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Foreign Aid and Economic Development: Tanzania's Experience with ODA

Elena Rotarou[1] and Kazuhiro Ueta[2]

[1] *Corresponding Author: PhD Candidate, Graduate School of Economics, Kyoto University*
Email: elena.rotarou@fy5.ecs.kyoto-u.ac.jp
[2] *Professor, Graduate School of Economics and Graduate School of Global Environmental Studies, Kyoto University*
Email: ueta@econ.kyoto-u.ac.jp

The paper deals with official development assistance (ODA) to Tanzania and its impact on economic growth and poverty reduction. Although there has been much debate about the relationship between foreign aid and economic development, in Tanzania's case, econometric analysis shows a significant dependence of GDP growth on ODA flows. On the other hand, ODA has not had much impact on poverty reduction, despite the efforts made by donors and the Tanzanian government to achieve the Millennium Development Goals. Overall, ODA has been beneficial to the country's economic growth, but only because other factors — implementation of sound macroeconomic policies, increase in foreign direct investment (FDI), stable political and economic environment — were also present.

In order to underline the importance of ODA, this paper also presents the impact of FDI, trade, and remittances on Tanzania's economic development, and concludes that, by comparison, ODA has been the most influential factor in the country's recent growth. It is argued that due to the ongoing financial crisis and the reduction in aid flows, the Tanzanian government needs to look at other sources of financing — public-private partnership, external borrowing, increased domestic revenue — in order to improve investment rate and eventually graduate from aid.

Keywords: Official development assistance (ODA), Tanzania, foreign direct investment, economic development, poverty reduction
JEL Classification Numbers: F35, O55

1. Introduction

This paper investigates Tanzania's experience with official development assistance (ODA) and assesses the impact of foreign aid on the country's economic development. Tanzania is one of the highest aid recipients, with bilateral and multilateral donors assigning increasing aid amounts or proceeding with debt relief. The country's stable economic growth and transition to a market economy has prompted its characterization as one of the few African "success stories." Since 2000, the average GDP growth of Tanzania has been around 7%, and inflation has fallen in single digits while trade and investment have greatly increased (IMF, 2009). Education and health indicators have improved, since these two sectors have become top priorities of the government of Tanzania (GoT), and several targets of the Millennium Development Goals (MDGs), such as primary education and environmental sustainability, have already been accomplished (Ministry of Planning, Economy and Empowerment (MPEE), 2007). All this progress, however, cannot hide the fact that Tanzania is still one of the poorest countries in the world facing many challenges on its way to economic development.

The paper employs the Ordinary Least Squares (OLS) technique in order to investigate the impact of ODA, FDI, and trade on GDP growth. The results indicate a significant dependence of Tanzanian GDP growth on foreign aid and FDI flows, but not on trade. Various analyses and reports, however, show a different picture with regard to the impact of foreign aid on poverty reduction: despite certain improvements, ODA has not been very successful in fighting poverty. FDI and trade have not been effective either due to the character of investments and the nature of the main exporting sectors. Remittances, on the other hand, do not have an impact on economic growth; however, they do help in the fight against poverty.

What should be stressed at this point is that the main focus of this paper is ODA's impact on economic development. Other factors influencing Tanzania's economic development, such as the implementation of sound macroeconomic policies, and a stable political and economic climate are presented only to support the argument that ODA on its own — without certain preconditions, policies, and institutions in place — cannot achieve its goals. In addition, the impact of foreign investment, trade, and remittances to the Tanzanian economy is presented in order to acquire a more thorough view of the country's development process.

The paper's structure is as follows. Chapter 2 presents the debate on whether foreign aid has been beneficial to economic development; certain studies indicate that aid promotes growth, others indicate that it inhibits growth, while other studies show no relationship or positive correlation, but only under certain conditions. Chapter 3 presents an economic outlook and describes various factors that have helped Tanzania transform itself from a socialist model to a market economy. Chapter 4 deals with ODA flows to Tanzania; in particular, it presents ODA amounts, bilateral and multilateral aid, sectoral allocation, current issues, and possible suggestions for improving aid effectiveness. This chapter also includes the econometric analysis of ODA, FDI, and trade, and assesses the impact of aid, investment, trade, and remittances on Tanzania's economic growth and poverty reduction. Finally, chapter 5 presents the conclusions as well as various perspectives, especially in view of the current financial crisis.

2. Foreign aid and economic development

Early theoretical research in the 1950s, influenced by the success of the Marshall Plan, was optimistic with regards to the impact of aid on economic growth. Development theorists, such as Lewis (1954) and Solow (1956), stressed the importance of capital formation and large-scale investment, which could help economies achieve self-sustained growth, without closely examining the relationship between aid flows and economic development. Nurske (1953) also stressed the importance of savings and capital formation in economic development in his "theory of the big push," and argued that developing countries remain poor because of a vicious circle of poverty. Later on in the 1960s, the gap models appeared. The first and most well-known model was the Harrod-Domar model, which underlined the necessity of aid to fill in the savings gap of developing countries and thus increase investment. Following this model, Chenery and Bruno (1962) and Chenery and Strout (1966) introduced the "two-gap" model by adding the foreign exchange gap. Since many developing countries do not have the necessary foreign exchange reserves to import capital goods for investment, aid can fill in this gap. A third gap was later introduced by Bacha (1990) and Taylor (1990), who argued that the governments of many developing countries lack the revenue raising capacity for investment and thus, aid can again fill in this gap. All of the gap models stress the importance of foreign aid in supplementing savings, foreign exchange, and domestic revenue, which leads to higher investment and thus, higher growth rates.

However, since the early days of foreign aid, prominent economists, such as Friedman (1958) and Bauer (1971), have strongly expressed their concerns regarding the positive effect of aid on economic growth. According to them, aid is a tool that only helps elites in recipient countries while at the same time misallocates resources and erodes civil society (Addison et al., 2005; Easterly, 2006). Boone (1996) finds evidence of aid fungibility: aid increases government consumption, but does not increase investment nor does it help the poor (he does find that aid in liberal political regimes helps lower infant mortality by up to 30% when compared to more totalitarian regimes). Furthermore, according to McGillivray et al. (2006), moral hazard can negatively influence the impact of aid predicted by the Solow model.

On the empirical side as well, there have been many studies on the impact of aid on economic growth. Research, however, is hampered by difficulties in data collection, differences in econometric models, and different views regarding the methods through which aid affects growth. According to Mosley (1987), there seems to be a micro-macro paradox, that is, aid seems to work at micro-level, but there is no evidence of its positive effect at a macro-level. Burnside and Dollar (2000) find that aid is positively correlated with economic growth, but only when it is accompanied by good policies and institutions. Nevertheless, Easterly, Levine, and Roodman (2004) questioned Burnside and Dollar's (2000) results and found that these results are not robust for a data set with longer time series that includes more countries. In answer to this criticism, Burnside and Dollar (2004) published a paper defending their previous findings and stated that the quality of institutions is important to aid effectiveness. Additionally, Rajan and Subramanian (2005) did not find evidence that supports Burnside and Dollar's (2000) results, nor did they find that certain types of aid (e.g., short-term aid used for economic infrastructure) work better than others, as suggested by Clemens, Radelet, and Bhavnani (2004).

Thus, it appears that despite the vast number of studies, there is no consensus on if and how foreign aid specifically affects development. However, researchers seem to have reached a common point, especially after the publication of the World Bank's *Assessing Aid* paper (1998): aid works in the respect that growth rates would have been lower in its absence (the Swedish International Development Agency — SIDA — estimates that growth rates would have been around 0.5%–1% lower). This report used a general equilibrium growth model in an attempt to address the endogeneity of aid and linked aid effectiveness to the economic policies and institutional environment in recipient countries and/or to the external conditions these countries faced (Hansen and Tarp, 2000). The importance of institutional quality and good governance for a country's economic development started to draw strong attention in the 1990s — after its initial influence on American academia in the 1920s and 1930s — following the work of the economist Douglass C. North.

However, an issue that it is often neglected in literature is the relationship between aid, economic growth and development, and poverty reduction (Lucas and Timmer, 2005)[1]. Although aid effectiveness should be primarily measured against the level of poverty reduction and improvement in the Human Development Index (HDI) rates, it is mostly measured against GDP growth. One World Bank report (2005a) on pro-poor growth shows a general strong relationship between economic growth and poverty reduction; nevertheless, there are cases where aid has led to a large increase in GDP growth, but not to an equivalent decrease in poverty levels[2]. Despite efforts to achieve the Millennium Development Goals (MDGs), aid has often failed to help the poor, as in the case of many resource-rich African countries.

Therefore, it can be concluded that the relationship between aid, economic growth, and poverty reduction is far from straightforward. The amount of literature focusing on the effectiveness of aid to promote economic growth and

[1] Economic growth refers to a rise in the national or per capita income and products. Economic development implies improvements in health, education, and other human development indicators, as well as the evolution of stable political and legal institutions. A significant restructuring of the economy with a decline in the agricultural share of GDP and a continuous increase in shares of industry, trade, banking, construction, and services is also an indication of economic development.

[2] For example, during the 1990s, Bangladesh experienced an average annual growth rate of more than twice that of Ghana, but the poor in Ghana saw their incomes rise substantially more than the incomes of the poor in Bangladesh (World Bank, 2005a).

fight poverty has been vast; certain studies confirm the positive relationship between economic development and foreign aid and others refute it, while other studies indicate that aid works, but only under certain conditions. Especially recently, various studies point to the fact that aid is most likely influenced by various factors and preconditions, such as level of corruption, initial conditions, geographical position, quality of institutions, or type of aid (economic vs. social, grants vs. loans). At present, the discussion regarding foreign aid focuses on the changing face of international cooperation — especially with the entrance of new donors such as China, India, Brazil, and the Arab states — on debt-related issues, the relationship between aid, government (policies, corruption levels, etc.), and private foreign investment, as well as on new innovative ways of making aid effective in a particular country.

Overall, more research is needed in order to be able to identify certain general patterns concerning aid and economic development, although in any case, "one solution fits all" cannot be applied. This paper takes the view that in Tanzania's case, foreign aid has been beneficial, mostly for economic growth and less for poverty reduction. Aid effectiveness was the result of a number of factors, such as sound macroeconomic policies and a stable political climate.

3. Tanzania: Economic Outlook

Soon after the independence from British colonization (1961) and the unification with the island of Zanzibar (1964), Tanzania embarked on an import-substitution development strategy. The basis of this strategy was the 1967 Arusha Declaration, which was a model of "African socialism" supported by the first President Nyerere. It stressed the importance of self-reliance, nationalization of key economic sectors, villagization of production, and universal education. This "Ujamaa" (family-hood) socialist model was successful for building a national identity after independence, but it also led to economic decline. According to Ndulu et al. (2007), the Tanzanian economy in the 1970s and most of the 1980s — as well as other sub-Saharan economies at the time — was suffering from a regulatory syndrome of pervasive and deep state controls. Loss-making state-owned enterprises (SOEs) and an increasing number of parastatals generated persistent deficits that were covered through general budget support and bank credit. Foreign exchange reserves diminished as agriculture production declined due to low centrally-determined prices. Overall, foreign debt increased and imports were reduced, causing the decline of the manufacturing and industrial sector.

In the early 1980s, Tanzania experienced its first post-independence economic crisis. This recession was caused by the government's poor economic policies in combination with a series of shocks — collapse of commodity prices, oil shock, serious droughts (1973–1974 and 1981–1982), break-up of the East African Community (1977), and the 1978–1979 Uganda-Tanzania War (Maliyamkono and Bagachwa, 1990). By 1985, the combined impact of these factors resulted in serious destabilizing effects for the Tanzanian economy: high inflation, decreasing GDP and exports, a balance-of-payments crisis, and increasing poverty.

In order to deal with these issues, the government turned to the IMF for help. However, since the government was still following a socialist agenda, it was reluctant to implement the liberalization policies set by the IMF's Structural Adjustment Program (Ross, 1998). Thus, it started its own SAP (1983–1986) without the IMF, which included reducing public expenditure, devaluating the Tanzanian shilling against the US dollar, increasing taxes on luxury goods, and ending restrictions on intra-regional trade (Messkoub, 1996). Unfortunately for Tanzania, these measures were not enough to reverse the downward spiral of the economy.

Thus, from 1986–1989, the government agreed to enact the IMF's Economic Recovery Program (ERP) in an effort to achieve economic growth through adjusting prices to market levels, reducing state ownership and intervention in the economy, and increasing agricultural exports that would in turn increase the depleted foreign exchange reserves (Nord et al., 2009). Due to the fall of socialism worldwide, which meant far less financial and political support from ex-communist countries, in 1991 Tanzania signed IMF's Enhanced Structural Adjustment Facility (ESAF). Under the "fiscal austerity, privatization, and liberalization" banner of the Washington consensus, the authorities liberalized foreign direct investments and trade, unified and liberalized the exchange rate, and started the privatization process of the parastatals (implemented by the Parastatal Sector Reform Commission in 1992). Nevertheless, until 1995, the economy remained weak, since reforms needed an adjustment period for their effects to become visible (Nord et al., 2009).

After 1995, however, the first results of the economic reforms started to show. The previously enacted liberalization policies continued with the 1996–1997 and 1998–1999 ERPs under ESAF. Liberalizing imports allowed the private sector to trade freely, a fact which led to booming exports that provided much needed foreign exchange reserves. The financial sector was restructured, with foreign banks allowed to enter the domestic market and provide much needed funding to the private sector, while refusing funding to loss-making SOEs. As a result, a virtuous cycle began that saw inflation decreasing and private investment increasing. At the same time, debt relief (which virtually eliminated all of Tanzania's foreign debt) and increasing foreign aid provided the necessary fiscal space to finance government priorities.

Another important factor that contributed to Tanzania's economic growth was the government's efficient management of its public finances. Although reforms in the revenue administration and tax policy began early, results started to show after 2004. After the creation of the Tanzania Revenue Authority (TRA) in 1996 and the introduction of a more modern tax system, the tax-to-GDP ratio has increased by 5% since 2000. Additionally, improvement in spending effectiveness has been sought through reforms to public services and through increased devolution of government functions to the local governments ("Decentralization by Devolution").

At present, domestic revenues have grown to 16% of GDP in 2007–2008 (and are projected to increase further to 18.5% in 2008–2009) due to improvements in the taxation system, as well as increased exports and tourism. Nevertheless, despite this progress, domestic revenue is still below the average level for sub-Saharan Africa mainly due to the extent of tax exemptions, under-taxed areas, and issues with implementation (PER Macro Group, 2008)[3].

Furthermore, Public Financial Management (PFM) was also strengthened. The Public Financial Management Reform Program (1998, 2004, and 2008) started with the aim of minimizing the inefficient allocation of resources, strengthening financial control, and enhancing accountability, mainly through the reform of budget processes and the introduction of a computerized Integrated Financial Management System (IFMS). Moreover, the Public Finance Act (2001) allowed for a commitment control system (supported by IFMS) and better control of the budget (Nord et al., 2009). Thus, although there are still many improvements to be made, at present Tanzania has one of the best PFMs in sub-Saharan Africa.

In addition, since 1998 the government has introduced a medium-term expenditure framework (MTEF) to guide its budget planning. It also conducts annual consultations in the form of a public expenditure review exercise with development partners and representatives of civil society to set spending priorities. Moreover, a Strategic Budget Allocation System (SBAS) was created to better link the budget with national priorities as identified by the National Strategy for Growth and Reduction of Poverty — NSGRP 2006–2010 (known by its Swahili name "MKUKUTA"). Since 2004–2005, MKUKUTA has been guiding the allocation of budget resources over the medium term (Nord et al., 2009). Nevertheless, despite the progress made, MTEF implementation faces certain challenges, such as huge variations of amounts from previous estimates, which can be linked to the still rather poor budgeting and reporting system and low human resource capacity (Ministry of Finance and Economic Affairs, 2009).

At the same time, due to the stable economic and political situation, donor countries have allocated more foreign aid to Tanzania. Debt relief under the Heavily Indebted Poor Countries (HIPC) initiative and the Multilateral Debt Relief Initiative (MDRI) has freed up domestic resources. As a result, government expenditure has almost doubled between 1995 and 2008 without endangering debt sustainability. Spending has been mainly directed towards priority areas, such as education and health (in line with both MKUKUTA and the MDGs), as well as economic infrastructure (mostly roads and water facilities).

Thus, despite previous dire predictions, Tanzania currently presents a totally different outlook: exports are booming, and yearly economic growth has been around 7% since 2000 while average inflation has been 5.8%. Figures 1 and 2

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3) For the period from July 2008 until April 2009, tax exemptions have cost the Tanzanian Revenue Authority USD 270 million. The projects under the Tanzania Investment Centre accounted for 83% of exemptions, with other beneficiaries being SOEs, government institutions, religious and other NGOs, and donor-funded projects (Edwin, 2009).

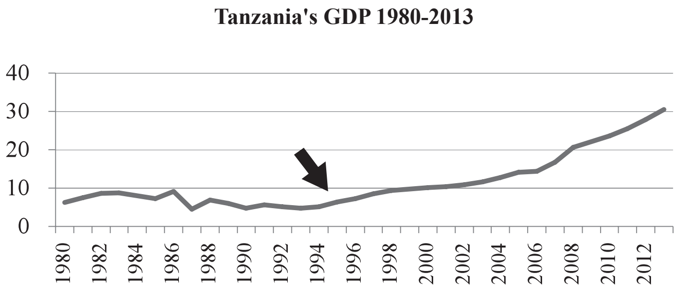

Figure 1: Tanzania's GDP, USD billions (IMF, WOE, October 2009)

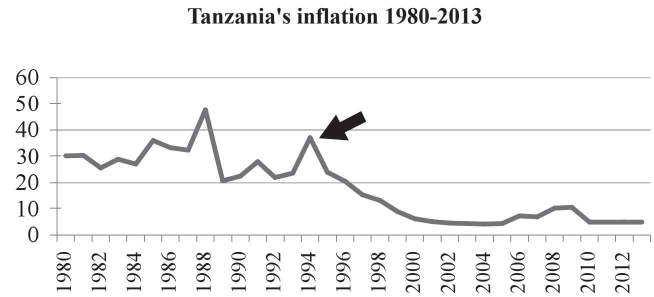

Figure 2: Tanzania's inflation, average consumer prices (IMF, WOE, October 2009)

illustrate Tanzania's GDP growth and average consumer prices from the 1980 until the present, including economic forecasts until 2013. The recent strong economic performance reflects growth in the service and construction industries and the recovery of the agricultural and industrial sectors (African Economic Outlook — AEO, 2009). Figure 3 presents the per-sector GDP growth for 2007. For the Tanzanian economy, agriculture is still very important since it accounts for more than 20% of GDP growth, 85% of exports (cash crops, coffee, tea, tobacco, cotton, maize, sugar cane, cashews, sisal, cloves, and pyrethrum) and 80% of the work force (Index Mundi, 2009). Despite its significance to the economy, the agricultural sector suffers from low productivity of land and labor, underdeveloped irrigation systems, poor infrastructure, environmental degradation, and a lack of access to credit and training opportunities for farmers (Nyoni, 2007).

The fastest-growing sectors have been services, tourism, and mining. Telecommunications and financial services in particular have shown the largest increase: 20.1% and 10.2%, respectively, since 2006. At the same time, tourism attracts increasing foreign direct investment and brings in foreign exchange and development of local firms that cater to tourists. On the other hand, the mining sector (gold, iron, diamonds) contributes relatively little to annual GDP, but it has received the largest foreign investment share overall; as a result, mining exports

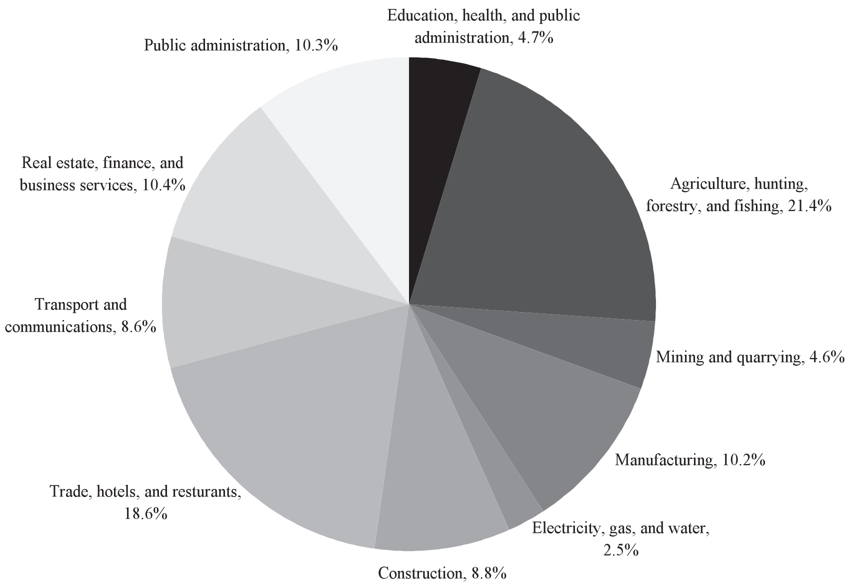

Figure 3: GDP by sector in 2007, percentage (African Economic Outlook, 2009)

have been constantly increasing. The GoT wishes to expand the mining contribution to GDP growth to 10% by 2025; it plans to achieve this by combating certain impediments to its development, mainly poor infrastructure, poor safety and environmental practices, and various bureaucratic procedures (Business Monitor, 2008). Overall, exports have generally increased with the government trying to focus on non-traditional exports (e.g., horticulture, mining, etc.) in order to increase the country's ability to withstand shocks to primary commodities. Nevertheless, although exports increased by 13% in comparison to 2006, imports (mainly oil and capital equipment) have increased even more, leading to a −19.2% trade deficit in 2008 (AEO, 2009).

In conclusion, it can be argued that despite various bottlenecks that inhibit or delay the country's development, Tanzania has recently started to enjoy a stable economic environment, which in turn has brought an increase in investment and trading opportunities. What also needs to be stressed is the fact that one of the main reasons behind the country's success has been its political stability. Although it is surrounded by conflict-prone neighbors (such as the Democratic Republic of Congo and Rwanda), is home to more than 120 tribes, and hosts the highest number of refugees in all of Africa (around 322.000 in 2008), Tanzania is generally characterized by strong ethnic unity and religious tolerance (UNHCR, 2009)[4]. Political stability has a major impact on economic development: according to Collier (2007), political and social strife have a prolonged negative impact on development (civil strife, for example, reduces growth on average by 2.3% per year), while having "bad neighbors" (in Tanzania's case, the Democratic

Republic of Congo, Rwanda, and Burundi) limits the benefits of intraregional trade and development, while increasing problems related to immigration and regional security.

4. Official Development Assistance in Tanzania

4.1 ODA Flows and Donors

The United Republic of Tanzania has a long history regarding official development assistance. While until the early 1970s foreign aid was rather limited, it started increasing at a fast pace after that period: in 1972 aid amounted to USD 61 million, but by 1973 it had surpassed USD 100 million. The main reason for this increase was the establishment of diplomatic ties with the People's Republic of China and more particularly, the subsequent USD 500 million spent in 1972 for the building of the TAZARA railways that united Tanzania and Zambia. This project was accomplished against the wishes of the West, which viewed a communist political influence in Africa as a threat to their long-established interests in the continent. Thus, in an effort to curb Chinese influence and increase their own political presence, Western donors started assigning more aid to Tanzania.

A further large ODA increase came in 2006–2007 in the form of debt relief (i.e., total or partial forgiveness of debt owed by Tanzania) under the HIPC Initiative and the MDRI. As of the end of December 2007, the government had received the following debt relief: a) multilateral institutions — USD 2.301.7 million, b) Paris Club — USD 867.6 million, c) non-Paris Club members — USD 184.6 million, and d) debt rescheduling — USD 171.2 million (Ministry of Finance and Economic Affairs, 2008). A more detailed presentation of the ODA flows to Tanzania can be seen in Figure 4.

Tanzania's development framework and long-term economic and social development goals have been guided by the National Vision 2025 and Zanzibar Vision 2020. The country's medium-term strategies are outlined in the aforementioned National Strategy for Growth and Reduction of Poverty — MKUKUTA and MKUZA 2007–2010 (for Zanzibar). The MKUKUTA in particular has strategically identified three major clusters of poverty reduction outcomes: a) growth and reduction of income poverty, b) improved quality of life and social well-being, and c) good governance and accountability. Each cluster contains specific goals and actions, many of which are interrelated and support each other. MKUKUTA's aim is to stimulate domestic saving and promote

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[4] One possible reason for the lack of conflict is that from the first president, Nyerere, to the current one, Kikwete, government members have originated from all tribes and belonged to different faiths. Additionally, Tanzanian people have been instilled with a very strong national identity: they are first of all Tanzanians who speak one language — Swahili. This, unfortunately, has not been the case with neighboring countries such as Rwanda, where tribal strife has cost the life of millions and caused serious economic decline.

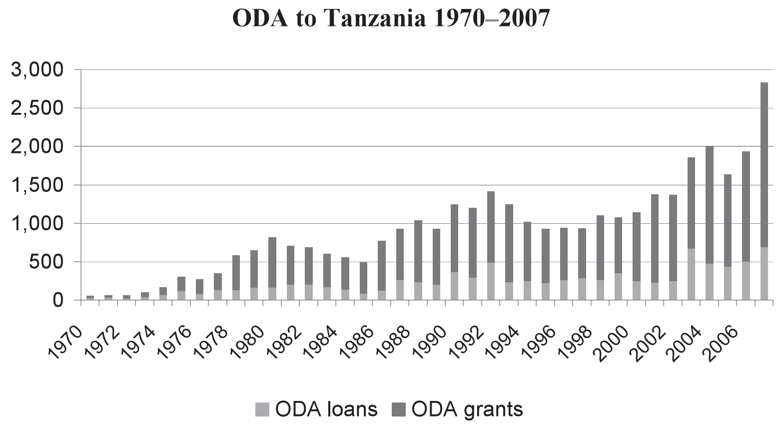

Figure 4: ODA loans and grants to Tanzania 1970–2007
(USD millions, OECD Stat. Database, 2009)
* ODA loans are disbursements, while ODA grants are gross disbursements; therefore, the total ODA amount in the figure is slightly higher than the total ODA amount of net disbursements (which was USD 2.810 million for 2007). Debt relief in 2006 is not included.

investment, as well as to address infrastructure needs and focus on priority areas and cross-cutting issues such as HIV/AIDS, gender equality, the environment, and poverty reduction (United Republic of Tanzania, 2005). MKUKUTA has become the guideline for bilateral and multilateral donors as well as the GoT with regard to the country's economic development.

As for bilateral donors, since the 1960s, United Kingdom has been a top donor, followed by Japan and the Scandinavian countries (Table 1). United Kingdom has directed much of its aid to Tanzania, indicating the British policy of giving preferential treatment to former English colonies (such as Kenya, Nigeria, Sudan, and Uganda, which have all received substantial amounts of British aid). Japan has greatly increased its aid to Tanzania in an acknowledgement of the country's adoption of sound macroeconomic policies. Scandinavian countries, on the other hand, have been known to provide aid on a much more humanitarian and concessional basis than other donors. Nevertheless, it is argued that even a very impartial donor like Sweden focuses more on Tanzania due to the political links (i.e., socialist party) between the two countries.

What should be noted is that new emerging donors such as China and India have recently started to provide or increase aid to Tanzania, much to the uneasiness of "old" donors. While the majority of Indian and Chinese involvement in Tanzania chiefly involves trade and investment, these two countries have nevertheless been quite supportive of Tanzania's development process, being developing countries themselves. For example, although no accurate data is provided — due to China's rather secretive nature in disclosing aid amounts to developing countries — according to the Chinese Ministry of Commerce,

Table 1: Top 10 bilateral donors to Tanzania 1960–2007
(USD millions, author's calculations based on OECD Stat. Database, 2009)

Top 10 Donors	1960–1969	1970–1979	1980–1989	1990–1999	2000–2007	Total
United Kingdom	166.65	101.5	439.67	693.39	1.719,53	3.120,74
Japan	2.64	50.5	452.54	807.85	1.459,93	2.773,46
Sweden	16.67	422.75	778.69	792.59	633.28	2.643,98
Netherlands	0.43	245.03	606.36	654.57	857	2.363,39
Denmark	5.74	193.15	474.42	785.09	654.79	2.113,19
Germany	32.57	251.72	532.23	702.72	425.31	1.944,55
Norway	2.52	148.52	566.44	641.25	493.7	1.852,43
United States	72.66	167	174	248.83	682.62	1.345,11
Italy	15.04	3.09	476.3	292.99	152.12	939.54
Canada	10.33	176.31	301.39	189.07	226.71	903.81

Tanzania is the largest aid recipient country in Africa. India, on the other hand, also has close ties with Tanzania, mainly due to the large Indian Diaspora living in the country. Although no figures are available, it is argued that India maintains one of the largest aid programs outside South Asia in Tanzania, with both ODA, and trade and investment activities increasing over the years (Jobelius, 2007).

With regard to the top 10 multilateral donors, by far the main aid provider to Tanzania since the 1960s has been World Bank's IDA, followed by the African Development Bank (AfDF) and the IMF (Table 2). It should be noted that due to its good macroeconomic performance, the IMF (February 2007) completed the final review of Tanzania's second Poverty Reduction and Growth Facility (PRGF) arrangement and approved a three-year Policy Support Instrument (PSI) as a successor to the PRGF. Under this program, Tanzania cannot borrow from the IMF anymore.

In 2004, the Development Partners Group (DPG) was formed in order to strengthen the development partnership and increase aid effectiveness in the country. The DPG is the body coordinating Tanzania's 35 Development Partners — DPs (United Republic of Tanzania — European Commission, URT — EC, 2007). In 2005, the Joint Assistance Strategy for Tanzania (JAST) was developed. JAST helps implement the development goals set by the Tanzanian government and the DPG, in line with Vision 2025 and Zanzibar Vision 2020, through the strengthening of recipient ownership, aligning development actions to the country's needs, and reducing the transaction costs of multiple strategies and programs (United Republic of Tanzania, 2005). The introduction of the DPG has been an overall good step towards improving aid effectiveness, since Tanzania is among the countries with one of the highest number of bilateral and multilateral donors — not to mention an impressive number of NGOs — a fact which increases transaction costs and adds extra pressure on the administrative capacity

Table 2: Top 10 multilateral donors to Tanzania 1960–2007
(USD millions, author's calculations based on OECD Stat. Database, 2009)

Top 10 Donors	1960–1969	1970–1979	1980–1989	1990–1999	2000–2007	Total
IDA	23.37	173.9	735.22	1.590,36	2.454,58	4.977,43
AfDF (Afr. Dev. Fund)	−3.46	6.76	93.71	403.58	526	1.026,59
IMF (SAF,ESAF,PRGF)	0	0	30.6	207.41	113.96	351.97
UNDP	4.44	41.14	105.21	136.63	59.4	346.82
UNICEF	0.14	16.69	87.79	118.12	80.99	303.73
UNHCR	0.49	25.69	46.25	70.46	104.12	247.01
WFP	0.45	27.24	52.6	95.91	56.34	232.54
Global Fund	0	0	0	0	225.12	225.12
IFAD	0	0.9	10.93	42.8	61.61	116.24
UNFPA	0	0.34	9.47	33.01	31.1	73.92

of the government.

With regard to sectoral aid allocation, since ODA has been focusing on the MKUKUTA and the achievement of the more socially-oriented MDGs, it has mainly targeted social infrastructure projects (primarily health and education) with a recent increase in projects related to good governance. This approach is also in line with the majority of Development Assistance Committee (DAC) countries that have placed a much larger importance on social aid, especially after the failure of many infrastructure projects ("white elephants") in the 1960s[5]. A few other donors, however, such as Japan, focus more on economic infrastructure aid as a primary means of achieving economic development (in recent years, though, allocations to social aid have greatly increased).

In Tanzania's case, ODA flows allocated for economic infrastructure (e.g., power, roads, railways, water, etc.) have also been increasing, but not at the level necessary for the country to deal with the physical infrastructure gaps. In 2002, ODA allocated to social infrastructure was USD 233.6 million, and it reached USD 653 million in 2007; on the other hand, ODA allocated to economic infrastructure increased from USD 60.2 million in 2002 to USD 136.4 million in 2007 (OECD, 2009). Thus, out of USD 2.810 million total ODA in 2007, 23.2% was social aid and only 4.85% was economic aid[6].

ODA funds about 40% of the national budget and about 80% of the development budget; these amounts make Tanzania one of the most aid-dependent countries. The net ODA/GNI ratio has increased from 10.6% in 2005 to 17.4% in 2007 (OECD, 2008). ODA/GNI ratios of this size usually pose the

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[5] The Development Assistance Committee (DAC) is the OECD's main body dealing with cooperation with developing countries. All of Tanzania's main bilateral donors belong to the DAC.

danger of causing higher domestic interest rates or more appreciated real exchange rate (Dutch disease). In an effort to avoid real shilling appreciation, in early 2001 the GoT limited foreign exchange sales, a fact which led to increased foreign exchange reserves and a decline in the current account deficit. This strategy was not sustainable, and after 2003 the GoT turned to the sale of treasury bills to sterilize money supply expansion. Later on, it proceeded with foreign exchange sales to individual banks; these sales were kept consistent with a depreciation of the nominal exchange rate in order to maintain competitiveness (Gylfason, 2009). Thus, with the exception of a brief period in the early 2000s, there has been no evidence of Dutch disease in Tanzania due to increases in aid flows. A recent IMF study (Hobdari, 2008) has shown that as early as 2008, Tanzania's real exchange rate was slightly undervalued.

Regarding aid modality, Tanzania receives grants and concessional loans (for 2007–2008, excluding debt relief, Tanzania received 58.7% of total aid in the form of grants). The GoT's preferred choice of ODA flows is general budget support (GBS), followed by sector budget support and basket funds, and lastly project support. GBS as a percentage of ODA has been increasing: in the FY 2003–04, GBS represented 33.5% of total disbursements to Tanzania while in 2007–08, it represented 51.3% (Development Partners Group – DPG, 2009). Overall, the country's experience with GBS has been strongly positive. According to Lawson et al. (2005), in Tanzania's case, GBS has managed to strengthen the ownership of the government, and increase aid predictability and allocation of funds according to GoT's priorities (GBS has been associated with a large expansion in education and health services). It has also succeeded in enhancing domestic accountability, strengthening public financial management (PFM), and reducing transaction costs (DfDI, 2009).

4. 2 ODA: Main Challenges and Suggestions

In Tanzania's case, ODA is the main source of external financing by far. However, despite the GoT, donors, and civil society's efforts to improve aid allocation and management, there are still certain issues that inhibit aid effectiveness. One of the main bottlenecks is the existence of a large number of bilateral and multilateral donors. Despite the fact that the DPG has strengthened cooperation between partners, there is still lack of joint analysis, advice, and communication. This lack of donor coordination results in project duplication, increased bureaucracy and transaction costs, and capital and human resources

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[6] Other noticeable characteristics in recent ODA allocations to Tanzania are the following: a) a large increase in general budget support, b) an increase in debt flows for 2006-2007, followed by an expected decrease, c) an increase in the administrative costs of donors (due to the increase in general budget support, transaction costs have been transferred from GoT to GPs), d) a decrease in support for NGOs (the majority of NGOs are funded by religious organizations or international development agencies), and e) an increase in aid for trade, capacity development, and regional integration purposes (especially since trade has been recognized as an important growth factor for Tanzania in the MKUKUTA).

misallocation. According to Roodman (2006), donors and various international development organizations, including religious and other NGOs, have separate accounts for accountability purposes (more than 1,000 accounts in total). This leads to capacity constraints and problems regarding project identification, design, implementation, and monitoring.

Another issue that needs to be taken into account is the general focus of the GoT on GBS and its possible implications. In the past, when foreign aid involved mainly projects, debt relief, and technical assistance, the impact on macro variables was muted, at least relative to the amount of the aid flows (Nord et al., 2009). Although GBS to Tanzania has been successful overall, the GoT needs to monitor the situation carefully in order to identify early signs of currency appreciation or inflationary pressures, especially since it plans to increase GBS as a percentage of total aid. Additionally, in many cases, GBS tends to increase aid fungibility and misallocation of resources, especially when corruption levels are high (according to the Transparency International 2008 Corruption Index, Tanzania ranks 102nd out of 180 countries). In December 2006, Denmark reduced its GBS to Tanzania by 20% for FY 2007–2008, because the GoT did not present a long-awaited anti-corruption legislation (Chêne, 2007).

Moreover, ODA has so far focused mainly on social infrastructure projects in accordance with the MKUKUTA and the MDGs. Although its impact on primary education, gender equality, and environmental sustainability has been considerable (and thus, actually ahead of schedule in the implementation of these particular MDG targets), it is argued that economic infrastructure has not received the necessary attention. In Tanzania, the quality of economic infrastructure (e.g., roads, ports, electricity, IT, water) is very low, while maintenance is practically non-existent (this is in line with the general policy of donors to support capital projects, but not the recurrent costs of these projects, a fact that leads to the rapid deterioration of capital stock). There is an even greater disparity between rural and urban areas, with major cities having received the largest amount of ODA for infrastructure. Nevertheless, by not investing more in infrastructure, Tanzania is not only failing to attract the necessary foreign direct investment and increase trade, but it is also failing to address the poverty disparity across the country. Thus, it is argued that at present, the GoT lacks a unifying growth strategy to guide both the direction of aid and investment as well as the implementation of specific interventions, such as challenges in modernizing the agriculture sector, an energy sector crisis, and scaling up infrastructure (Ministry of Finance and Economic Affairs, 2009).

Furthermore, another issue that needs to be addressed is the large number of NGOs operating in the country and their contribution especially regarding poverty reduction. In 2007, donors' support to NGOs fell to USD 4.6 million (OECD, 2009); overall, NGOs' funding is uncoordinated (and highly unpredictable) and they also show a structural inability to harmonize activities at grassroots level, a fact that leads to fragmentation and the misallocation of resources (Mamuya, 2008). Additionally, the presence of international NGOs (INGOs) in Tanzania (such as World Vision International and the Gates Foundation) increases project duplication; these organizations not only do they receive a large amount of ODA but they also have their own private funding and thus, many of them control budgets larger than those of official donors (Koch, 2008). The existence, however, of such a large number of (I) NGOs causes extra administrative burden on central and local government; a comprehensive strategy to combat poverty by involving civil society would release social aid flows that could be employed in other sectors.

Overall, Tanzania is on the path to increasing aid effectiveness, especially with regard to achieving the Paris Declaration 2010 targets; however, there are still challenges regarding alignment indicators, aid predictability, and the use of national systems by donors (OECD, 2008). Therefore, some suggestions for improving aid effectiveness in Tanzania are listed below:

- ✓ improve aid allocation and management through cooperation between donors and the GoT in order to achieve an effective division of labor among donors, avoid aid fragmentation and proliferation, and increase ownership of the government[7]
- ✓ engage with DPs over the medium-term projected level of financial assistance in order to avoid abrupt reduction and identify programs that would be protected and continued through domestic resources in case of an aid shortfall (PER Macro Group, 2008)
- ✓ streamline administrative procedures for project implementation and monitoring (for donors, GoT, and NGOs) in order to increase efficiency and avoid wasting resources
- ✓ increase the role of civil society: build local capacities and empower communities, participate in meetings and discussions at community, regional, and national levels to promote the rights of disadvantaged and vulnerable groups
- ✓ address disparities, inequality, and poverty between urban and rural areas through ODA-funded physical infrastructure projects (transport, energy, IT, water) as well as social services (donors should first identify the gaps in the social aid provided by (I)NGOs and then step in, so that project duplication is avoided)
- ✓ promote Public Private Partnership (PPP) for the provision of infrastructure projects, particularly at present due to the capital scarcity caused by the

[7] "Ownership" is particularly important to the government due to the large number of DPs, each with its own agenda and procedures. On the other hand, "ownership" gives the power to the Tanzanian government to (mis)use aid for its own goals: GBS in particular provides much freedom in aid allocation, which is not always put in the best of use. For example, out of GBS detailed expenditure, 43% of "other expenditure" is spent on salaries, i.e., a daily subsistence allowance (DSA) of 80,000 TSH — around USD 60 — used for travelling and seminars (information acquired during an interview with a local aid expert). This amount comes into perspective if we take into account that the lowest legal monthly salary for an unskilled worker is around 60,000 TSH.

financial crisis (the GoT has already set up a PPP unit at the Ministry of Finance and Economic Affairs)

- ✓ increase projects promoting good governance and accountability (by improving the judicial system, police, and accountability of government towards its citizens and donors) in order to combat corruption and bureaucracy through the elimination of red tape, weak courts, nepotism, and bad norms
- ✓ improve cross-border/regional coherence: since many DPs are active in neighboring countries and support regional organizations (for example, the Southern African Development Community and East Africa Community), they could become more involved in sectors such as migration, environmental and natural resources management, conflict prevention, and intraregional trade, so that there are no "aid orphans" in the wider region (URT — EC, 2007)

Overall, greater cooperation between bilateral, multilateral donors, and the GoT, as well as civil society's participation in the decision-making process, is required in order to increase the benefits of foreign aid to the Tanzanian economy.

4.2 ODA, FDI, Trade, and Remittances: Impact on GDP Growth

Before proceeding with the econometric analysis, it would be useful to provide some information on foreign direct investment, trade, and remittances in Tanzania. Since the mid-1990s, FDI flows have greatly increased on account of the financial reforms and privatization programs (Figure 5). Thus, from USD 4.4 million on average during the period from 1970 to 1990, FDI flows reached USD 600 million in 2007, mainly due to investments in mining, tourism, manufacturing, transport, and services (Ministry of Finance and Economic Affairs, 2008).

Although this impressive increase in investment is an indication of investors' confidence in the economic and political stability of the country, FDI is far below the country's potential if we take into account Tanzania's geographical location, biodiversity, and ecological and geological condition. In the 2008 competitiveness index rankings, Tanzania ranked 113th out of 130 countries; it was in 104th place in the previous year (World Economic Forum, 2008). Furthermore, Tanzania's inward FDI performance was ranked 65th in 2007, down two places from its position in 2006 (UNCTAD, 2008). A series of bottlenecks — poor infrastructure, various regulatory and administrative barriers, low quality of the labor force, underdeveloped private sector — impede Tanzania from fulfilling its potential.

With regard to trade, the increase in exports observed after 2002 was mainly due to trade liberalization and the government's decision to focus on non-traditional exports such as minerals and horticultural products. The diversification of its export base was necessary, because primary commodities are generally volatile on the world market, while production is vulnerable to weather conditions and supply constraints. Nevertheless, the large increase in exports was accompanied by an even larger increase in imports, mainly fuel and capital goods.

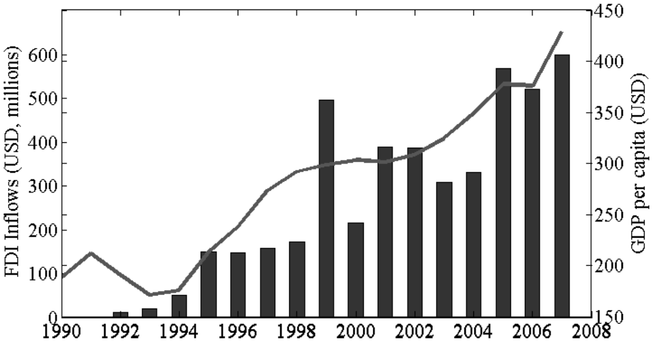

Figure 5: FDI flows and GDP per capita in Tanzania 1990–2007 (UNCTAD, FDI Stat. database)

Although these imports are mainly used for human and capital investment, which leads to economic growth, the trade deficit has been rapidly increasing. The current account deficit (estimated at USD −2.219 millions in 2008), which is so far largely covered through donor support, is a major cause of concern.

Finally, although remittances are increasingly being viewed as an important source of financing for development, for most African countries, including Tanzania, the major external financing source remains ODA followed by FDI. Despite the fact that a large amount of capital is transferred through informal channels, such as family and friends, and is thus not included in official data, it is argued that remittance flows to Tanzania are too insignificant — only about USD 14 million in 2007 — to have an impact on GDP growth. In Tanzania's case, the Diaspora stock — and especially highly-skilled professionals — is very limited with the majority of immigrants returning back home; thus, the country does not suffer from the "brain-drain" phenomenon, but it does not gain from remittances either[8).

4. 2. 1 Data collection, methodology, and results

The analysis uses time-series data spanning from 1970 until 2007. Three independent variables are used (e.g., official development assistance (ODA), foreign direct investment (FDI), and trade balance), while the dependent variable is GDP growth. Remittances were not included in the analysis due to the fact that their very limited amounts do not have an impact on economic growth and because data on remittances was only available from 2000 onwards. Remittances are discussed later in this paper due to their impact on poverty reduction.

Data for ODA (total net disbursements) was extracted from the OECD

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8) In contrast, for other African countries, remittances form the primary source of foreign exchange reserves; e.g., in 2006, 25% of the GDP of Lesotho was due to remittances (Ratha, 2008).

statistical database — DAC aid statistics database. Data on FDI flows to Tanzania was recovered from the UNCTAD statistical database for foreign direct investment. Moreover, data for the trade balance was extracted from the WTO statistics database, while data for GDP growth came from the United Nations statistics division — National accounts estimates of main aggregates. All variables are measured in millions of USD at current prices.

For the analysis, the Ordinary Least Squares (OLS) technique was employed. The hypotheses of the analysis are the following:

1) ODA flows are likely to have a greater impact on Tanzania's GDP growth than FDI due to the fact that a) ODA is at present quadruple the amount of FDI flows, and b) ODA in Tanzania is generally thought to have been effective in assisting the country in achieving economic development.
2) Although FDI is generally regarded as promoting growth through technology transfer and improvements in efficiency and productivity, in Tanzania's case, FDI's impact on growth is expected to be rather limited (one of the reasons being the relatively modest FDI inflows).
3) While exports have greatly increased and imports are generally used for development purposes, it is expected that due to the increasing trade deficit — especially after 2002 — trade's impact on economic growth is limited.

The OLS was used to estimate the effect of the independent variables — ODA, FDI, and trade balance — on GDP growth (see Appendix). The results show that these three independent variables explain almost 72% of the variation in Tanzania's GDP growth (the adjusted R-Square is $R^2 = 0.718$). The analysis of variance (ANOVA) shows that the F-statistic value is $F_{3,34} = 32.447$ ($p<.001$), signifying that the regression is significant.

The regression equation is shown below:

$$Y = 4710.954 + 2.153X_1 + 4.898X_2 + 0.135X_3$$

where Y = GDP growth, X_1 = ODA, X_2 = FDI, and X_3 = Trade balance (T-statistics values for ODA and FDI regression coefficients are positive and significant)

The beta coefficient for ODA is $\beta_1 = .374$, for FDI it is $\beta_2 = .290$, and for trade balance it is $\beta_3 = .023$, signifying that, as assumed in the hypotheses, ODA is the most important factor in explaining/predicting GDP growth, followed by FDI.

The regression was tested for multicollinearity among the independent variables, heteroskedasticity in the error variances, and autocorrelation in the error terms. Results were corrected for heteroskedasticity using the White-test, while Cochrane-Orcutt estimation was used to correct the autocorrelation in the error terms. Regarding multicollinearity, the variance inflation factors are VIF<10 for all variables: $VIF_{ODA} = 5.025$, $VIF_{FDI} = 2.538$, and $VIF_{TRADE} = 4.525$. Thus, we conclude that independent variables are uncorrelated.

4. 2. 2 Comments on the econometric analysis

The above results, which indicate ODA's important contribution to the

Tanzanian economy, are supported by various other studies (Hatemi-J and Irandoust, 2005[10]; Danielson and Mjema, 2008[9]; IMF, 2008). Nord et al. (2009), in particular, argue that in Tanzania's case ODA and GDP growth are positively correlated from the mid-1970s through the early 1990s, a fact that indicates that at the time donor-funded infrastructure projects stimulated the economy, particularly because there was a large supply of underutilized labor. This view is also shared by Kweka and Morrissey (2000), whose aid regression indicates that the coefficient on the growth of aid is positive (0.70) and significant (at 1% level). In their view, the positive growth effect of policy reforms in the mid-1980s was associated with increased aid effectiveness.

In the first half of the 1990s, however, growth decreased rapidly despite higher aid flows. An important conclusion that can be drawn from the information above is that until the early 1990s, aid efficiency[11] was low, mainly due to limited administrative capacity to absorb aid flows as well as the existence of loss-making SOEs that were using large amounts of domestic and foreign savings (Nord et al., 1993). The results of the implementation of sound macroeconomic measures in the mid-1990s and the shift to GBS seem to have improved aid effectiveness. Additionally, the increase in the aid-to-GDP ratio for 2001-2008 in comparison to the second half of the 1990s (i.e., 10.8%) contributed to a large increase in capital accumulation, which has had a positive impact on GDP growth.

On the other hand, foreign direct investment has also had a positive impact on Tanzania's economic growth, a view supported by a number of studies (Moss et al., 2005; World Bank, 2005b). It should be mentioned that behind the increasing amount of foreign investment that the country attracted lay the investors' confidence in Tanzania's stable macroeconomic environment and the relatively low country risk. Nevertheless, Tanzania, like most other sub-Saharan countries, still relies heavily on foreign aid for its economic development.

Finally, concerning trade, Tanzania's economic growth and the government spending on social development will continue driving up imports, and thus, increasing the trade deficit, which is already very large at -19.2% of GDP in 2008. Various studies have pointed out the serious problem of increasing current account deficits, which at present is covered mainly through donor transfers, and more recently from tourism receipts and net foreign investments (Parikh, 2004; Rabobank, 2009). These studies show that in some cases, like in Tanzania's, trade liberalization constrains growth through an adverse impact on balance of payments.

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9) Danielson and Mjema (2008) distinguish between aid and loans; they argue that while aid has fostered growth, loans have not because, in Tanzania's case, certain preconditions are not met.

10) The authors investigated the relationship between foreign aid and economic growth in Tanzania over the period from 1974 to 1996. The long-run foreign aid elasticity is positive (0.873) and significant (at 1% level), indicating that foreign aid had a positive effect on the country's economic growth.

11) Aid efficiency refers to maximizing the results of aid used for a particular activity. Aid effectiveness refers to the extent to which aid has achieved its objectives.

4. 3 ODA, FDI, Trade, and Remittances: Impact on Poverty Reduction and Human Development

Although ODA flows have been in line with MKUKUTA, poverty alleviation efforts have not led to the desired results. The latest Household Budget Surveys (HBS) in 2007 has revealed that there has been significant progress in areas such as primary education, gender equality, and environmental sustainability, as well as increase in assets and improved residence (National Bureau of Statistics — Tanzania, 2009). The country has managed to increase its Human Development Index (HDI) from 0.436 in 1990 to 0.530 in 2007, thus occupying the 151st place out of 182 countries (UNDP, 2009). This HDI value is similar to those of other sub-Saharan countries, but it is much lower than the values of other emerging and developing countries in Asia and Latin America. There are also concerns about whether Tanzania will be able to reduce child mortality, improve maternal health, and combat HIV/AIDS, malaria, and other diseases, according to both 2010 MKUKUTA and 2015 MDGs'targets (URT — EC, 2007).

On the other hand, income poverty declined only marginally in real terms (the 2007 HBS indicates that poverty declined from 35.7% in 2001 to 33.3% in 2007). The problem is particularly acute when comparing income inequality between urban and rural areas. The Gini coefficient for 2000-2001 was 0.35 while for 2007-2008 it was 0.346 (UNDP 2007/8). Tanzania's Human Poverty Index (HPI) value (which includes the adult literacy rate, a decent standard of living, the probability of not surviving to age 40, and the proportion of underweight children under the age of 5) is HPI-1 = 30%, which ranks Tanzania 93rd out of 135 countries (UNDP, 2009). Despite the declining fertility rate, Tanzania's population is still expanding at a fast pace (4.62 children/woman in 2008); taking into account that the majority of the population lives in rural areas, more targeted action is needed in order to fight poverty effectively. So far, Tanzania's economic growth has not translated into poverty reduction, that is, the growth has not been pro-poor growth (Ministry of Finance and Economic Affairs, 2009).

On the other hand, FDI has not had a positive impact on poverty reduction or human development. The majority of investment has been focused on the mining sector, which has been the fastest-growing sector, averaging growth of about 15% for the period from 2000 to 2007. However, there is no indication that the growth of the mining sector has large positive effects on the local economy or on local employment (MPEE, 2007). In fact, the mining sector, especially gold-production, is very import-intensive and employs around 10,000 people at present with few linkages to the local economy (URT — EC, 2007). Moreover, concerning FDI in the tourism sector (the other sector that has attracted increasing amounts of investment), the majority of FDI has been in the form of M&As. According to Jomo (2002), M&As do not usually result in increased employment opportunities or knowledge transfer to the local community, since they mainly involve a change in ownership and control of assets, as well as some changes in managerial positions.

Furthermore, it is argued that the two main exporting sectors — agriculture and mining — have not particularly contributed to poverty alleviation either. The main reason behind this is that whilst 80% of the population is involved in agriculture, the vast majority is involved in subsistence agriculture with no access to training, credit, and machinery. On the one hand, agricultural production still depends on various factors (weather conditions, primary commodity prices, available infrastructure), but on the other hand, the budget allocations to agricultural development and rural development are insufficient to transform Tanzania into a major food-export country or to solve its food security problems[12]. Furthermore, the mining sector and its exports do not contribute to poverty reduction either due to the same issues discussed above concerning FDI (i.e., it is an import-intensive sector).

Finally, regarding remittances, the primary uses of remittance transfers to Tanzania (e.g., food, healthcare, communication, transportation, housing, education, clothing) clearly indicate that these mainly combat poverty (International Organization for Migration — IOM, 2005). Although there are services for migrants to encourage investment from remittances, for example matching funds for local development projects, these options are not widely used. Other services that are offered in various African countries (for example, Burundi, Mali, Uganda), where remittances can be used for development purposes such as partnerships with local, national, or international development agencies and various business incentives, are not provided by the GoT (IOM, 2005). Thus, although remittances increase household income and are mainly used to cover basic needs, in Tanzania's case, one could suggest that in the long run, better education or healthcare provided by remittances can lead to improved quality of the labor force, better health, and thus, increased productivity. Therefore, it can be argued that remittances do promote economic development in Tanzania, even though it is in an indirect and long-term manner.

5. Conclusions — Perspectives

Tanzania has made considerable progress over the last two decades, particularly after 1995 when macroeconomic policies initiated in the previous period started to show results. It has managed to transform itself from a centrally-planned economy to a market-oriented economy through the successful implementation of legal, regulatory, and institutional reforms such as restructuring public enterprises, liberalizing the financial sector, and establishing sound public

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[12] Although it is argued that agriculture is one of the two sectors — the other being mining — where Tanzania has a comparative advantage, it is suggested that the country has lost its comparative advantage in agriculture due to the higher productivity and advanced technology of other markets in Latin America and Asia, as is the case with coffee and cashew-nuts. Thus, as important as agriculture might be, it is argued that it will be a beneficiary of other drivers rather than a leading driving-force itself (MPEE, 2007).

institutions. The country's economic strategy was clearly encapsulated in the Poverty Reduction Strategy Paper — PRSP in 2000, which was followed by MKUKUTA in 2005. Overall, the GoT took a proactive role in dealing with reforms and poverty by increasing tax revenues (which in turn increased government spending in priority areas, especially health and education) and by engaging civil society and supporting public debate, thus promoting country ownership. As a result, the economic growth and political stability acted as a virtuous growth circle, leading to improvements in macroeconomic indicators: a GDP growth of around 7% since 2000 and inflation rates in the single digits.

Table 3 presents the impact of the four factors discussed in this paper (ODA, FDI, trade, and remittances) on Tanzania's economic growth and poverty reduction. Out of these four factors, foreign aid has been the most significant factor to the recent GDP growth rate — more important than FDI, trade, or remittances. Large aid flows have not caused Dutch disease, mainly due to increased aid efficiency as well as to increases in imports and high government investment. Despite the large ODA-funded projects dealing with health and education, economic growth has largely not addressed the poverty reduction issue.

FDI has also been responsible for GDP growth, mainly due to large investment in the mining, tourism, and service sectors; however, it has had no impact on poverty reduction due to the nature of investment (i.e., mining and tourism). Trade's role in economic development has been complex: increasing exports have been accompanied by an even further increase in imports, leading to a negative current account. It has also had no impact on the fight against poverty because the main export sectors (i.e., agriculture and mining) are not adequately linked to the local economy. Finally, remittances, due to their low amount and thus, negligible contribution to Tanzania's GDP, do not promote economic growth directly; however, they do combat poverty since they are mainly used for consumption purposes.

Thus, at present, one of the main concerns of the country should be the reduction of poverty, which despite previous efforts has not been as successfully addressed as expected. Rural areas in particular should be given priority with an emphasis on agriculture, infrastructure, and social services. Agriculture should be supported through land and water management, improved agricultural technology,

Table 3: Conclusion table — Impact of ODA, FDI, trade, and remittances on Tanzania's economic development

TANZANIA'S ECONOMIC DEVELOPMENT		
Aim	Economic Growth	Poverty Reduction
Means	1. ODA	1. ODA
	2. FDI	2. Remittances
	3. Trade	

and adequate funding and resources. Since 80% of the population is involved in agriculture, reducing poverty levels is very much linked to improving food and agricultural security. Nevertheless, although agriculture should be supported, other more value-added sectors should be developed as well: it is predicted that through proper training, incentives, and investment in physical and human capital, a higher percentage of the population will be employed in industry, manufacturing, and services, thus leading to a restructuring of the Tanzanian economy without endangering food security.

Another major concern for the country that inhibits development is the magnitude of infrastructure gaps. In particular, transport, energy, IT, and water infrastructure are underdeveloped and poorly maintained. At present, not only are the available resources insufficient to close those gaps, but also maintenance work is seriously undermined by donors' general reluctance to fund recurrent expenditures on aid-funded projects. This fact, however, affects both the fight against poverty and the efforts on behalf of the government to attract more investment, increase trade opportunities, and diversify its economy.

What should be stressed at this point is that ODA, FDI, trade, and remittances, as well as their impact on economic development, are influenced by both internal and external factors. Macroeconomic stability, better infrastructure, improvements in health and education indicators, and low corruption levels can actively attract more foreign aid and investment, while at the same time increase trade. Remittance transfers can be increased by lowering the sending fees and through the promotion of various investment strategies. However, external factors such as trade shocks can seriously affect and impede the economic development process — the latest such example is the ongoing financial crisis.

Tanzania has already felt the effects of the global financial turmoil: according to the central bank of Tanzania, the country's 2009 growth forecast was cut to around 5% from an earlier projection of 7.3% due to a rise in inflation, which reached 10.3% in 2008, hitting double-digits for the first time in nearly a decade (Muhau, 2009). The crisis has also hit commodity prices, exports, and the tourism sector, while investment flows have also been reduced. The GoT has officially announced that the "second-round effect" of the global financial crisis has predominantly hit the agriculture, tourism, and mining sectors. There are already foreign investment projects that have been postponed or stopped altogether in the face of financial difficulties experienced by investors, for example the postponing of plans for a USD 3.5 billion smelter by the U.S.-based Century Aluminum Co (Obulutsa, 2009).

Furthermore, since Tanzania is also among Africa's main aid recipients, with 34% of its 2008-2009 fiscal budget coming from external sources in terms of concessional loans and grants, the effect of the financial crisis on aid flows is a matter of concern. The GoT has already revised aid projections over the next three years in anticipation that aid will be almost halved by 2010-2011. Already for 2008-2009, the government anticipates that total ODA inflows as a percentage of GDP would decrease by 2 points; this 4.7% decline is largely attributed to a decline in grants (−14.8%) despite an increase in foreign loans (PER Macro Group, 2008). Due to the future decline in aid flows, the GoT plans to scale down expenditures starting from FY 2009-2010: expenditure will be gradually reduced from 28% to 25% of GDP as aid decreases from 9.4% to 6% of GDP between 2008-2009 to 2010-2011 (PER Macro Group, 2008). Reduced flows, however, may lead to adverse effects on growth, poverty reduction, and the implementation of the Millennium Development Goals. Despite President Kikwete's announcement in June 2009 that in the 2009-2010 budget, a TSH 1.7 trillion package (about USD 13 million) will be added to cushion the adverse effects of the global financial crisis, it is argued that this amount is far too insignificant to protect the poor (*The Citizen*, 2009).

This contractionary fiscal policy is also due to the Policy Support Instrument (PSI) agreement between Tanzania and the IMF, which states that the GoT must aim to shrink its budget deficit from 3.7% of GNP in FY 2008-2009 to 3.1% of GNP in FY 2009-2010. A January 2009 IMF review of the agreement states that any decrease in revenue due to the financial crisis, whether tax revenue, official development assistance, or remittances from Tanzanian Diaspora, should be met with "expenditure restraint." Furthermore, the agreement restricts the government from seeking domestic sources of financing, and it aims to reduce inflation to 5% through monetary policies that reduce economic activity, "including through rising interest rates when necessary" (Human Development Trust, 2009). At the same time, while the global financial crisis is unfolding, developed countries are implementing expansionary stimulus policies in efforts to trigger growth and fight off recession.

In order for Tanzania to maintain and even increase the current pace of development, it needs at least a 7% annual growth rate. Despite the fact that ODA forms the largest source of funding in Tanzania by far, it will not be adequate to achieve this kind of growth rate. According to Ratha et al. (2008), the private sector needs to become the engine of growth while official flows should work along with the private sector to provide innovative financing solutions. Especially at present due to the financial crisis, it is important to promote the complementarity of ODA and FDI. The role of Public Private Partnership (PPP) in the provision of policies, services, and infrastructure is paramount: the pooling of public and private resources through the implementation of co-financed projects could be an answer to the current capital scarcity.

Overall, in order to promote growth and achieve pro-poor economic development, the country needs to increase the investment rate[13], while at the same

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[13] Tanzania has a low gross fixed investment rate that averaged 17.5% of GDP from 1999 to 2003, and 19.5% of GDP from 2004 to 2009. These figures are even lower than the 20.5% average for low-income sub-Saharan countries (Index Mundi, 2009). A value below 20% indicates that a country is facing or will face difficulties maintaining a high growth rate. At the same time, private gross fixed investment is very low: 11% on average from 2002 to 2006 (SADC, 2008). Any value below 15% suggests that donors should focus on interventions aiming at improving the business environment.

time reduce its aid-dependency. Besides PPP, some other suitable options include:

1. increase domestic revenue: despite improvements in tax collection and revenue administration, more measures need to be taken in order to reduce tax exemptions (almost 30% of domestic revenue was lost through tax exemptions in 2008) and broaden the tax base[14)]
2. attract more foreign direct investment: improve regulatory and business environment and encourage private sector growth in order for the country to become a regional development hub (this will also increase Tanzania's export capacity and intraregional trade, as well as offer employment and training opportunities for the local work force)
3. access concessional borrowing: while grants do not increase the debt burden and they are useful for social projects with delayed returns, they are also more likely to dampen domestic collection efforts; loans, on the other hand, are useful for economic infrastructure projects that yield quick returns, while they also increase debt management capacities (the World Bank and the IMF's debt sustainability analysis (DSA) is a useful tool to evaluate balance and adjust the ratio between grants and loans in case Tanzania faces a debt service risk; in such a case, the composition of aid may be adjusted towards more grants or higher concessionality of loans), and
4. access careful commercial borrowing: since this type of borrowing is more expensive and carries debt service risks, a cost-benefit analysis of planned infrastructure projects needs to be made to ensure that the investments are worth the cost of servicing the debt (DSA can also help evaluate Tanzania's ability for scaling up external debt in this case)[15)].

However, the country needs to pay careful attention to the use of these increased resources. Investments and policies that will only serve foreign and local business interests (for example, various tax exemptions for mining companies) will definitely not have positive spill-over effects on the general population. Instead, services and infrastructure projects should aim to address the very large regional and income disparities, and they should improve opportunities for the poor while reducing their vulnerabilities. The government needs to focus on a pro-poor growth strategy that involves improvements in primary health and education, the creation of jobs and income opportunities, support for the private sector (especially SMEs and start-ups), the development of skills, microfinance,

[14)] It is a common phenomenon for aid-receiving countries to be below their tax potential; in turn, weaker revenue collection often leads to aid dependency (Gylfason, 2009). It is argued that in Tanzania's case, despite recent improvements, the tax base is rather limited and the GoT treats aid as a substitute for domestic resource mobilization.

[15)] Commercial borrowing and accumulation of debt service arrears increased Tanzania's external debt stock to USD 5.8 billion (31% of GDP) at the end of June 2008 from USD 4.9 billion (30.3% of GDP) at the end of June 2007 (AEO, 2009). The GoT, which is currently seeking financing from sovereign wealth funds in the Gulf and Asia, is also planning to issue sovereign bonds for infrastructure financing, which entails borrowing at commercial rates (Obulutsa, 2009).

agricultural development, and gender equality.

Nevertheless, at present, Tanzania cannot afford to lose foreign aid since a large percentage of the government expenditure is financed through ODA. The anticipated large decrease in aid flows will have to be covered through a reduction in expenditure or an increase in revenue (a measure that is not politically popular with either the general population or investors). However, what should be borne in mind is that Tanzania's long-term aim is to graduate from aid, whose volatility, general unpredictability, and cyclical nature can undermine the country's economic development if other measures are not in place to substitute the loss of ODA flows. Thus, Tanzania needs to develop an exit strategy, since ODA is going to be greatly reduced in the future, by tapping into other funding resources, both domestic and external, on the premise that it successfully manages to handle debt.

APPENDIX

Econometric Analysis

Correlations

		GDP	ODA	FDI	Trade balance
Pearson correlation	GDP	1.000	.828	.783	−.771
	ODA	.828	1.000	.767	−.877
	FDI	.783	.767	1.000	−.736
	Trade balance	−.771	−.877	−.736	1.000
Sig. (2-tailed)	GDP	.	.000	.000	.000
	ODA	.000	.	.000	.000
	FDI	.000	.000	.	.000
	Trade balance	.000	.000	.000	.

N: 38

Regression

Model Summary

R	R square	Adjusted R square	Std. error of estimate	Observations
.861	.741	.718	1750.725	38

a) Predictors: (Constant), ODA, FDI, Trade balance (USD millions)

b) Dependent variable: GDP growth (USD millions)

ANOVA (b)

	Sum of squares	df	Mean square	F	Sig.
Regression	298357806.076	3	99452602.025	32.447	.000
Residual	104211234.378	34	3065036.305		
Total	402569040.453	37			

a) Predictors: (Constant), ODA, FDI, Trade balance (USD millions)
b) Dependent variable: GDP growth (USD millions)

Coefficients (a)

	Unstandardized coefficients		Standardized coefficient	t	Sig.
	B	Std. error	Beta		
(Constant)	4710.954	1323.523		3.559	.000
ODA	2.153	.896	0.374	2.404	.016
FDI	4.898	2.477	0.290	1.978	.047
Trade balance	0.135	0.807	0.023	.167	.867

a) Dependent variable: GDP growth (USD millions)

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