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TANZANIA

# Vigorous reform hurts some, but strong growth and capable state will result

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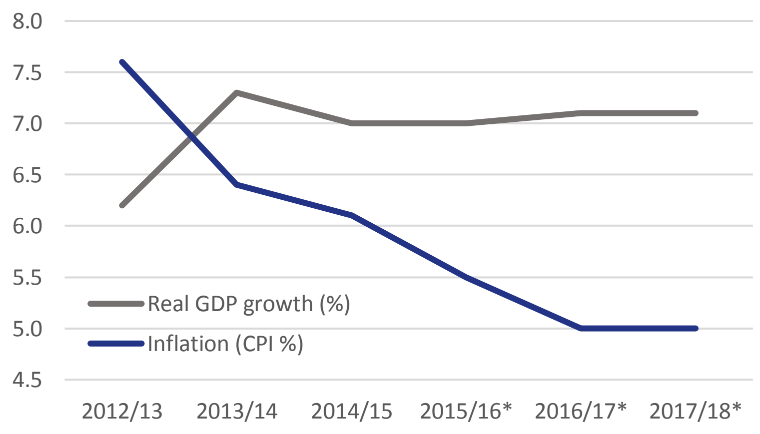
**Economic growth is pursued with almost religious zeal in East Africa's fastest-growing nation. With several years of 7%-ish growth behind it, Tanzania is set to deliver several more years of the same. That makes it an attractive investment destination, but the governing administration, only a year old, is not satisfied. President John Magufuli is vigorously trying to address deep structural weaknesses in the Tanzanian economy, particularly the low rate of tax collection and widespread corruption. The ambition is to turn Tanzania into a middle-income country by 2025 and, on paper anyway, it has the plans to do it.**

Magufuli has earned the title "the bulldozer", an appropriate moniker given his focus on driving infrastructure spending, summarily firing public servants implicated in corruption and the aggressive tax enforcement under his direction. He won as a candidate for the Chama Cha Mapinduzi party (Party of the Revolution), which has held power since independence in 1977. CCM won with 58% of the vote, down from 63% five years earlier. Magufuli, who was a surprise presidential candidate in the CCM, is building a strong reputation for action that is proving popular with many, though detractors include business people who complain of arbitrary tax assessments and the damage to the competitiveness of Dar's port following the imposition of 18% VAT on services attached to goods in transit.

FIGURE 1: TANZANIA GDP GROWTH AND INFLATION




*Source: World Bank*

Some sweeping policy directives have been issued since he took power. One is a move of the whole government from Dar to the central city of Dodoma, a vision that has been mooted since Tanzania obtained independence and is now being implemented despite the huge cost. Dar businesses are nervous about what it means for the city, given that government is currently a large part of economic activity there.

He has also pushed through a campaign promise of free secondary education, stretching government finances to subsidise schools. Another policy causing consternation is a requirement for Tanzania's mobile telecoms companies, among the biggest companies in the country, to list on the fledgling Dar es Salaam stock exchange within six months. The exchange suffers a shortage of liquidity and obstacles for foreign investment. Another is a cap on prices for medical services, which applies no matter whether the services are offered in private facilities in Dar or rural facilities in the countryside.

But there are indications that Magufuli intends to drive greater private business activity, continuing the generally pro-free market policy direction Tanzania has followed for the past decade. He has talked up the need to industrialise the country, hinting at import-substitution industrialisation policies involving trade barriers to protect new industries. That has been interpreted by some as negative for international trade, compounded by Tanzania's recent opposition to an EU trade agreement with the East African Community, much to the frustration of its neighbours. Tanzania already has duty-free access to the EU as a less-developed country, but neighbouring Kenya does not. But a five-year plan developed last year places significant emphasis on improving the environment for the private sector.

TABLE 1: ECONOMIC SECTOR GROWTH RATES
*% change in constant 2007 prices*

| | 2015 y-o-y | Q2 2016 y-o-y |
|---|---|---|
| Agriculture | 2.3 | 3.2 |
| Mining & Quarrying | 9.1 | 20.5 |
| Manufacturing | 6.5 | 9.1 |
| Electricity | 5.8 | 7.1 |
| Water | 0.1 | 4.3 |
| Construction | 16.8 | 9.0 |
| Wholesale & retail | 7.8 | 5.2 |
| Accommodation & restaurants | 2.3 | 2.5 |
| Transport & storage | 7.9 | 30.6 |
| Information & communication | 12.1 | 12.6 |

Source: National Bureau of Statistics

The general view of Magufuli's efforts is that the intentions are good, but the execution sometimes frustrated by unintended consequences. There has been little engagement with the business community so far on what would address inefficiencies and other blockages to increased business activity. Business people complain not only of the aggressive and, in their view, often arbitrary tax assessments, but also of difficulties in importing skills and accessing the highest level of government to state their case. They remain shackled by high levels of bureaucracy, which sees Tanzania ranked 132$^{nd}$ out of 190 countries in the World Bank's ease of doing business survey. That rank has been improving recently, though it is some way off the top 100 ranking it held a decade ago.

In my view, the government will become more open to business ideas as it beds down under the still relatively new presidency. Magufuli's rash of hiring and firing in the civil service will settle as he builds a trustworthy team, which will in turn begin to develop constructive ways of engaging with business. There are strong indications that government recognises the need to engage the private sector to deliver on ambitious infrastructure targets. Public-private partnerships for infrastructure ranging from roads and rail to power are an obvious part for the private sector to play. Construction has been one big driver of economic growth and other sectors including private tertiary education look set to benefit from government policies. And Tanzanians' creative energies will continue to unlock business opportunities in surprising ways. Consider, for example, that Tanzania boasts the most advanced mobile financial services market in the world.

## GOVERNMENT FINANCES

Tanzania has generally maintained a prudent fiscal position, with the latest budget deficit at 3.3% of GDP. That compares well to other countries in the region, but does not reflect the whole picture. Government finances are blighted by a high level of arrears, mostly payments to contractors for infrastructure projects and obligations to pension funds. The World Bank estimates that if arrears are included, the deficit is closer to 5% of GDP.

On the revenue side, Tanzania has traditionally relied on a mix of foreign aid and domestically collected revenue. Aid has been declining over several years as major donor countries have pulled back on spending to repair their own fiscal positions. In 2014/15 aid accounted for just 15% of government spending compared with 45% in 2007/08. As a result, government has been under pressure to generate domestic revenue.

TABLE 2: MAJOR EXPORTS (TZN$bn)

| | 2014 | 2015 |
|---|---|---|
| Coffee | 204.3 | 309.7 |
| Cotton | 558.4 | 79.7 |
| Sisal | 111.3 | 340.2 |
| Cashew nuts | 647.9 | 497.3 |
| Cloves | 50.9 | 5.9 |
| Tobacco | 319.3 | 428 |
| Tea | 72.8 | 90 |
| Gold | 2705.7 | 2717.2 |
| Diamonds | 80.3 | 65.6 |

Note: As at 31/12/2015 1TZ$bn=US$466,000

Source: National Bureau of Statistics

Tanzania has among the lowest revenue collection rates in the world. At only 13% of GDP, the taxes collected do not come close to funding government expenditure of 17.5% of GDP. That has to change, and makes clear why increased tax collection has been a priority for Mugufuli. And despite the protests of business people, the fact is that revenue collection has begun to trend in the right direction. Since December 2015, revenue collection has exceeded targets by an average of 3%. The VAT Act as well as a new Tax Administration Act, both passed in 2015, have given authorities increased powers to levy taxes and removed many exemptions. Government has said it intends to streamline the processes, though businesses complain about duplication in submissions and conflicts between different agencies in just what is expected. Given Tanzania's remarkable success in new payments mechanisms based on mobile phone technology – the country has the highest penetration of phone-based payments and even has micro insurance and loans services available through phones – innovation could be the way to relieve some of these frustrations.

The government's arrears position is a major problem for overall fiscal management. Central government owes billions to suppliers and pension funds, with the outstanding obligation now bigger than government's planned development spending, according to the World Bank. Several state-owned enterprises also have significant arrears that are not on the national balance sheet. Some private companies will no longer supply the government. Magufuli has promised to deal with the arrears problem, but progress has been slow.

Debt has had to be raised to cover the budget shortfall. Total public debt was at 36% of GDP in mid-2015, which is modest compared with similar countries in the region. A significant amount of public debt is in hard currency, leaving the fiscus highly vulnerable to exchange rate movements. A rapid depreciation in the first half of 2015 – the Shilling spiralled from 1,735 to the US$ to 2,285 – saw debt and debt service costs balloon, though some recovery and a more stable exchange rate since has made this more manageable. Debt service costs are high at 26% of total domestic revenue raised. Magufuli has mooted the prospect of raising additional debt to fund infrastructure development. While this will be positive for the economy, the fiscal position and currency risks have to be carefully managed to ensure they does not place too great a burden on future debt service obligations. Projects will have to be prioritised for those with the greatest likely impact on growth. One of those will be a $4bn pipeline connecting Uganda's oil fields to the Dar port, which Tanzania won from rival Kenya.

FIGURE 2: TANZANIAN SHILLING/US DOLLAR

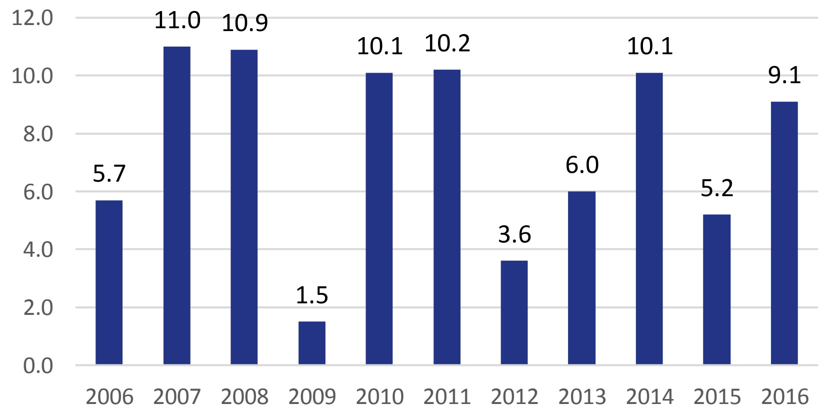

*Source: Inet BFA*

### A FIVE-YEAR PLAN

Tanzania's power and transport infrastructure suffers from years of underinvestment which has left it lagging its peers on various indicators. Magufuli's government has clearly committed itself to addressing the problem. It is a major impediment to business growth and addressing it offers significant opportunity for international investors. The World Bank has estimated that an increase of investment in infrastructure of 1.2% would result in an increase in GDP of 1.7% the following year.

The challenge for the government is how to fund it. For the past several years fixed investment spending has amounted to about 6% of GDP each year, of which government spending accounts for one percentage point, which is relatively low for the region. The domestic funding environment is constrained and government borrowing has already sucked liquidity out of domestic credit. The solution therefore seems to be to tap international investors for funding and as project developers.

FIGURE 3: ANNUAL GROWTH IN MANUFACTURING (%)




*Source: National Bureau of Statistics*

A five-year development plan (FYDP) launched last year places significant importance on private investment. It promises to "unleash" the private sector's



*Source: National Bureau of Statistics*

creativity by improving the business environment to one that is "reliable, secure and predictable for the private sector to profitably operate, sustain and flourish", says Magufuli in the preamble to the plan. It is an extensive document with elaborate thinking on how to position Tanzania as a regional economic hub and reach its 2025 objective of becoming a middle-income country. It sets out a range of incentives including special economic zones, with a total investment amount of TZ$107-trillion, equivalent to about US$48.7bn. A significant amount of this is earmarked for government, relying heavily on envisaged fruits from enhanced tax collection efforts, though given its funding constraints it is unlikely to be able to

TABLE 3: REGIONAL INFRASTRUCTURE INDICATORS, 2015

| | Tanzania | Kenya | Rwanda | Uganda | Zambia |
|---|---|---|---|---|---|
| WEF Global Competitive Index Infrastructure Score | 2.26 | 3.27 | 3.14 | 2.28 | 2.67 |
| Access to electricity (% of pop) | 15.3 | 23.0 | 18.0 | 18.2 | 22.1 |
| Electricity consumption (kWh/capita) | 98.8 | 159.7 | n/a | n/a | 571.3 |
| Improved water sources (% of pop) | 55.6 | 63.2 | n/a | n/a | 65.4 |
| Improved sanitation facilities (% of pop) | 15.6 | 30.1 | 61.6 | 19.1 | 43.9 |
| Mobile cellular subscriptions (per 100 people) | 62.8 | 73.8 | 64.0 | 52.4 | 67.3 |
| Internet users (per 100 people) | 4.9 | 43.4 | 10.6 | 17.7 | 17.3 |
| Logistics performance index (1 to 5) | 2.32 | 2.40 | 2.32 | 2.35 | 2.31 |

Source: World Bank

deliver on the full commitment. The private sector is also expected to play a large role.

The FYDP talks extensively of public-private partnerships for infrastructure projects but acknowledges that the regulatory environment for PPPs has to be improved first. It has committed itself to improving its own capacity to structure bankable PPPs and creating the necessary environment to ensure appropriate risk sharing. It looks good on paper and could materialise into significant opportunities for independent power producers, toll roads, rail, ports, petrochemical processing and transport. For example, Tanzania's huge gas reserves present an excellent opportunity for gas turbine electricity generation. Other African countries including South Africa, Nigeria, Kenya and Ghana have been highly successful in mobilising billions of dollars in funding for PPPs.

## INVESTMENT OUTLOOK

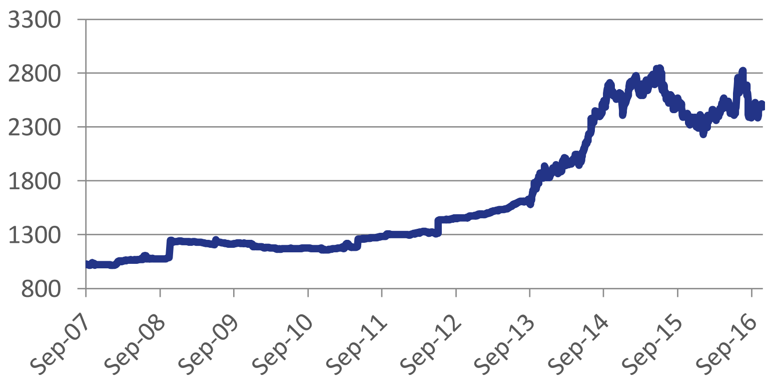
Investment volumes have fallen around the election and early period of the Magufuli presidency. Largely that is a result of uncertainty as investors wait to get a proper sense of the policy direction of Tanzania under his leadership. In my view a picture is emerging of a generally business-friendly philosophy from the government. This has to translate into policy that makes it easier for businesses to operate, both at the level of mega-projects but also at the micro level of small businesses operating across the country. Businesses are feeling the pain from increased VAT and other regulatory obligations, which could be compensated by improving the efficiency of government engagement at large. So far that has not happened. The clampdown on corruption has actually meant a slowdown in the way business applications are handled, with an abundance of caution from civil servants. This needs to be addressed, with fundamental improvements to processes needed, in which technology might play a prominent role. These extend to those faced by foreign investors, who must navigate an elaborate bureaucracy to set up a new business in the country, including multiple regulators, depending on the industry.

But one cannot ignore that Tanzania's GDP growth rate underpins a wide range of opportunities. One of the fastest-growing areas of activity has been tourism, with Tanzania rich in biodiversity, beaches and mountains, including the highest peak in Africa. Government has long been welcoming of foreign investors in tourism and continues to promote it. A new airport is set to open in Dar in the next 12 months that will ease the flow of tourists into the country. The national airline has purchased four new aircraft to add long-haul flights.

Other opportunities exist in servicing the retail market as well as other tertiary sectors such as financial services and telecommunications. The government is developing a set of industrialisation incentives to promote its manufacturing sector – it wants to double manufacturing's contribution to GDP by 2020.

Tanzania's primary industries also offer opportunities, though government policy is less clear. The country has recently made a string of large natural gas discoveries that are being developed, adding to metals and minerals mining including diamonds and tanzanite. Commodities account for a relatively small proportion of Tanzania's economic output at 4% of GDP, so the country has been a net beneficiary of the decline in commodity prices. Government is pushing to increase beneficiation within the country.

FIGURE 4: TANZANIA ALL SHARE INDEX




*Source: Inet BFA*

Agriculture is another area of increasing activity. It adds significantly to the country's foreign exchange earnings and accounts for a quarter of GDP. While a great deal of agriculture is on a rural subsistence basis, there is a growing agri-industry including large-scale exports of food products. There is extensive scope for enhancing agricultural processing that could fit the overall industrialisation project.

The East Africa region is another substantial source of economic activity. The East Africa Community is lowering trade barriers and improving infrastructure with a customs union in place among the six member states including Kenya and Uganda. The East Africa Central Corridor is a major transport backbone that connects the DRC, Burundi and Rwanda to the Dar port with fast-tracked goods clearance and efficient border crossing. Tanzania recently called for tenders to design and build a $7.6bn standard gauge railway line to connect the four countries.

For portfolio investors, the opportunities are also gradually emerging. The Dar es Salaam stock exchange was established in 1996 as part of the nation's move from a centrally planned economy. Several privatisations have seen formally state-owned companies list, alongside local banks and some larger industrial companies. Several government bonds are also listed with maturities of two to 15 years. The exchange has a market capitalisation of TZ$29bn though trade is thin, with a market turnover of less than 4% per year. Foreign interest was brisk until the currency weakness in 2015 and the elections and foreign volumes have not yet recovered.

Several initiatives are intended to help grow the capital market including the requirement for the country's telecoms companies to list on the exchange, which was first required in legislation in 2010 but deadlines have been extended several times. The biggest are Vodacom, Airtel and Tigo. Pension fund reform is also intended to stimulate trading activity. The large public sector pension funds are currently managed by internal teams though regulations have been promulgated to require them to appoint outside managers. The current investment strategies are heavily biased toward government paper and property, so it is widely expected that when the regulations are enforced there will be a major liquidity injection into the exchange. Legislation requires pension funds to have a minimum 20% equity allocation, but this has been largely ignored.

These developments have the potential to dovetail with the requirement for private capital to invest alongside government in industrialisation and infrastructure across the economy. Tanzania's ultimate ambition of becoming a middle income country by 2025 will inevitably drive major development of its capital markets. For foreign investors, there are many opportunities to investment alongside government in projects or directly into other business opportunities in the country. Portfolio investment will gradually evolve alongside the growth of the economy as a whole, but patient investors might benefit from staking out the territory now. ■