is one example of this. Although this may in part be explained by the financial needs of the company also getting larger as it grows, the outcome indicates a situation in which there are few financial incentives for small scale industries to develop and become larger. Thus, in Tanzania, large scale and long term investments from SSIs may be obstructed by both lack of timing and access to formal credits, as well as by a financial institutional setting which may adversely affect the growth of small scale enterprises over a certain threshold level.

6 The Tanzanian Experience: Implications for Transaction Costs

6.1 Small Scale Industries, Institutional Setting and Transaction Costs

Many of the outlined sources of transaction costs apply to both small and large scale industries operating in Tanzania. However, the analysis done carries certain implications for formal small scale industries. First and foremost, formal small scale industries and traditional co-operatives in effect happened to symbolise two aspects alien to the ideology and the policy framework that prevailed in Tanzania for almost 20 years: private ownership and small scale. In other words, formal small scale industries can be expected to have suffered from the combination of a generally hostile attitude towards private business, and from an unclear role of small scale industries within the industrial policy framework. Apart from the general insecurity about private property rights and its expected adverse effect on the expansion of private, including small scale, businesses in Tanzania, property rights have tended to restrict SSIs in their dealings with the financial sector. For instance, since land is formally owned by the state and banks generally do not accept leasehold land titles as collateral, the SSI is usually limited in its borrowing to the value of the physical construction on the land itself. Furthermore, in the SIDO run industrial estates, SIDO is the owner of the sheds in which the SSIs operates. This leads to either the SSI being restricted to SIDO programmes for credits, or that an agreement has to be worked out between SIDO and the bank, most possibly with NBC.

Secondly, formal rules and regulations as formulated by the Party and the Government, may have had a sever transaction cost effects on small scale industries. The stated examples of licensing requirements, of taxation procedures and of access to credits, all indicate high transaction costs for SSIs. These activities involve substantial information gathering about proper conduct as well as about possible exemptions from regulations, and in addition are found to be extremely time consuming and often costly. On the whole, legislation and regulatory practices in Tanzania do not seem to have identified the particular needs of SSIs as compared to large scale enterprises, which have more resources to work through the required processes and documents.[155] In addition, transaction costs of this sort may be increased by the prevalence of corruption in the public sector. For example, Tripp has found that in order to get through the bureaucracy to receive a business license, an entrepreneur may have to extend bribes amounting to three or four times the cost of the actual licence itself.[156] Moreover, licenses must be renewed annually and this requires clearances from a number of public authorities, which, according to Levy, often results in side payments. The same author also found ”lubrication” to have been pervasive in the system of tax collection, as tax officials may visit firms to ”negotiate” their tax burden as often as on average five times a year for sales taxes and two times a year for income taxes.[157]

Thirdly, small scale industries can in general be expected to have been excluded from one of the greater market opportunities in Tanzania: the parastatals and the public sector. Due to the incentive structure and the decision making process outlined earlier, parastatals may have had few incentives to turn to SSIs for purchase or outsourcing. This situation may be changing, however, as the economic reform measures finally reaches the parastatal sector.[158] Finally, preferential treatment of parastatals and regulations on resource allocation, including allocation of foreign currency, and on distribution, have often excluded formal SSIs from easy access to inputs, foreign currency and imports. As shown earlier, though, this is the field in which economic reforms have been most extensive, and transaction costs originating from these sources may have decreased in Tanzania. The economic reforms have also lead to stiffening competition in some sectors, which may reduce the possibility of opportunism and failed contracts and lead to reduced transaction cost as the risk of information asymmetries declines. Both winners and losers among SSIs are created in the process.[159]

6.2 Some General Implications

A general finding of this paper is that the economic system formed after the adoption of the Arusha declaration in 1967, does not seem to have given much thought to lowering overall transaction costs in the markets in Tanzania. Rather, the economic system may be seen as having increased transaction costs to its participants by creating information asymmetries, distribution

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[155] Bagachwa (1995) p. 28.
[156] Tripp (1989) p. 31.
[157] Levy (1993) p. 76.
[158] Levy reports that seven of his sampled 20 SSIs in the furniture sector had won their first tenders to supply government agencies in the 1980s. Six out of the seven had done this after 1987. See Levy (1993) p. 68.
[159] Bagachwa (1995) pp. 28-31.

bottlenecks and severe shortages. There are reasons to believe that small scale industries have been more badly affected by these transaction costs than large scale industries, and that these transaction costs also may constitute one reason behind the growth of the second economy in Tanzania during the late 1970s and early 1980s. Moreover, transaction costs may be expected to remain high - maybe even increase in some areas - during the period of transition as uncertainty among economic agents is high, and as, despite reforms, many of the main features of the old system still remain.

As a number of empirical studies have shown, there are active and innovative entrepreneurs in Tanzania, not least within the informal sector, and the question becomes how to incorporate these into the formal part of the economy. This paper indicate that some obstacles preventing this from happening are built in to the institutional framework itself. The obstacles referred to here are the licensing and registration procedures, as well as the requirement of yearly renewals: the system of taxation collection; issues of property rights and collateral; complex and time-consuming credit procedures; the still uncertain position of private businesses and the threat of nationalisation. A firm may successfully avoid all of the transaction costs connected with these issues by staying out of the formal sector. One way of doing this is to remain small in size and to expand operations by adding new, equally small business to existing ones. Thus, these institutions may work as a disincentive for enterprises operating outside the formal sector to enter it, and as an obstacle to dynamic growth of small scale enterprises in Tanzania.

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