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THE DISCONNECT BETWEEN FORMAL AND INFORMAL INSTITUTIONS IN THE TANZANIAN FIRM SECTOR: NO SHORTCUT TO A CONDUCTIVE INVESTMENT CLIMATE.

by

Marion J Eeckhout¹²
Ministry of Foreign Affairs
Netherlands

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Background

This article is part of three pronged research program in a research exchange arrangement between the Institute of Social Studies (ISS) and The Netherlands Ministry of Foreign Affairs. The research program aims to shed light on the disconnect between formal and informal institutions from three angles - e.g. policy domains - public service delivery, the judiciary system, and the business environment for the private sector. This article specifically focuses on the institutions in the private sector for the country case study of Tanzania.

Introduction

Tanzania is hailed these days for the rapid turn around in the nineties towards an ambitious social and economic reform program. The improvement in the macroeconomic situation in recent years is astonishing. Over the period 1995 till 2004 growth rates of 4% and 5% p.a. in real terms were attained, whereas the growth rate in the early nineties was a meagre 2% p.a..

The rapid growth rate is mostly accounted for by tourism, mining and other services. In fact the export revenues boom largely due to high demand from China. Mining constitutes 3% of GDP and grows with 14% p.a.. Growth in the agricultural sector, which constitutes 50% of GDP, remains at just 3% p.a.. During the same period the firm sector responds lukewarm to the improved macroeconomic environment.

In a previous article by Eeckhout and Dekker (2005) about the micro-macro linkages in Tanzania, the evolution in the poverty situation of the individual household was put centre stage. In that article the poverty situation was described on the basis of statistics from the household budget survey (HBS). The HBS of 1991 indicated 39% lived below the basic-needs-poverty line. According to the HBS in 2001 ten years later this was reduced to 36%. In terms of food poverty lines the respective statistics were 22% and 19%. Demombynes and Hooegeven (2004) argued that in the past decade an improvement in the poverty situation did occur, but that the effect was muted because an increase in poverty at the beginning of the decade cancelled out the decrease in poverty by the end of the decade. Conversely, Eeckhout and Dekker (2005) argued that the improvement in the macro environment did not affect the individual firm and household level, because the malfunctioning at the intermediate level of markets and institutions blocked the transmission of the macro effect to the firm level and because the growth was mostly externally oriented.

The 2005 article explored the linkages between the macro reforms and the results at micro level. Its hypothesis was that the transmission from the macro to the micro level via the markets and institutions didn't function well because the formal institutions established by the state didn't fit well with the informal institutions established by the society. In the words of Jutting (2003), apparently there occurred a disconnect between the formal rules of the game and the play of the game. It elaborated on two policy domains e.g. marketing reform and decentralization of service delivery and concluded that the results of the formal reforms were disappointing because the implementation differed markedly from the intentions.

This follow-up article addresses the question whether these macroeconomic achievements resulted in improvements for individual households and firms. It continues the previous line of debate while focusing on the response of the firm sector to the improvement in the macro environment. It draws on broadly similar, but largely unconnected, schools of thought in economics and sociology to generate an analytical framework that is able to explain the muted response of the firm sector and the heterogeneity of firm performance (Bigsten and Soederbohm, 2005). It aims to delve deeper than the firm survey literature by probing into the underlying determinants of firm performance that can be found in the institutional and social environment of the firm and it looks into the disconnect between formal and informal institutions.

It concludes that support activities by outsiders - whether government, official donors, or non-governmental organisations - will only succeed in fostering a positive firm response if the scope of activities is broadened from strengthening formal institutions such as business organisations towards influencing the informal institutions that constitute the "play of the game" such as norms, trust, networks, collective action and propensity to innovate.

The article unfolds as follows: section one provides some background on Tanzania; section 2 reviews the literature; section 3 applies the framework to Tanzania and section 4 concludes, draws some lessons for policy relevance and suggests further research.

Section 1: Tanzania's recent development

Background.

In the 1990's the reigning Washington consensus came to be overtaken by a growing awareness among policy makers and academics that the institutional capacity to implement the reforms varied enormously between countries and determined the wide divergence of outcomes with more or less similar economic policies. The famous words of Rodrik (2003) were that institutions trump all. Quite reputable economists followed in this line of argument:

- Stiglitz (1996, 1998): *"Theory and evidence suggests that pervasive market and institutional failures are holding back the supply response of many developing countries. As a result LDC's don't have absorptive capacity for investment and technology"*[quoted in Lall, 2002].
- Lall (2002): *"Countries with similar factor endowments and policies perform very differently because their modes of social and political interaction differ"*.³
- Tomasi (2002): *"It is the details of the implementation that matter, not the titles of the reform. It is all about the difference between de jure and de facto reforms"*.

1.2 Recent socio-economic developments in Tanzania

Tanzania undertook structural adjustment reforms from the end of the eighties. The first five years with home grown programs, after that with guidance from IMF and WB (ERF 1 and 2). The track record of implementation of reform in the first period was chequered with few successes and many failures. The reform program was regularly interrupted and taken up again, thus creating an atmosphere of mistrust of the government's unpredictable and unreliable policies. The response of the firm sector was muted because firms did not perceive an improvement in the investment environment, did not want to take risks to innovate, and responded lukewarm to the reforms.

This disappointing track record changed when president Mkapa came to power in 1995. The reform program was in disarray: The balance of payment and fiscal deficits were untenable, the exchange rate overvalued, state banks were on the verge of bankruptcy and inflation was skyrocketing. The investment climate was marred with bureaucracy and clientelism. Mkapa proclaimed and implemented a far reaching set of social and economic reforms and undertook an ambitious civil service reform program. Structural reforms carried out by the government focused on realigning the incentive structure towards efficient use of scarce foreign exchange, liberalizing markets for goods and services, and reducing the involvement of the public sector in the economy. He also initiated an ambitious poverty reduction program (PRSP) in 2000 during his second term as president. The macroeconomic results were astonishing, with annual growth rates of 4 and 5 percent per year, but at the micro level of households and firms the results apparently did not trickle down to the same extent.

1.3 Recent political developments in Tanzania

The political situation in Tanzania is viewed as exceptional for Africa. It maintains a stable political system, a commonly shared sense of nationhood, and a political system based on class division not on ethnic division. Perhaps because Tanzania has many diverse ethnic groups, not one ethnic group is dominating and not one ethnic political leader has supremacy.

³ Refers also WB/PREM Lessons of the Nineties(2005) and GDN Understanding reform(2005)

Underpinning this stable political situation was the socialist ideology that the state would provide for the basic human needs of the population. When the economy collapsed in the eighties, the institutions that had been used to build up Tanzania faltered. Under the previous presidency of Nyerere the party leaders were required to forsake private enterprise, but after 1985 party members acquired substantial property and as observed by Dorye [quoted in Wield 2004]: “*public office was used more and more for private gain*”. Since the state did not provide the public services for basic human needs anymore, the urban and rural middle classes retreated more and more into informal arrangements for services. The other side of the coin was that the traditional mistrust between the public and the private sector aggravated. In Murphy’s (2002) terminology: the level of generalized trust in society rapidly eroded. This process of citizens disengaging from the formal government institutions led to a major crisis of legitimacy of government institutions including the sole political party (CCM) and opened the way for a more patrimonial style of government.⁴

1.4 Recent developments in the firm sector in Tanzania

In the meantime the firm sector reacted lukewarm to the improvement in the macro economic situation. During the nineties, the share of manufacturing in GDP hovered around 6% and the rate of private investment remained at 10 to 12% of GDP. The World Bank country assistance strategy in 2000 blamed the poor investment climate on the legal framework, administrative and bureaucratic complexities and poor infrastructure.⁵

In 2004 the Management for Development Foundation (MDF) undertook a business climate scan for the Dutch program on private sector development based on interviews with Dutch and local firms. It limits itself to economic and administrative problems at the level of the relationship between the firm sector and the government and within the firm sector level itself.⁶ The main problem areas were: taxation and administration; business registration and licensing; access to finance; utilities (electricity and transport); skills and attitude towards entrepreneurship and corruption. According to WB data for 2001, in about 30% of contracts it appeared a 10% kick back was expected. Only after 2000 the government showed commitment to implementing a private sector development program and prioritised the private sector in the second poverty reduction strategy paper of 2005. The present government thus shows a remarkable turnaround towards stimulating the private sector.

Another MDF firm survey in 2005 confirms that the main problems for micro firms are not so much the costs of public services, but the bureaucracy surrounding it. In their view it is not the cost of public utilities that matters, but the arbitrariness of getting access to these utilities such as electricity. Again, firms confirm it is not the level of taxation that matters, but the unpredictability of the implementation of the taxation regulations. MDF recommends a review of the poor behaviour of government officials towards the private sector. It recommends that issues of private sector development are merged in a comprehensive strategy together with a governance improvement strategy. This points to Tomasi view of the disconnect between formal and informal institutions.⁷

⁴ Landau observes that this started off the transition to multi-party elections halfway the nineties. However, multi-party democracy did not change much in the relation between societal actors, because “the political liberalisation was in fact meant to re-establish the party’s effective dominance of politics at both the national and local level” [Landau. L: National politics in post-Nyerere Tanzania, 1998, pg 21, quoted in Evans]

⁵ Grenier and McKay, CREDIT paper 1999/2: In the seventies manufacturing contributed 13% to GDP, by 1986 fell back to 7.9% and by 1994 to 7.6% . This means that there was a recovery in absolute terms in manufacturing, but in relative terms the primary sector just grew faster.

⁶ Notably absent from the interviews for the MDF business climate scan are issues of unreliability and unpredictability of the macro environment such as volatility of the exchange rate or high inflation rate.

Firm surveys limit itself to stroke of the pen administrative measures.

⁷ Tomasi (2002) quote: “*It is not the rules of the game that matter, but the way the rules are implemented*”.

Hypotheses

We grapple with a number of issues in explaining the muted response of the firm sector in Tanzania. While the macro environment improved in the last five to ten years, we are not quite sure what happened to the quality of the formal institutions, how the behaviour and attitude of government officials evolved towards the private sector, and how the relationship between the firms transformed itself. Evidently, it is not only a matter of supply of finance and technology, but also a matter of demand for innovation. Also we need to know more about the response of small firms in the sense of informal self-governance arrangements.

This leads to the first hypothesis, which will be explored in the following sections, that the performance of the firm sector in Tanzania is not only hampered by lack of markets, finance and technology etc., but also by the way the social relationships within the private sector and towards the public sector affect the economic performance of firms. It may not be the only constraint, but is too important to neglect. In the following section an analytical framework is presented to research in what way the quality of social relationships affects firm performance.

The second hypothesis is that micro firms have created a self governance system that compensates for the lack of formal institutions such as property rights and rule of law. These informal self-governance mechanisms depend on self enforcement mechanisms. These mechanisms can only function in small-scale networks and for simple contracting relations. Obviously, this hampers firms' growth and amounts to a low level equilibrium in the manufacturing sector.

Section 2:

Review of economic and social schools of thought on firm sector performance

2.1 Microeconomic firm survey literature

The RPED (WB regional program for enterprise development) database of firm surveys of two hundred firms each in eight countries over ten years constitutes the most extensive microeconomic evidence database of firm performance in the nineties. According to Biggs (1996) the objective of the program is to assess the perception of firms of the investment climate in their respective countries. It enumerates constraints at different levels: a) government towards the firm sector; b) individual firm level constraints.

a) Constraints at national level government policies towards the firm sector mainly consist of: unpredictability of the macro environment (exchange rate, inflation); unpredictability of government policies toward the firm sector; policy failures in the financial sector (lack of access to credit); excessive regulation and bureaucracy. As a result, firms are not willing to take risks because firms don't trust the policy environment. Firms refrain from lumpy investments in innovation and don't specialize vertically [vDijk 1992; Biggs, 1996; Collier and Patillo, 2000].

b) Constraints related to the individual firm performance: In economic terms a distinction can be made between the transformation costs of production (such as high labour cost, lack of skilled labour, lack of technical training) and its transaction costs (such as information cost of screening suppliers and clients leading to high inventory cost and frequent delays in production and payments [Bigsten and Soederbohm, 2005; Biggs and Shah, 2006].

These economic constraints are valid points for the non-performance of the manufacturing sector in general, but provide no answer to the causes of large heterogeneity of performance between countries and between firms, which Bigsten and Soederbohm (2005) describe. Firm surveys point to the symptoms, not the causes of malfunctioning. This underscores the argument of Lall (2002) that countries with similar factor endowments and policies perform very differently because their modes of social and political interaction differ.

Firm survey literature most often focuses on the administrative and economic reform measures such as strengthening formal institutions and organisations in particular business associations. Recommendations often are limited to “*stroke of the pen*” measures a president can take. The microeconomic evidence in the firm survey literature does not take into account the so called social dimension (of behaviour) of entrepreneurs, which can be described with certain features of shared values, norms, trust, networks, collective action and collective learning effect through innovation. This cannot be transformed overnight. As they say trust comes walking in and running out.

Recently, the firm survey literature became aware of the need to broaden the scope from a microeconomic analysis of transformation and transaction cost towards a study of the social dimension of entrepreneuring. For example Biggs and Shah (2006) underscore the second hypothesis of this article that social relationships may be used to fill in the gap for (and substitute) weak government institutions with regard to property rights and contract enforcement.

2.2. Cluster theory

In 1974 Mead already described industrialization as a process involving an increasing complexity of production, which in turn demands greater reliance on other firms for certain activities. To come to efficiency gains (lowering transformation costs) requires technological and organisational change. The assumption behind cluster theory is that clustering makes these changes easier. The assumption is that clusters lay the groundwork for industrialization. Clustering allows firms to grow in incremental rather than giant steps. [ref Biggs 1996].

This theory has hardly been tested for African circumstances. If it is correct that political, economic and social institutions influence the cluster behaviour then the experience in Africa could be quite different from Asia and Latin America. It is obvious that institutions don't function well in Africa. Institutional weakness may occur in several domains such as: markets, legal systems, financial institutions, technological systems and social structures.

Mc Cormick (1999) was the first to apply the theoretical framework of cluster theory to six case studies in three countries in Africa. The theoretical benefits of clustering are the opportunities of access to markets; the possibilities for collective action (e.g. quality control, actions to get government attention); the riskable steps to firm growth rather than being forced to lumpy capital investment (e.g. borrowing costly equipment and tools); and the sheltering against risk and crises.⁸

In the six case studies she found little evidence of the advantages of clustering. Actually, she concluded that: improved access to markets is limited to a few clusters where traders come to buy the produce in bulk to distribute in rural areas; that joint action is limited to application for government subsidies; and that the collective response was limited to crisis situations in case of failing quality control (the case of the ban on Nile perch export). In line with the argumentation by Barr (1998) she found that the main function of networks in these African case studies was sheltering against risk and crises. It appears the theoretical benefits of clustering through improvement of collective efficiency⁹ don't materialize due to limiting factors in the social and economic environment. She concludes that: “*it may well be that the political hurdles are too high to overcome to obtain any benefits of clustering*”.

2.3 Organisational theory of the firm

Murphy (2003) micro economic study is useful in broadening the analytical framework beyond a study of the economic transaction costs in order to understand the working of clusters and networks. The study is restricted to the firm sector itself, however, and does not take account

⁸ H. Schmitz (1999) in his article about collective efficiency coins the term *riskable steps* which help to climb up the innovation ladder.

⁹ Ibid H. Schmitz (1999)

of the interlinkages with the public sector.¹⁰ Murphy proposes a relational approach rather than a transaction cost approach (Fafchamps) or a rational choice approach (Barr). He argues that relations, patterns and processes need to be taken into account when assessing the limited potential of clusters in the African reality. Trust is the pivotal element in his view to facilitate the collective action, mutual assistance and information exchange which is required to establish strong clusters or networks. Firms need trust first, then clusters will spring up by itself, but without trust clusters will not survive.¹¹

Micro firms have different requirements for different types of networks and generate different types of social relationships to fulfil the different functions. Networks may have different functions and their logic may show overlap. The main functions are access to credit, information gathering and accountability assurance.

Murphy's paper of 2002 takes a slightly different perspective and focuses on the pivotal element of trust as a requirement for innovation (in economic terms of so called collective learning effects). The line of argument is that the quality of social relations within and between firms determines the type and scale of innovation. He distinguishes between responsive and creative innovation. The innovation capacity depends on social characteristics and features of trust at different levels. Firms need trust first, then innovation will follow. Responsive innovation will occur in case of generalized trust of the surroundings (thus of government and citizens) and creative innovation will take place in case of micro level trust between two persons. Social relations may help to transmit information, facilitate knowledge creation, foster mutual assistance and will help build social capital. The downside is that social relations may limit information sharing to the insider group, and may restrain mutual help to exclude outsiders. It may stifle information access and maintain status quo and discourage innovation. A conducive environment for both responsive and creative innovation is required in order to generate sustained growth in the firm sector.

Murphy (2002) makes the analytical distinction between: micro level trust, which corresponds to bonding relations between persons with credibility in personal behaviour and meso level trust which corresponds to ascribed trust between specific groups. This enhances efficiency in transactions through greater accountability and risk mitigation, but does not foster innovation. Macro level trust corresponds to generalized trust in the community and the government. It will express itself in a kind of general goodwill towards all citizens in the society. Macro level trust means trust in contract enforcement mechanisms (whether based on government mechanisms, private mechanisms or self enforcement). Responsive innovation will only flourish in an environment with a high degree of generalized trust.

The levels of trust are reflected in the types of behaviour of entrepreneurs from maximalist and pragmatist to isolationists. Murphy equates isolationist with micro enterprises of the so called "*jua kali*" type. Typically these produce in the open air, produce a low quality product, compete on price, depend on clients advance payment, hardly deal with credit relationships and generally are conservative and suspicious. In this *jua kali* type of firm meso level trust of ascribed characteristics such as race, local background, religion and wealth status are primary determinants. This limited degree of trust will not stimulate innovation and will hinder firm sector growth. In section 3 this framework will be applied to the case of Tanzania.

2.4. The elusive quest for clarity in the concept of social capital

Some researchers are very positive about the concept of social capital. They even point to the quality of social capital as the deep determinant for firm's growth.

Knowles (2005) draws together different schools of thought on the social dimension of entrepreneurship and concludes that the perspective from sociology and institutional economy overlap considerably. "*Social capital is generally interpreted as the degree of trust,*

¹⁰ in that sense he does not follow up on the seminal work by Evans (1996) who stresses the interlinkage with government to create synergy between public and private sector and to enhance complementarity and embeddedness.

¹¹ Moore (1999) points out that trust is used in two meanings a) as an ascribed characteristic of certain (groups of) individuals and b) as generalized trustworthiness backed up by an incentive framework. As Evans (1996) says: *Trust is an endowment but is also constructible in as far as government can scale up generalized trust.*

cooperative norms and networks and associations within a society. This implies that social capital can be modelled as a deep determinant of economic development."

Lall (2002) asserts that social capital certainly has an influence on economic development:

"Social capital smoothes economic adjustment and failing markets through collective action; association; lower transaction costs. It also facilitates information flows; lowers risk; allows joint action and supplements formal contracts and property rights."

At the same time he refers to the World Bank development report (WDR 2002) which describes the same features but calls it informal institutions e.g.: *"norms, trust and networks that allow for collective action between actors"*

And Douglas North while describing informal institutions, quotes the same features and transmission channels as the social capital school claims e.g.: *"institutions provide the rules and enforcement mechanisms: a) to structure economic behaviour b) reduce the cost for managing information and exchanges and c) constrain the rationality of the agent's behaviour"* [quoted in Murphy, 2003].

Some other researchers, however, are more sceptical about the usefulness of the concept of social capital. Social capital is a tricky concept, since the terminology is by no means generally accepted and it is by no means clear to which phenomena of social capital the optimists refer to. The sceptical school asserts that sociological concepts can explain the same phenomena with more clarity [ref Berner 2005 forthcoming and even Durlauf and Fafchamps (2004) who point to statistical weaknesses (in the uses and abuses) of the concept of social capital in their recent paper].

In summary, most authors use the term social capital when in actual fact they refer to social phenomena which have economic effects. In that sense the term may not have value added and only increases the miscommunication between economists and sociologists. In the following text, social phenomena will be described for the country case study. The term social capital will be avoided as much as possible unless the term is explicitly used in the referred literature.

2.5 Institutional economics applied to the firm sector

The most extensive application of institutional economics to the firm sector is an Unido study by Knorringa and vStaveren (K-S, 2006). The authors explore the usefulness of the term social capital at different levels of analysis of firm sector performance. K-S propose a broad description of the concept of social capital which refers to the impact of different types of social relations on economic outcomes.¹²

The K-S study describes social capital as all types of social relations between firms having economic effects through multiple transmission channels. The impact of these social relations is broader than the economic effect of transaction costs. It embraces also the collective action and technology learning effect. The study proposes two very important refinements in the concept of social capital. It introduces an essential distinction between manifestations of social capital at *national, micro and meso level*. It distinguishes between social capital as a personal asset, secondly as a general trait of the society, and thirdly at meso level as the density and quality of the firm level network.

- At national level social capital articulates in generalized trust in the society in general and the functioning of the government. It works through predictable policies, enforcement of property rights and the rule of law and protection against risk and vulnerability.¹³

¹² A point in case is Durlauf and Fafchamps article (2004) who after years of research on the concept of social capital in their latest study reject the term because of its statistical weaknesses and abuses.

¹³ Actually, Evans (1996) asserts that the stock of social capital in society increases through the embeddedness of local government and through complementary government interventions

- At micro level social capital articulates in the density of group membership and network participation of the individual. This can be seen as an individual asset stock that determines a person's reputation and creditworthiness which facilitates its access to finance.
- And at meso level social capital in the sector can be seen as the type and quality of social relations having economic effects on firm performance through the relationships between firms and within firms e.g. in the form of networks, joint action lobby networks and business associations. The downside of strong meso level relations could be the narrow group affiliation and thus the limited information exchange and limited potential for responsive innovation.

The second essential distinction the study introduces is between so called *bonding social capital* and *bridging social capital*. The first type is based on strong ties of ascribed trust within a closely knit society. This type of relation helps to reduce the transaction costs of screening suppliers and customers. It will enhance accountability and contract enforcement in case of price competition with low quality goods. There are limits to the expansion of this type of neighbourhood groups and ethnic networks, however, based on the span of control of an actor e.g. of the number of contacts an actor can oversee. The well known case study of A. Greiff (1996) describes how Maghrebi traders built on these close knit relations to facilitate contract enforcement through reputation and social control mechanisms and how they finally succumbed to overly optimistic expansion of networks that made direct oversight impossible (quoted in Murphy, 2003).

A second type of relations - *called bridging capital* - is based on weak ties needed for firms to communicate with other communities, grow and adopt new technologies. It then becomes important to have contacts with a wider network. This is facilitated by a type of bridging social capital based on vertical (and earned) trust. For instance firms expand operations through building up networks with customers and suppliers in other towns or countries. Expanding firms need contacts with larger firms, larger banks and exporters to acquire contracts for export. The conclusion is that this transformation from bonding to bridging type of social relations is a prerequisite for firms to be able to specialize and to link up to international or global value chains. In Murphy's terms it requires a certain level of general trust and goodwill in the society - including towards the government - to have relationships that build across communities and social groups.

In summary, this study indicates how social relations have an economic effect on firm's performance and through which transmission channels the effect is obtained. It is debatable, in my view, whether the authors need the social capital concept to explain the workings of this mechanism. The core contribution of the study is to think in national, meso and micro types of relations and to think as well in bonding and bridging relations. These elements will be used to build an analytical framework for the case study. We will use standard sociological concepts to describe these phenomena.

Section 3:

Generating a framework for analysis for the country case of Tanzania

This section explores whether an institutional lens will provide a better framework for explaining the heterogeneity of firm performance. The hypothesis of this article is that firm surveys based on national business climate scans are not able to explain the heterogeneity in the performance between firms. Some firms are able to cope and even to thrive in a difficult business climate and others don't survive and go bankrupt. Until now there is no good explanation what factors are at play. We need a broader framework that puts economic and

sociological elements into perspective. Elements that come to mind are: *shared values, collective norms, trust, networks, collective action in clusters, enforcement of contracts and the propensity to innovation.*

As mentioned in section 1, the second hypothesis is that the small firm sector creates its own informal governance arrangements to substitute for the lack of property rights and contract enforcement. In that sense formal institutions lag behind the informal arrangements. Trust, power and political governance may very well provide a better explanation.

This section seeks to apply the analytical framework as outlined above to the situation in Tanzania. Rather than covering the broad range of features of social relations it will seek to elaborate on a few elements of the quality of social relations e.g. in building trust in networks and in informal arrangements for contract enforcement between firms. The article will end with a proposal for further research along the outline of the analytical framework.

3.1. Micro economic evidence about the firm sector in Tanzania

While the macro performance improved in Tanzania, the stagnation in manufacturing exports continued over the period 1990 to 1998. Grenier (1999) - quoting WB data and Tanzanian economic surveys - indicates that the manufacturing sector contributed 13% of GDP in the seventies, but it decreased to 7% in the eighties.

The Tanzania business climate scan - implemented by MDF in 2004- pinpointed a number of problems micro firms face in their dealing with government. The macro environment in the sense of maintaining a stable exchange rate and inflation was not mentioned by interviewees, but regulatory burden and rule of law were frequently mentioned. Unfortunately, the scan does not distinguish between formal rules and regulations and the perception of the way the rules and regulations are being implemented. In between the lines one can read that the firms mostly complain about the way services are provided, specifically about the unpredictability and unreliability of services. In other words it is not the formal rules that matter, but the way the rules are implemented. This points to a serious disconnect between the formal and informal arrangements.

Just an example from the 2004 business scan: the investment authority decrees the regulation on tax exemption for foreign based firms, but the revenue authority ignores the ruling and insists that firms have to pay Value Added Tax. It then takes two years to pay back the VAT to firms who formally are exempt from VAT. Worse example is that local government still maintains certain local fees and taxes, although they have been formally abolished by national decrees, because it fears abolishing taxation will narrow their discretionary control over locally based firms. The MDF 2005 review confirms the above. It suggests a better dialogue between the local officials and the business associations, but at the same time observes that some close bilateral relations between certain business men and certain officials undermines the formal institutions of dialogue and communication. This disconnect between the formal and the informal systems reinforces the inequality between "the have and the have not". In this case it privileges firms who have good networks and sufficient working capital to work their way around the rules above the firms who have no networks and no connections.

Fjeldstad (2004) argues that firm surveys always come up with the same list of constraints for the business sector. Mostly the surveys focus on formal institutions and often make no distinction between small enterprises and micro enterprises. His own survey of 160 micro firms (130 in Dar es Salaam and 30 in Moshi) comes to a different ranking of constraints: micro firms don't complain about access to finance neither about insecure property rights. They complain about severe (price) competition and low demand (for the same low quality good) and complain about the government behaviour in terms of harassment and bribing that accompany the taxation (not the level of taxation matters, but the way the regulation is implemented).

The MDF 2005 review of pro poor private sector development among micro firms confirms the general results from the business scan 2004 and emphasizes the difference between the formal rules and the implementation of the rules, e.g.:

- Registration of a firm is a bureaucratic hassle; only in urban areas the government institutions make it easier; however the business license needs to be renewed annually for every firms with more than 20 mln Tsh turnover;
- Access to finance through banks, mostly the administration surrounding it; only 4 banks out of 60 financial institutions provide credit to micro firms;
- Lack of technical capabilities and business skills;
- Lack of types of business associations for market linkage and global value chains;
- Complex and non-transparent tax regime; however the tax rate is only 30% corporate tax, 20% VAT and 19% income tax;
- Traders syndicates that maintain price fixing for inputs and supplies;
- Lack of access to markets and weak market linkages;
- Expensive utilities and administrative burden surrounding it.

When addressing the issue of enhanced communication and dialogue structures between the local officials and the business associations, MDF observes that the bilateral relations between certain business men and certain officials undermines the formal channels of communication. A yearly dialogue in the national business council (NBC) cannot remedy this. It pinpoints the core of the problem in the way the rules of the game are applied. Tanzania seems a long way off from the ideal situation, which Evans (1996) eloquently describes as: *“the synergy between public and private sector and the constructability of social capital in society”*. When it comes to policy recommendations the MDF report, unfortunately, falls back on administrative and economic measures to strengthen formal institutions. It recommends district level training for business associations and district officials and strengthening business associations. The report purports this will solve *“the motivational issues and will change the culture and mindset”* of the societal actors.

3.2. Organisational theory, firm behaviour and levels of trust in Tanzania

Murphy (2002) explores the framework of different levels of trust leading to different types of innovation behaviour in the town of Mwanza, a flourishing business town on the shores of Lake Victoria. The main activities in the region are fishing, gold mining and cotton farming. The survey was held among 41 micro firms mostly in furniture making and metal works. The level of technology and capital intensity varied, but most were so called *“jua kali”* (open air) firms. The main constraints mentioned by these firms were access to credit; low technical capacity; lack of access to outside markets and the predatory behaviour of municipal government. The complaint was about harassment of informal enterprises and purging campaigns against itinerant traders. Generally, there was low trust in government institutions and a low degree of general goodwill in general. As a matter of fact there was more trust in own networks based on religion and ethnicity. In other words it is a matter of ascribed trust, not generalized trust. As a result upscaling of networks cannot be expected.

Murphy’s theoretical framework relates the type of relations of entrepreneurs with the level of trust and the intensity of networking. Entrepreneurs entertain three types of relations which are partially overlapping: relations based on access to credit; relations based on building its individual reputation and relations based on information gathering. He then categorizes the social behaviour of the entrepreneurs in three groups: the minimalists, the pragmatists and the maximalists. He equates minimalist and isolationist behaviour with micro enterprises of the so called *“jua kali”* type who produce in the open air, who produce a low quality product, compete on price, depend on clients advance payment, hardly deal with credit relationships and generally are conservative and suspicious. In this *jua kali* type of firm it seems meso level trust of ascribed characteristics such as race, local background, religion and wealth status are primary determinants. This environment does not stimulate innovation and the limited level of trust hinders expansion. The pragmatists use their relations strategically for innovation in cost reduction and in price competition, but socially are not maximalists. They stick to their own networks based on race, local background, religion and wealth status. The maximalists build

relations among very different groups and use the information acquired to the maximum to respond with suitable innovations. The maximalists also have the largest degree of bonding trust in individuals which they use to maximize creative innovation opportunities. Thus only the maximalist entrepreneur who is capable of combining the different types of trust (micro bonding trust and macro bridging trust) makes maximum use of the opportunities to innovate.¹⁴

Murphy's (2002) main conclusion is that macro trust (or so called generalized trust) is missing in Mwanza, which affects negatively the response of entrepreneurs to innovation. He suggests the first priority should be for the government to improve its attitude towards the micro firm sector and to respect the rule of law even towards micro entrepreneurs. This is a prerequisite for slowly rebuilding the macro trust among entrepreneurs. Without macro level trust entrepreneurs remain risk adverse and will not step up innovation opportunities.

The tragedy of Tanzania may well be that trust at macro level - so called generalized trust - has eroded rapidly during the liberalization period of the eighties, while the micro level of trust is too limited to overcome the political hurdles of patrimonial government. At the same time the meso level of trust is mostly based on ethnic networks, from which African indigenous entrepreneurs are excluded. The challenge is perhaps to scale up the informal networks which rely on narrowly constructed ethnic networks into bridging type of relations and networks which will foster creative and responsive innovation. The challenge then is to overcome a situation where even those firms who have ample resources, skills and market access do not feel confident to innovate.

3.3 Evidence about informal institutions: the case of contract enforcement in Tanzania

The study by Kakkonen, Lee and Semboja (2001) sheds light on the role of legal institutions in economic development. It is based on a survey with 105 firms in 1997 with follow-up surveys among 25 firms in 1998 and 1999 among larger and well established firms, which are on average 14 years old and have less than 100 employees. The sample covers firms in the food industry, chemicals, woodcarving and furniture making. 60% in Dares Salaam, 20% in Moshi and 20% in Mwanza. The study assumes the use of informal contract arrangements in micro firms is probably even higher than the mini firms studied here. In general the perception of the quality of public governance and of upholding the rule of law is very negative. The survey reveals that major constraints for firms are taxation policy and administration, bureaucracy, inflation and lack of finance. On the contrary, problems with contract enforcement are not often mentioned because are perceived as a fact of life and are normally solved within one's own network. In other words micro entrepreneurs don't even count on government in upholding rule of law.

Firms have established in a way a self-governance system. Most firms prefer to maintain good relationship with well known and long term suppliers and consumers. Firms rely on their social network which is often based on ascribed trust among ethnic or religious groups. Even though 80% of firms have problems with contracts with clients and suppliers, they prefer not to escalate the situation by entering open disputes. 89% of the firms rely on self enforcement or private enforcement of contracts. African owned firms encounter 25% more problems than Asian owned or government owned firms esp. with regard to late payment of customers. Private enforcement is preferred above (even threatening with) legalistic measures. The confidence in the government system is very low. Going to court may take up to two years, own enforcement two and half months. To go to court is not a complement to own enforcement methods, but is perceived as a substitute for it. In actual fact, there is hardly any confidence in the government system. It is hardly surprising that making recourse to the formal system implies that the informal relations between the quarrelling parties are disrupted and the relationship ends there and then. The results strongly indicate that self-enforcement is much more relationship-preserving than any other mechanisms.

The difference between Mwanza and Moshi indicates that stronger competition leads to more legalistic enforcement. Entrepreneurs in Mwanza depend more on social capital and close knit networks. In Moshi there is more competition and one depends less on social capital. The

¹⁴ This resembles Moore's distinction in individual and general trust.

explanation is that when more suppliers and customers are around it is not so important to keep good old relationships, which require the firm to negotiate and bargain its way out to peaceful settlement.

Kakkonen summarizes his observations as follows: "The situation on the ground is such that small businesses are confronted with high risk and uncertainty in their relations with other businesses. Small firms often rely on informal, simple contracts and half of all trade credits are delayed. Complex contracting is impossible. Often small firms assess that the continuation of trustworthy relations is more important than timely payment. Therefore most businesses renegotiate the contract when the contractor is delayed". Then he concludes pg 8: "The substitution of policing through social networks for strong formal enforcement mechanisms therefore appears to have direct detrimental effects on productivity growth, scaling up of trade networks, on financial requirements and indeed entry requirements".

Section 4:

Conclusions, policy relevance and suggestions for further research

Conclusions

Tanzania is now on the right track. The new government shows more commitment to private sector development and in general the national policy environment is more reliable and predictable than a decade ago. Macroeconomic volatility in exchange rate and inflation has come down. The transformation and transaction cost of doing business is decreasing. In that sense, the first order determinants for a conducive investment climate are in place. The second order determinants for a conducive investment climate, however, are still a long way off and the growth of the private sector is still disappointing. This article has drawn attention to the insights from cluster theory, organisation theory and social capital school about the importance of the social aspects of entrepreneuring for the economic performance of firms. This requires a certain complementarity between building formal institutions and anchoring them firmly in the social structure of the sector. More specifically, when a certain degree of generalized and individual trust in society obtains, social networks will expand and will lead to joint action and collective learning. The degree of generalized and individual trust is pivotal for doing business. It may not be the only constraint, but it is important enough not to overlook.

The two hypotheses this article forwarded are not refuted: First, the performance of the Tanzanian firm sector is hampered not so much by lack of markets, high taxation and lack of credit. Many of these hurdles have come down. What remains now is awareness building of the way social relationships with the public sector and within the firm sector affects the economic outcomes. In that respect the firm survey literature provides little insight in the determinants of the malaise in the firm sector, while the social and institutional analysis deepens the insight into the causes of the malaise considerably. Constraints may play out for instance at the national, meso or micro level of analysis at the same time, as the K-S study indicates.

Secondly, the firm sector responds to the lack of formal institutions of property rights and rule of law by creating a self governing system, which depends on self enforcement within narrowly defined networks. The result is simple contracting, vertical integration and risk aversion. This hampers up-scaling of activities and inhibits technical innovation. It thus leads to a low level equilibrium in manufacturing.

No need for pessimism?

Some readers will now succumb to utter pessimism and will repeat Platteau's conclusion in his seminal article (1994) of the tragedy of the *erosion of generalized trust and morality*. It is

too easy to blame everything on generalized morality or lack of trust. There is some reason for optimism that the level of trust is not only a natural endowment e.g. Mick Moore comments on that article in the sense that “social relations underlying markets can be created more rapidly than *Platteau* assumes through the social ties and trust built up through the experiences of market transactions: for instance through inter-business markets and institutional reputation mechanisms.” Evans (1996) also professes to belong to the school of optimists in the sense that the level of trust in the right institutional context can be influenced by outside players. The way forward is thus to look carefully for opportunities to enhance trust between networks, build bridges between networks and demonstrate the benefits of joint action.

What further research needs to be done?

Further work needs to be done to analyze constraints in social relationship issues at the macro, meso and micro level (in light of the K-S study):

Constraints may refer to the interlinkages between the public sector and the private sector at national level such as maintaining macro stability, predictability and reliability of policy measures; to the rule of law in the implementation of the reform measures; to governance issues such as the attitude of public servants to the private entrepreneurs; to building generalized trust and to providing a social safety net or insurance mechanisms so that entrepreneurs can take the risk to innovate.

Constraints may be located at the meso level e.g. the social relations within the firm sector which affect economic outcomes; such as the potential for bonding and bridging social relations and for scaling up of networks; or the social conditions for responsive and creative innovation.

At the same time, constraints may be located at the individual level of the firm where the lack of social relations affects firm access to markets, to finance and to information about suppliers and clients.

Findings of direct policy relevance

There is no shortcut to improve the investment climate through *stroke of the pen* policy measures or transplanting western institutions. It requires deep understanding of the underlying processes of social relationships to identify the binding constraints which hold back the expansion of activities. [Biggs and Shah, 2006]

The binding constraints may be located at micro, meso and macro level at the same time. An effective PSD strategy comprises interventions at different levels and needs to be embedded in the social structure. [K-S, 2006]

Clusters don't seem to function in an African institutional context. Therefore establishing Business Associations (BA) and providing Business development services (BDS) may not suffice to create clusters. BA's may serve different purposes to different types of entrepreneurs. BA's need embedding in the social structure. [McCormick]

Entrepreneurs may prefer social networks for bonding and bridging type of relations and thus require different composition of the network. Scaling up networks to include different ethnic and religious groups may help expanding firm activities [K-S, 2006].

Trust building within the firm sector needs more attention. Perhaps government can support by providing a screening mechanism for creditworthiness of business partners and by providing safety net and insurance mechanisms. [Barr, Mc Cormick]

Trust building at nation wide level is a number one priority. The Tanzanian National Business Council¹⁵ dialogue between (representatives of) the private sector and government officials is

¹⁵ The TNBC was created in 2003 to provide a platform for debate about PSD among private sector representatives, government representatives at central and decentralise level and the civil society.

Another interesting platform could be the International Investors Roundtable chaired by Mkapa.

an encouraging initiative, but should not be limited to the private sector. The objective should be expanded to build generalized trust in society, through better governance, rule of law and reliability of public administration.

A trust building strategy could consist of three steps. A useful first step would be a code of conduct for government officials. Step two should be a strict sanction mechanism in case the code of conduct is not respected and step three could be a mobile phone number where citizen's complaints about the code of conduct are taken seriously and get acted upon. [Evans 1996]

Moore argues that trust can be considered as an individual trait and as a function of the institutional context. Government can perhaps influence the outcome of the incentive assessment for trustworthy behaviour through providing so called "coordinated sanction mechanisms" such as screening database for creditworthiness of business partner; issuing quality assurance certificates; offering membership of select networks and sanctions in case of misconduct. Either government steps in itself, or alternatively establishes a private implementation agency [Moore 1999].

How to ensure the research findings will enter the policy dialogue?

This article only briefly pointed to a number of plausible constraints for firm sector performance. The analysis needs deepening and broadening. It is suggested to:

Delve deeper into the determinants of the binding constraints for private sector development with the use of the "drivers of change" methodology to analyze the drivers in the private sector and implement a multi-stakeholder analysis of common goals and common constraints for private sector development.

Then use the outcomes to look at sector specific impediments to cooperation and look for opportunities for joint action involving several networks where cooperation makes a difference for success.

Broaden the diagnosis of binding constraints by debating the issues raised in the "drivers of change" analysis during the yearly Tanzanian National Business Council¹⁶ meetings. The aim is to raise awareness of the social dimension of entrepreneuring brought forward by the drivers of change analysis. Then deepen the case studies per sector.

Broaden the policy dialogue between civil society, government and donor community around the second phase of the poverty reduction strategy (in Swahili called Mkukuta) to include a dialogue on binding constraints for private sector development.

Finally, as the above clearly points out, there is no shortcut to a conducive investment climate.

¹⁶ The TNBC was created in 2003 to provide a platform for debate about PSD among private sector representatives, government representatives at central and decentralise level and the civil society.

Another interesting platform could be the International Investors Roundtable chaired by Mkapa.

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