Tanzania's Experience with Trade Liberalization

After Tanzania's economy deteriorated during the 1970s and early 1980s, it took a series of bold steps to liberalize trade. How successful have these efforts been in improving its economic performance, and what lessons can other developing countries derive from Tanzania's experience?

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ALTHOUGH there is a broad consensus today among policymakers on the economic costs of delaying trade liberalization, several countries—including many with socialist-type ideologies—are still clinging to inward-oriented trade regimes. The experience of Tanzania, which several decades ago had economic features these countries have today, offers them important lessons and points to some pitfalls.

The way it was

In the late 1960s, Tanzania embarked on a development strategy of substituting domestically produced goods for imports, based on the concept of "socialism with self-reliance" articulated in the 1967 Arusha Declaration. This import-substitution strategy had among its key economic objectives promoting heavy industry and achieving self-sufficiency in food production. Two main instruments were employed in implementing the strategy. First, a series of ambitious investment programs, embodied in five-year plans, targeted mainly at the expansion of the capital-intensive industrial sector and infrastructure projects; and, second, a set of large public enterprises that dominated most industries; had legal monopolies in the pricing, marketing, and processing of agricultural crops; and, by the mid-1970s, had become the country's largest importers and exporters.

Throughout the 1970s, the government used trade restrictions as key tools for achieving its development priorities. Producers of export cash crops (mainly coffee, cashew nuts, sisal, tea, and tobacco)—traditionally Tanzania's main source of export earnings—had to sell their products to marketing parastatals (quasi-governmental organizations), which offered prices well below world prices. Exporters of other, nontraditional exports had to surrender most of their foreign exchange earnings and cope with a cumbersome and nontransparent system of export permits, which required exporters to obtain a license for each consignment and effectively gave individual ministries the right to regulate a wide range of exports on an ad hoc basis. Similarly, all imports were regulated through administrative allocations of foreign exchange and an import-licensing system, both of which became increasingly restrictive toward the end of the 1970s as foreign exchange earnings declined.

Producers of export cash crops were faced with procurement prices that declined steadily, in relation to both the consumer price index and world prices. Those declines resulted from the appreciating real exchange rate, the increasing inefficiency of the marketing boards, and the government's policy shift to favoring food crops over export crops. Tanzania also experienced economic shocks that were beyond its control, such as drought and declining terms of trade. The overall result was that per capita output of export crops fell by about 50 percent during 1970–82 as the share of food production in

agricultural output increased. Other (nontraditional) exports also contracted sharply during this period, owing to the pervasive administrative restrictions imposed on them. Falling export earnings soon led to foreign exchange shortages, and the consequent drop in imports of intermediate goods and raw materials led to sharp cutbacks in production, especially in the highly import-dependent industrial sector, and to a deterioration in the country's infrastructure.

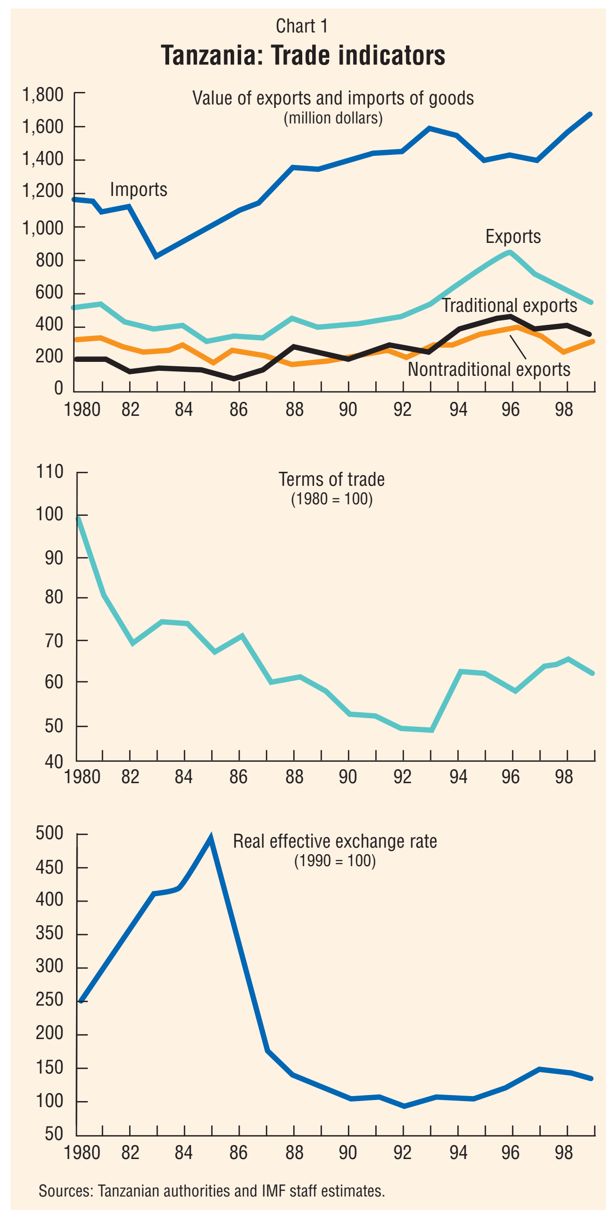
The distorted incentive structure in the tradable goods sector and its consequent contraction worsened Tanzania's fiscal position. Contracting international trade eroded revenue and significantly changed its structure, with the share of import duties in total budgetary revenue falling to 11 percent in fiscal year 1979/80 (July 1979–June 1980) from 22 percent in 1969/70. The government was becoming increasingly dependent for revenues on transfers from public enterprises, whose profitability was being undermined by import shortages and rising operating costs. On the expenditure side, subsidies and transfers to public enterprises accelerated sharply, and essential expenditure on operations and maintenance had to be curtailed, leading to a degrading of the country's capital stock and infrastructure. The rising fiscal imbalances created strong inflationary pressures and both an accumulation of external payments arrears and an increased reliance on external borrowing.

Trade liberalization

Tanzania suffered from large financial imbalances throughout the early 1980s, and its external payments situation continued to be precarious, with recurrent foreign exchange shortages and a heavy reliance on balance of payments support. During 1980–85, the real effective exchange rate increased by about 16 percent, and real exports decreased by about 10 percent, annually (Chart 1). Large imbalances in the country's fiscal and external accounts emerged, and gross official reserves fell to the equivalent of less than one week of imports by the end of 1985. By the mid-1980s, it was generally recognized that Tanzania's overly restrictive external trade policies and the consequent reduction in its exports were seriously undermining its economic performance. To address these issues, the government's 1996 Economic Recovery Program sought to reinvigorate the export sector by eliminating cost-price distortions and introducing import liberalization measures.

One important objective of the reform program was to increase the profitability of cash crops by introducing multiple channels for marketing them and allowing farmers to receive a higher share of the proceeds from export sales. Although the government attempted to restructure the marketing boards and improve their efficiency, including through the replacement of parastatals by "cooperatives" that had some flexibility in setting producer prices, a complete dismantling of marketing boards' monopsonistic power—that is, the power a sole buyer has in dealing with many sellers—did not occur until 1994, when regulations were issued allowing private sector competition in the marketing and processing of cash crops.

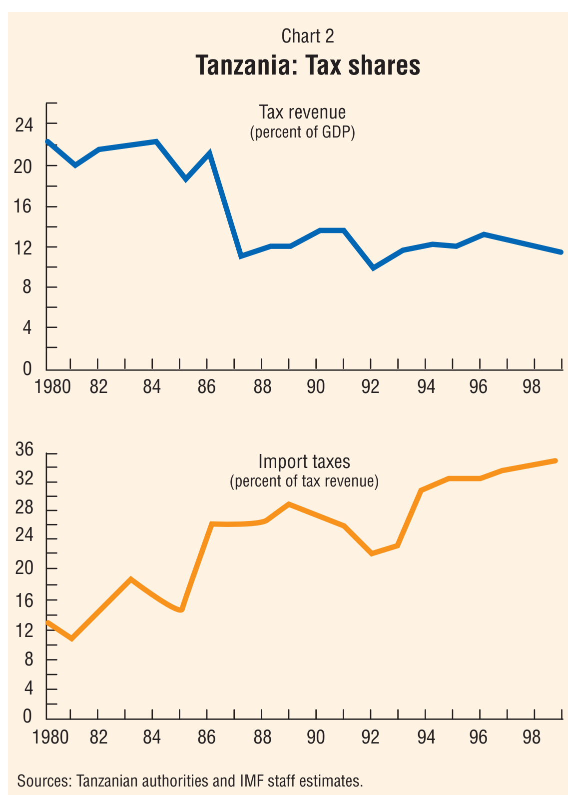
Chart 1
Tanzania: Trade indicators



Sources: Tanzanian authorities and IMF staff estimates.

Restrictions on the exports of nontraditional crops were also slowly relaxed, beginning with the introduction in fiscal year 1985/86 of a scheme allowing exporters to retain an increasing share of their export proceeds to finance their import requirements. By 1993/94, the system of export licensing, including for traditional crops, was abolished, the requirement of registration of exporting companies eliminated, and foreign exchange surrender requirements dropped. By the end of 1999, virtually all export restrictions had been eliminated.

The gradual recovery in Tanzania's exports led to a steady relaxation of foreign exchange constraints and facilitated the



liberalization of imports. An important step was the 1988 rationalization of import tariff rates, which reduced the trade-weighted average tariff rate to 23 percent from 35 percent in 1986. This reduction in the tariff burden was complemented during 1988–90 by two key liberalization measures: introduction of an open general license system under which import licenses were provided automatically for eligible imports; and creation of the Own Funds Facility, under which import licenses were provided freely to importers that used their own foreign exchange holdings to pay for specified imports. The scope of these facilities remained limited, however, until a major intensification of liberalization efforts in 1991–93 eliminated all administrative allocations of foreign exchange and abolished import licensing.

The relaxation of trade restrictions was supported by strong macroeconomic stabilization measures, which brought about a substantial fall in inflation, as well as steps to correct the exchange rate misalignment, reflected in a sharp depreciation of the real effective exchange rate. Owing to the increasingly favorable incentives to exporters, the average annual rate of growth of commodity exports also rose steadily in real terms. These increases, in turn, contributed to the steady relaxation of the foreign exchange constraint, as evidenced by the increase in Tanzania's gross official reserves and the rebound in its commodity imports. The rapid expansion in trade and the associated economic recovery took place despite a deterioration in the country's terms of trade that continued until 1993 (Chart 1).

The liberalization of imports slowed markedly in 1993/94 as emerging fiscal imbalances led the authorities to increase customs duty rates (in both fiscal years 1993/94 and 1994/95) to compensate for shortfalls in domestic tax revenues. This slowdown reflected, to a large extent, the steady erosion of the tax-to-GDP ratio, as well as the government's increased dependence on trade taxes for revenue (Chart 2).

The sweeping exchange and trade liberalization measures described earlier had a pronounced effect on the level and composition of budgetary revenues through the following key channels:

- the removal of agricultural price controls and the liberalization of marketing arrangements significantly shifted agricultural income from marketing boards to small farmers;
- the liberalization measures led to rapid growth in the informal sector; and
- the economic weight of public enterprises, which had previously been subject to frequent and discretionary increases in taxation, was reduced substantially.

The erosion of the tax-to-GDP ratio could have been moderated if the shift in income from the public sphere to farmers, small enterprises, and the informal sector had been accompanied by adequate improvements in tax and customs administration and by reductions in the scope of exemptions. While the tax ratio was gradually being eroded, trade taxes came to account for an increasing proportion of tax revenue. The liberalization of the trade and exchange system caused imports, and thus customs duties, to grow rapidly while revenue from domestic taxes—in particular from sales and income taxes—was shrinking.

Both the erosion of the total tax ratio and the increased weight of trade taxes in total revenue led the Tanzanian authorities to delay further reductions in tariff rates until measures were put in place that improved tax and customs administration, reduced the scope of exemptions, and broadened the domestic tax base. Still, it is clear in retrospect that Tanzania has come a long way in liberalizing its trade regime over the past two decades, as reflected by the decline of its IMF trade restrictiveness index rating to 6 (moderate) from 10 (restrictive). During 1980–86, nontariff barriers covered more than 50 percent of imports, and the average simple tariff rate was about 40 percent; but by 1999, nontariff barriers were largely confined to restrictions on imports of petroleum products (owing to physical constraints at port facilities), and the simple tariff rate was between 15 and 20 percent. With the removal of all nontariff barriers, progress toward which continues to be made in 2000, the country's trade restrictiveness index rating is expected to decline further, to 3.

Remaining challenges in trade reform

The slow progress in domestic tax reform and the related concerns over its impact on budgetary revenue have continued to retard the pace of trade liberalization to this day. One particular challenge for Tanzania has been how to abide by the ambitious timetables and goals set under regional trade

arrangements—notably the Cross-Border Initiative and the Common Market for Eastern and Southern Africa (COMESA)—while pursuing a strategy designed to promote both intraregional integration and multilateral liberalization. The timely implementation of preferential tariffs on intraregional trade has proved especially difficult: although Tanzania adopted a preferential tariff schedule, granting COMESA members a preferential tariff margin (as a share of the maximum tariff rate) of 20 percent, in 1996/97, this measure was reversed in the 1997/98 budget and then readopted in the 1998/99 budget. More recently, the Tanzanian authorities announced their intention to withdraw from COMESA in late 2000, thus avoiding the requirement under the treaty to fully eliminate the preferential margin. Budgetary difficulties have also induced the authorities to introduce ad hoc or discretionary measures, including the recurrent use of temporary duties and "minimum dutiable values" for import tax assessment, that have reduced the efficiency and transparency of the tariff system.

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Another important issue that needs to be addressed is the uneven level of effective protection implied by the tariff structure, which leads to inefficiencies among firms producing import substitutes. The current tariff structure imposes relatively high rates on raw materials and intermediate inputs, and low rates on finished goods, which implies an unduly heavy implicit tax burden on domestic producers of finished goods (notably, consumer goods). In addition to its adverse effects on allocative efficiency within the industrial sector, the distorted tariff structure has encouraged the pervasive use of exemptions on imported inputs to partially compensate for the heavy tax burdens on these goods—a practice that reduces both the transparency of the tariff structure and budgetary revenue.

Even with the existing constraints on the pace of domestic tax reform, the adverse impact of trade liberalization on revenue can still be tempered by markedly reducing the scope of the exemptions and allowing partial remissions of import duties—in particular, those applying to industrial inputs and to holders of certificates issued by the Tanzania Investment Center—which have increased substantially in recent years. Eliminating exemptions on public sector imports and introducing an exemption control system, whereby the relevant import taxes are paid for with tax credit checks issued by the treasury, would yield additional revenues by reducing the diversion of imported goods to nonpublic uses.

The fiscal constraints Tanzania faces have also had adverse effects on its exports. The competitiveness of manufactured exports has been reduced by delays in providing refunds to exporters for taxes they have paid on imported inputs. Budgetary difficulties have also contributed to the high domestic transportation costs exporters must incur owing to Tanzania's weak infrastructure, including the dilapidated transport routes that link farmers to outlets to external markets.

Conclusion

Several important conclusions can be drawn:

• Tanzania's experience makes clear the adverse consequences of a restrictive trade regime and the associated cost-price distortions on both allocative efficiency and longer-term macroeconomic performance. In the 1970s and early 1980s, trade distortions reduced the profitability of export crops, leading to a sharp contraction in export earnings and foreign exchange shortages. Despite the imposition of tight import controls, these shortages led to reductions in critical imports of intermediate goods and raw materials, cutbacks in industrial production, and a deterioration in the country's infrastructure. The phasing out of trade restrictions since the mid-1980s played a key role in the revival of the export sector and the recovery and rationalization of imports, and laid the foundations for sustainable growth.

• Trade liberalization induced a pronounced shift in income from the public sector and areas of the private sector that could easily be tapped for revenue by the government, toward farmers, small enterprises, and the informal sector. At the same time, the liberalization of the trade and exchange system caused imports and customs duties to grow rapidly while the domestic tax base was shrinking. This was reflected in a falling tax-to-GDP ratio and increased reliance on trade taxes for budgetary revenues. This dual effect, which had not been fully anticipated in Tanzania, points to the importance of broadening a country's tax base and implementing reforms in tax administration in the early stages of liberalization.

• The slow progress Tanzania has made in domestic tax reform has hampered its efforts to achieve import liberalization and tariff rationalization, encouraged the use of both temporary duties and nontransparent means of import taxation, and indirectly reduced the competitiveness of exports. This has impeded Tanzania's efforts to achieve steady multilateral trade liberalization and to become better integrated with regional common markets.

Today, a central objective in Tanzania's development strategy is reducing the import tax burden, with a view to further improving export incentives and raising allocative efficiency. It is important to avoid the recurrence of past episodes of reversals in trade reform owing to budgetary shortfalls. The recent implementation of the value-added tax, which broadens the country's tax base and improves the efficiency of its tax system, is an important step toward preventing such reversals. Strong political will should now be exerted, however, to remove the tax and tariff exemptions that continue to place a burden on Tanzania's budget and impede its efforts to achieve further trade liberalization. F&D