SPEECH DELIVERED TO THE NATIONAL ASSEMBLY ON 7TH JUNE, 1990, BY THE HON. PROF. G. SAITOTI, VICE PRESIDENT AND MINISTER FOR FINANCE, REPUBLIC OF KENYA, WHEN PRESENTING THE BUDGET FOR THE FISCAL YEAR 1990/91

(1ST JULY, 1990 TO 30TH JUNE, 1991)

Mr. Speaker, Sir,

I beg to move that Mr. Speaker do now leave the Chair.

1. INTRODUCTION

Mr. Speaker, the development of a country must mean the development of all its people and consequently, whatever programme or project is implemented it must have the welfare of the people as its main objective. Our planning process has placed priority on rural development programmes and the provision of such basic services as education, health and water supplies. We are therefore convinced that the economic strategy which we have chosen for ourselves is the right one. Our faith in the principles enunciated in the Sessional Paper No. 10 of 1965 remains unshaken. We will reject the uninformed and misguided arguments of those who would like us to change our course and place our hard won independence in peril. We will be guided by our own experience in determining how best to respond to the development needs of our people.

As Hon. Members are plainly aware, the economic wellbeing of a nation owes far more to the vitality and political foresight of its leadership and the stability of its institutions than to any single act of the Government, however important. Our beloved President has all along been on the forefront in maintaining peace and stability. Under his leadership and his philosophy of Peace, Love and Unity, Kenya should be able to achieve the economic and social goals which we have set for ourselves. I am sure I speak for all Hon. Members, in stating that we should individually and collectively resolve to continue to support His Excellency's efforts.

Mr. Speaker, this is the fifth consecutive budget which has translated into action the policies for rapid economic growth through the restructuring of the economy, contained in Sessional Paper No. 1 of 1986 on " Economic Management for Renewed Growth". While the process of transformation is continuing, the need to control inflationary pressures, to provide employment opportunities for a rapidly rising labour force and to achieve a sustainable balance of payments position, requires enhanced growth with emphasis on a strong export drive. It is within this context that I have formulated the 1990/91 Budget around the theme "ENHANCED ECONOMIC GROWTH THROUGH EXPORT PROMOTION".

As is customary, I would like to begin by reviewing the international economic environment, the Sub-Saharan African regional scene and Kenya's economic performance in 1989 and provide a prognosis for this year and beyond. Finally, I shall address the budget out-turns for 1989/90 and 1990/91 fiscal years and propose specific taxation measures with other changes.

2. THE GLOBAL SCENE

Mr. Speaker, the moderate slow-down in economic activity in the industrial economies and in the world economy that we are presently witnessing is primarily the result of restrictive monetary policies pursued in most industrial countries. The tighter monetary policies, reflected in rising interest rates throughout the world, have been motivated by signs of rising inflationary pressures over the past few years. However, the more restrictive policies seem already to have calmed inflationary expectations. Various international forecasts predict lower inflation rates in the next few years. For instance, the rate of inflation in the industrial countries, measured as the GDP deflator, is expected to be reduced from about 4.0 % in 1989 to 3.5 % in 1991 and even lower thereafter. Thus, we do not have to fear a repetition of the extreme inflationary episode experienced early in the 1980s. World inflation has, in fact, remained very moderate during the past eight years, except in Latin America.

The performance of the world economy in the period ahead is likely to be influenced by a number of specific factors. Firstly, the political changes in Eastern Europe will have economic consequences which are difficult to predict. Most observers believe that the liberalization of these economies will strengthen economic activity in Europe as a whole. In particular, the prospective unification of East and West Germany is expected to induce economic activity in both countries. Secondly, the movement towards an integrated Europe in December 1992 will stimulate investment and output, as well in intra-European trade. Thirdly, the reduction in defence spending in USA and the Soviet Union may have an initial dampening effect on demand and output in those two countries, but the longer term effects in the world as a whole are likely to be positive as resources now spent on defence will be used in more productive ways.

Turning now to the economic performance in Sub-Saharan Africa, gross domestic product recorded a growth rate of 2.9% in 1989 compared with 2.4% in 1988, the rate of population growth is estimated at 3% leading to a per capita GDP fall of 0.1%. In 1990- 1991, growth is likely to remain broadly unchanged at some 3% per year and this implies that per capita output will remain stagnant.

However, the economic outlook for the continent is, somewhat brighter than a few years ago. For sometime now weather conditions in Sub-Saharan Africa have been favourable and a number of countries have adopted structural adjustment programmes. These two factors are key to further improvements in incomes and welfare. There are signs that the growth rate of population is declining and this means that per capita output will improve in the long run. The demographic figures for Kenya indicate that the rate of growth of our population has been reduced to about 3.5 % per year and that fertility rates are still declining. A continuation of these tendencies in Kenya and elsewhere in Africa, together with economic policies designed to foster productivity and a better use of our human resources, should lead to a growth in per capita incomes in Sub-Saharan Africa over the coming years, thus reversing the negative trend that has prevailed for nearly two decades.

Inflation in Africa has accelerated in the last few years to an average of about 20 % per annum. One factor behind this unwelcome development is most likely the appreciation of foreign currencies, which makes imports more expensive. Another factor is the remaining fiscal imbalances and excessively rapid monetary expansion in many countries. As adjustment programmes have only recently been implemented, significant recovery seems unlikely in the short run. These structural changes should stimulate exports, reduce price distortions and thereby raise growth.

Looking ahead, and relating the Sub-Saharan countries to the global economy, I want to stress the need for continued and large capital inflows into the region. Private capital flows have been negative in the past decade. Although concessional aid flows will remain important for all countries on the continent, it is hoped that as our economies recover and our policies become more outward oriented, Africa will once again begin to attract net private capital inflows. These are necessary to complement our own domestic savings, to help reduce high external debt burdens, and thus augment growth.

3. <u>THE DOMESTIC ECONOMY</u>

<u>Five Year Track Record</u>

Mr. Speaker, I would now like to go out of tradition and provide an overview of our five year track record since 1985, the year in which I presented my first Budget within the framework of what came to be known, when it was published, as the Sessional Paper No. 1 of 1986. We then set ourselves a target to restructure the economy into a more efficient and less vulnerable one. We aimed among other things, to increase the inflow of external resources and to reverse the deteriorating investment environment. Mr. Speaker, with the exception of the post coffee boom years of 1977 and 1978, the years 1985 to 1989 have been better as a block than any period since 1972. Our average growth in real terms since 1985 has been 5.2 %. Both the secondary or manufacturing sector and the tertiary or service sector have grown by some 5.5 %, while the primary or agricultural sector has been growing by about 4.4 % which is well ahead of population growth. The primary sector on average, now accounts for just over 31 % of our Gross Domestic Product compared with 35.5 % at the beginning of the 1970s. Consequently, we have now become less vulnerable to the international changes of our major export commodities.

The growth of Gross Fixed Capital Formation by sectors is even more spectacular. Again, with the exception of the post coffee boom years, we experienced an average decline in investment in each sector up to 1984. Since 1985 we have not only reversed this trend but have also recorded a very healthy annual average investment growth in the secondary sector at 7.1 % with services close behind at 5.4 %.

It is important that we should review the economy with this perspective since past experience is easily forgotten. In this context I would wish particularly to note that the average rate of inflation over these last five years is 9 % against the average for the preceding 12 years of over 13 %. This has meant that workers have in fact had real growth in their average wage over these last five years in contrast with the earlier period. We should also not forget that there were negative real rates of interest on average from 1972 to 1984 with the consequent discouragement of savings and of the efficient utilisation of scarce resources. The positive real interest rates which we have had since 1985 have reversed these undesirable effects.

With respect to the rate of growth of our external debt, I would like to inform this House that the quality of our debt has improved substantially. The average interest rate on public external debt is now less than 3 % compared with about 4.3 % ten years ago. The grace period on loans is now on average around 8.7 years against 7.1 years 10 years ago, while the maturity of our overseas debt has improved between those two periods, from about 27.9 years on average to 29.4 years.

Mr. Speaker, this five year review has shown that our average living standard has annually recorded an improvement in contrast to the average annual decline of the Sub-Saharan economies. I now turn to a review of last year's performance of the economy. In my analysis I will assume that Hon. Members have already read their copies of this year's Economic Survey which describes the performance of the economy during 1989 in detail.

<u>Sectoral Performance</u>

Mr. Speaker, last year the economy grew by 5.0 %. This is the fifth consecutive year since 1985 that the economy has performed at about this level. I would now like to review last year's performance of the key sectors of the economy.

The agricultural sector recorded a growth of 3.9% in 1989 and so continued to grow ahead of population. This growth was somewhat below the previous year's excellent result. However, the poor world price of coffee dampened the growth of both investment and income in this sector.

Manufacturing production has continued its satisfactory performance, growing by 5.9%, only marginally below the 6.0% recorded in 1988. Even though investment in the sector fell in real terms by 3.5 %, it was still a comfortable 21 % above the 1987 level so showing a continuation of the rising trend. The rising cost of plant and machinery may well account for this decline from 1988.

Mr. Speaker, the building and construction sector continued its improvement in 1989 when it recorded a growth rate of 5.4 % compared with 4.3 % in 1988. This is reflected in a welcome 24% increase in private sector investment in these areas, although there was a deceleration in public sector investment, largely due to the near completion of major Government construction projects.

<u>Saving and Investment</u>

Mr. Speaker, investment and savings were lower in 1989 than 1988. We invested 25.6 % of GDP of which 34.4 % was financed from abroad. This compares with an investment of 25.3 % the previous year with an external component of some 32.1 %. In real terms, Gross Fixed Capital Formation grew by less than 2 %, well below the 8.7 % recorded in 1988, but this was not general since investment in the service sectors grew by 18.8 % against contraction of just under 10 % in 1988. These investment figures would be far higher were the Kenya Airways purchase of aircraft included.

Balance of Payments

Mr. Speaker, our balance of payments position is an important indicator of the sustainability of our economic growth. For a number of years we have emphasised the need to restructure our industry away from production for import-substitution under the protection of high tariffs and quantitative restrictions, to production oriented towards the export market. It is too early to indicate how far this restructuring strategy has succeeded. In 1989 total value of imports including government and special imports rose by 26.2 % compared to the rise in the value of exports, of only 7.1 %. Earnings from coffee exports declined in the wake of the collapse of the International Coffee Agreement, although part of the impact of the sharp price decline was absorbed by some rise in volume. Tea performed well as both price and volume rose, while the earning from tourism rose by 24 %. The capital account registered a sharp growth including private long term capital which registered a large net positive inflow, after registering a net outflow in 1988. The overall balance in the balance of payments recorded a surplus and our reserves stood at 12 weeks of normal merchandise imports compared to 10 weeks at the end of the year.

Money, Credit and Prices

Mr. Speaker, I wish now to turn to money, credit and prices. From an exceptionally high level of 33 % in 1986, the rate of growth of money supply decelerated to 8 % in 1988, but this trend was reversed in 1989 when it registered a growth rate of 17.6 %. The rate of inflation, as conventionally measured on a 12 month average, was marginally lower at 10.6% in 1989 compared to 10.7% recorded in 1988. The money supply increased due both to improvement in net foreign assets and expansion of domestic credit. High liquidity ratios prevailing in commercial banks in 1986 and 1987 declined in 1988 and averaged around 26% in 1989. During the year there was a decline in the share of domestic credit going to the Government from 35 % in 1988 to 32 % in 1989 and therefore the corresponding share going to the private sector increased. To achieve the objective of curtailing the growth in credit to the level enough to sustain economic activities within the private sector and to encourage savings by ensuring that interest levels are positive, the Government raised the minimum interest rate paid on deposits in two instalments during 1989 from 10 % to 12.5 %. The maximum rates charged on loans of various maturities were also raised during the year. This trend has continued as evidenced by further change in interest rates in April this year.

PROGNOSIS

Mr. Speaker, having taken stock of our economic performance last year, we should reflect on the prospects for 1990. In 1989 our performance in economic management, stabilisation and growth has been somewhat mixed. Real GDP growth rate has been more- or-less on target and developments in external trade and balance of payments have been, by and large, as anticipated. However, I must express concern in two crucial areas: the first is the Government budget deficit for the financial year 1989/90, which has exceeded the expected rate and the second is the growth in money supply and the domestic consumer price inflation, both of which have recorded higher than programmed rates.

For the current year, the target for the rate of growth of GDP is 5.1 %. The balance of payments financing gap is anticipated to be very large and this has to be filled through new concessional borrowing. As far as Government budget deficit is concerned, we plan to lower it as a percentage of GDP from 4.2 % in 1989/90 to 3.8% in 1990/91. The policy objective for inflation is to bring it down gradually to the average rate experienced by Kenya's major trading partners. The attainment of these targets and objectives would require enhanced structural adjustment and stronger macro-economic management policies. Although 1990 itself might not be an easy year, Mr. Speaker, I would like to emphasise that our economy has entered the decade of the nineties in better shape than it entered the eighties.

4. THE POLICY FRAMEWORK

a/ Introduction

Mr Speaker, given the international and domestic developments that I have just outlined, I would now like to turn to the policy framework for the 1990/91 Budget, the theme of which is "Enhanced Economic Growth Through Export Promotion". The policy ideas behind this theme were discussed in the Sessional Paper No. 1 of 1986. Since then, we have gradually and systematically introduced policy measures to restructure the economy. Each Budget has been an installment in that process. This year's Budget, with its focus on export promotion, is therefore yet another building block in that long-term strategy.

In our efforts to promote exports I am reassured by the historical evidence of international development patterns: it is those countries which have adopted an outward, export-oriented development strategy that have been successful in achieving growth and improving welfare. Those countries, on the other hand, which have based their policies on export pessimism and isolated themselves from the international economy have recorded stagnating or declining income levels.

Kenya has followed a pragmatic development strategy, stressing the need for a dynamic private sector as a driving force in the economy. As a result, growth in production and incomes have been stimulated over the past five years. A more rapid and more diversified export expansion during the coming years will ensure a sustained growth in output and incomes; it will bring us more foreign exchange to use for needed imports; it will stimulate domestic industries which have to compete in international markets; and we expect that the open economic policies will also attract into Kenya know-how and risk capital. These will spur production in the modern sector and create employment opportunities.

It is against this background that I will now discuss the fiscal, monetary and financial policies which we want to pursue as a basis and framework for the export strategy. I will then turn to the centerpiece of this Budget, namely export policies. I will also discuss agricultural policies and rural urban balance, before I go on to the budget outturns and specific proposals on taxation.

b/ Fiscal Policy

Mr. Speaker, fiscal policy can play an important role in supplementing and stimulating export growth. A restrictive fiscal policy is necessary now, both in order to maintain stability in the domestic economy, and to release resources for the private sector, particularly for export production. Tax policy can also be used specifically to increase incentives for export production as I will illustrate later in my speech.

I want to deal with four areas of fiscal policy: the budget deficit, the changing tax structure, the control and pattern of public expenditures, and problems relating to the finances of the parastatals.

The need to contain the deficit in the Government's budget is of paramount importance, if we are to achieve our economic goals of containing inflation and releasing resources for private sector growth, including more importantly, export growth. With great efforts we have managed to reduce the relative size of the deficit, from 6.6 % in 1986/87 to an estimated 4.2 % in 1989/90. However, progress in this area has been slow and the difficulty is entirely a reflection of rapidly rising demand for Government services. Revenues both from domestic sources and from foreign grants have been flowing in reasonably well.

The increase in revenue is partly due to the introduction of VAT, and I expect increasing gains from that tax over the next few years. In this Budget, we will continue our efforts to shift the tax structure towards indirect taxation. At the same time we have continued and expanded the Tax Modernization Programme in the Treasury, with the task of restructuring our tax system while also increasing efficiency of the tax administration. Later in my speech I will make a number of specific tax proposals, partly to carry the tax reform work forward, and partly to stimulate exports and trading in securities.

Developing countries seldom manage to mobilise more than 20% of their Gross Domestic Product in tax, but as they progress they replace borrowed resources with revenues arising from their increased prosperity. I am pleased to inform the Hon. Members that we have raised our tax revenue effort and are now approaching the target of 24 % of GDP stated in the Sessional Paper No.1 of 1986. Unfortunately I must report that our endeavours to control the growth of expenditure have not been as successful and we are still well above the Sessional Paper goal of 28% of GDP. In part this has been a consequence of the need to provide recurrent expenditures so as to operationalise past development projects. This must continue to be a key area of concentration if we are to regain fiscal balance and release productive resources for export expansion.

Mr. Speaker, in 1984, we went to great lengths to articulate a public expenditure strategy, in a document entitled Budget Rationalization Programme. I want to remind Hon. Members of that policy. It remains as relevant today as it was when it was published. A major aim in that Programme was to complete all on-going projects before starting new ones. Hon. Members have already received the Expenditure Estimates which clearly reflect a concentration of government resources on the completion of on-going projects. We have to be much more restrictive in starting domestically financed projects. Such outlays will, depending on how they are financed, either add to inflationary pressures, or reduce the finance that is available for private sector investment.

Another important issue discussed in the Budget Rationalization Programme concerns the balance between recurrent and capital expenditures. The continued increase in public sector employment and thus in its salary bill has encroached on the funds needed for operational expenditures. Lack of funds for maintenance and repairs, and other recurrent expenses is resulting in a deterioration of existing infrastructure. I am determined to put tight limits on the wage and salary bill in this and coming budgets, in order to free resources for operational expenditures and to improve the efficiency of Government services.

The last area I want to discuss under the heading of fiscal policy is the finances of State Corporations, or parastatals. This is also an area of public sector finance that is causing me great concern. There is now a widespread lack of financial control and of discipline. For instance, it is not unusual that parastatals engage in new investments while they are falling behind, or are even in default on their obligations to the Treasury. In addition, there is another equally disturbing development. The Government, as guarantor of external loans by parastatals, is increasingly being called upon to honour parastatal debts to foreign lenders. The Treasury is then forced to divert funds from budgetted purposes to meet these obligations. As a consequence, the Budget becomes distorted and the deficit remains too high. These developments are totally unacceptable.

I want to make it quite clear that the Treasury will no longer honour such parastatal debt obligations without a thorough investigation of the circumstances behind the payment default. Indeed, I will insist that appropriate corrective measures are taken before assuming any obligation.

c/ Monetary policy

Mr. Speaker, turning now to monetary policy, its main task is to control the growth of credit and of money supply. The aim must be to ensure, on the one hand, that the economy is supplied with adequate amounts of finance for investment and other activities, and on the other, that credit and money is not so ample that it will fuel inflation. The correct balance is always hard to strike.

Over the past several years, we have set ourselves targets for the maximum credit expansion and growth of money that we consider are consistent with financial stability. For the calendar year 1990, the target growth rate for domestic credit, which includes credit to both the private sector and to the government, is about 15 %. The target rate of growth in money supply is 10.5 %. We believe that these targets should provide the economy with sufficient finance for its growth, while avoiding an acceleration in the rate of inflation.

Mr. Speaker, the most important tool for controlling the supply of new credit and of money is the price of money, which is the interest rate. Since independence, the key interest rates, namely those for loans and deposits in the commercial banks, have been controlled by the Central Bank. For many years now, these interest rates have been kept at levels above the prevailing rate of inflation. In other words, our policy has been to have interest rates that are positive in real terms.

One important effect of this policy has been to encourage savings. Various other ways are being tried, including the introduction of new deposit instruments. Bearer Certificates of Deposits, designed primarily for large depositors, were recently introduced as a new form of savings. These certificates have the advantage that they are negotiable, which means that they carry maximum liquidity. An additional instrument for enhancing savings which the Treasury and the Central Bank will introduce in the course of the next fiscal year, is the Foreign Exchange Bearer Certificate. These are primarily designed to attract foreign exchange from outside the banking system and their bearer nature will preserve the confidentiality of their owners' names thereby enhancing their attraction. These new financial instruments will be tradable in the secondary market thus increasing their liquidity and inducing large investors to retain funds in Kenya rather than moving them abroad.

Increased interest rates also have important effects on the lending side. Commercial banks and other financial institutions will increasingly allocate their loanable funds to projects which have high returns and which therefore will yield larger benefits to the economy as a whole. There is ample evidence from other countries that high and positive real interest rates <u>do</u> produce a more efficient capital stock in the country.

In the process of raising the interest rates in the commercial banks, we have also virtually eliminated the differences in interest rate structure between banks and so-called non-bank financial intermediaries, which means financial institutions whose activities resemble those of the commercial banks. The latter type of institutions are becoming increasingly similar to the commercial banks. This unification of the interest rate structures of the two systems will, I expect, lead to increased competition, which will benefit all those who use these institutions, depositors as well as borrowers.

Mr. Speaker, as I informed the House in my Budget Speech last year, we have embarked on a process of reforming and strengthening our financial system. On that occasion, I tabled a revised Banking Bill, which was debated and passed by this House. That legislation has enabled us to restructure and consolidate weak institutions by ensuring that their capital base is adequate and that their lending practices are commercially sound. As Honorable Members are aware, the Central Bank and the Treasury recently worked out a successful merger of ten financial institutions, including one commercial bank, to establish the Consolidated Bank of Kenya. This operation, backed by financial resources from the Deposit Protection Fund was undertaken in order to forestall problems which would otherwise have jeopardised confidence in the banking system. As we move into a situation of increased competition in financial markets, it is essential that we have a strong financial system and that individual institutions are adequately capitalized. Over the next decade, a further consolidation of the banking system may be called for as competition is likely to increase during the process of financial reform.

<u>d/ Capital Markets for Industrial Growth.</u>

Mr. Speaker, an important aspect of the financial reform programme is the expansion and deepening of the securities markets, particularly the stock market. In order to put these efforts in a proper framework, it is necessary to give a brief background. Kenyan companies, like those in most other developing countries, have traditionally financed themselves either by borrowing from the commercial banking system or through retained earnings. The third alternative source of capital and expansion, the equity, or stock market, has not been used on any major scale in Kenya. That is a weakness in our financial structure. If companies finance themselves too much with borrowed funds from the banks, they are exposed to various risks, including the risk of higher interest rates. In addition, borrowed funds are short-term in nature, while the bulk of the financial needs of companies in the modern sector is of a long-term character. In brief, the debt/equity ratio in Kenya's modern sector is at present tilted too much towards debt. This entails an element of potential instability which we want to reduce and preferably remove.

In order to redress this situation we have worked over the past few years to create a new and stable framework for the capital markets, which should be amenable to modern trading in securities. Last year, I tabled new legislation to establish a legal framework conducive to trading in securities, both private and public. This House passed that legislation in November 1989. Following Presidential assent, the Capital Market Authority was established in January 1990. The Authority has strong representation from the private business sector and is now functioning on a regular basis. A major task of the Authority is to review the activities of the Stock Exchange in order to establish rules which will be conducive to a more active trading on the Exchange.

In this Budget, I am taking further action to stimulate trading in securities by proposing several tax changes which will make it more profitable for companies to issue shares and for investors to hold them. I am proposing changes regarding the tax treatment of Unit Trusts. The Unit Trusts Act which was enacted in 1963, has so far been dormant and today I am tabling the Unit Trusts (Amendment) Bill with changes in their regulatory framework. As has been shown in a number of other countries, Unit Trusts can serve a useful function as an investment intermediary for small domestic investors who do not have sufficient knowledge of individual companies. I am also opening the Unit Trusts for foreign investors and there, again, these trusts can function as a useful channel for foreign investors who want to put money into the stock market.

I am certain that the strengthening of the capital market that I envisage over the next few years will provide a stronger financial base for companies which want to expand their trade abroad. In that sense, the expansion of capital markets is an important part of our export strategy.

e/ Strategy to Promote Exports.

Mr Speaker, I now turn to the CENTREPIECE of this Budget and its policy framework, the promotion of exports. In this Budget, I want to effect a major shift in the structure of incentives towards export production, and particularly towards production of industrial and other non-traditional exports. In this respect, I will introduce a series of new measures, of which I will discuss the main ones here. These policy initiatives are to a large extent based on the development strategy outlined in Sessional Paper No.1 of 1986, where industrial growth and export expansion were stated as crucial elements in a policy for creating jobs and strengthening the balance of payments.

A fundamental requirement for a successful export strategy is the maintenance of a realistic exchange rate. There are many examples in Africa and elsewhere of the detrimental effects of a rigidly overvalued exchange rate. It becomes unprofitable to export, and imports become so cheap as to kill all efforts to develop a domestic industry. The gradual and pragmatic adjustments in our exchange rate that we have made over the past several years have had the effect of making exports more profitable, while providing a stimulus to domestic production through higher import costs. We intend to continue with a flexible exchange rate policy as the basis for all our other export promoting policies.

For export producers to respond to the various stimuli that we are introducing, it is essential that they have secure and easy access to imported inputs. Over the past few years, we have gradually been changing our import policy, relying less on quantitative restrictions and more on tariffs. In early 1989, we liberalized the import licence policy dramatically. We will continue with this reform and, at the same time, rationalize and modify the tariff structure of imports. With this Budget I am shifting a number of items from Schedule IIIC to IIIB. At the same time, I propose to lower the average tariff on all the items that were previously on Schedules other than IIIC by an average of about 5 percentage points. I will return shortly to the details of these proposals.

An important stimulus to export production is to guarantee exporters unrestricted access to imported inputs at world market prices. One method of achieving this is the Export Compensation Scheme. This scheme will now be expanded and supplemented with an import duty exemption scheme. Later, this scheme will evolve into a duty-drawback system of a kind that has been applied successfully in many other developing countries. I will return to the details of these policies in the Finance Bill.

Mr. Speaker, finance is critical to the success of any economic venture and export business is no exception. Well established export firms or manufacturing enterprises receive adequate pre-and-post shipment credit support from our financial institutions. However, they are known to be reluctant to finance small and new exporters whom they consider too risky. In order to encourage banks to extend facilities to such small exporters without collateral security, the Central Bank will make available a line of credit to be secured by way of export bills. This will enable commercial banks to extend pre-shipment credit secured by export bills and to discount such bills at the Central Bank.

Lastly, Mr Speaker, in the Budget centrepiece, I want to discuss two specific export promotion schemes, one of which already is in operation, and one that I foreshadowed in my Budget Speech last year. The manufacturing under bond scheme has been in operation for some time now. It was slow in catching on at first, but interest is now increasing noticeably. I am hopeful that this scheme will become increasingly useful as a stimulus for export production.

More important this year is the establishment of Export Processing Zones to attract foreign investment and to stimulate industrial growth and exports. We know from other developing countries which have tried such schemes that the results can be very encouraging. The main benefit for the host country in the short run is the generation of employment, which can be quite sizeable. Over a longer time span, Kenya should also be able to reap other benefits from the EPZs, such as management knowledge and technical know-how as well as foreign exchange, once linkages to the domestic economy have been established.

Mr. Speaker, last year, I announced that we would pursue this avenue to promote exports. Today, I am tabling a Bill establishing the legal and administrative framework for the Export Processing Zones. In this respect we have already made considerable progress during 1989. We have completed an Export Processing Zone study and appointed international consultants to work on the design of the Athi River Zone; and we have had successful discussions with both the World Bank and the African Development Bank about the financing of infrastructure for the Nairobi and Mombasa sites. Three zones, one on a private site and two on government sites, have already been identified. The specific package of incentives to be provided to firms operating in the zones will be competitive with those that are provided in comparable sites internationally. This will include a 100 % write-off of investment costs, a ten year moratorium on income tax as well as duty and tax free access to inputs. We will publish a separate, detailed document presenting all the tax incentives.

f/ External Debt and the Need for Capital Inflows

Mr. Speaker, I now turn to the issue of external debt. We borrow capital from abroad as a supplement to our own savings. The rationale for this borrowing can be viewed from two angles. First, we need to borrow in order to finance the deficit we have in our trade and other current transactions with the rest of the world. If we did not borrow, our foreign exchange reserves would rapidly be depleted. Second, foreign borrowing can also be seen as a supplement to our own savings and thus as a capital injections to raise investment in Kenya and thereby to sustain economic growth.

Foreign borrowing has fluctuated over the years, mainly reflecting the fluctuations in the deficit in our current transactions with the rest of the world. After the second oil crisis in the late 1970s, we were forced to borrow large amounts abroad. As a consequence, our external debt increased rapidly. The debt service ratio, which measures the public and publicly guaranteed external debt as a percentage of export revenues, increased sharply through most of the 1980s and reached a peak of nearly 34 % in 1987. I am glad to inform the House that in the past few years, this trend has been broken. The debt service ratio has begun to decline, the grant element in our debt is increasing, and interest rates on new loans are significantly lower than they were during the preceding ten years. The last two factors will make the debt less costly to service in the years to come.

There are several reasons for the favourable trend in the past few years. First and foremost, and as a result of initiatives taken by His Excellency the President, several donor countries have generously decided to convert their loans into grants. We are most grateful to all countries which have made this decision. We are also grateful to those donors who have all along extended support to us in the form of grants.

Another explanation of the improved debt situation lies in the fact that we have been able to negotiate, on the basis of our economic policies, a number of large loans from the World Bank, extended on highly concessional terms, as well as low interest rate facilities from the IMF. Increasingly, bilateral donors are co-financing World Bank loans, thus increasing the size of capital inflows. I welcome this type of co-financing as it is flexible and quick disbursing and fits in with our own priorities and it is also administratively easier for us to handle than project financing, which due to Budget Rationalisation, is constrained.

The various positive developments in the past few years have led to a shift in our external debt profile away from commercial loans, which now account for only about 10 % of the total debt, towards soft loans with long maturities. This debt is therefore less costly to service.

However, even if the debt profile has improved in the past few years and the debt service ratio has declined from a peak of nearly 34 % in 1987 to an estimated 27.5 % in 1990, it still remains a large external debt to be serviced. This means a major cost to the nation in several ways: it is a drain on the foreign exchange earnings, and it is a reduction in our disposable incomes as a nation, since part of those incomes will have to be set aside for repayments each year. It is therefore important to reduce the stock of debt further. And we are determined to do that rather than go to the Paris Club and reschedule our debt, thus jeopardising our credit rating. On certain reasonable assumptions, the debt service ratio should be reduced to around 20 % by the middle of this decade. The more successful our export policy is in raising export earnings, the more rapidly can we reduce the external debt. This is, therefore, another reason for concentrating our efforts on raising exports.

Mr. Speaker, as I have already mentioned, the need for foreign capital is primarily determined by the deficit in our external trade and other current transactions. This deficit was large last year and is expected to remain so this year, reflecting low coffee prices and the leasing of planes for Kenya Airways. However, I expect the deficit in our current transactions to decline in the years ahead. Nevertheless, we will need continued and substantial financing for both the current account deficit and for repayments on earlier loans. External finance is also needed to sustain our policies of import liberalization and rapid economic growth. We have recently concluded negotiations for several loans on concessional terms from both the World Bank and the IMF, with co-financing from bilateral donors to assist in closing the gap.

As a complement to the public funds that we borrow abroad, we also need an increased inflow of private capital. We will therefore continue to introduce measures to improve the climate for private investors in Kenya. The Investment Promotion Center will be strengthened in order to play an important role in coordinating public policy and private investment plans. These measures, including the development of the securities market, will, over, time attract foreign investors. Together with the capital they bring, they often come with technical expertise and management know-how, which can transform the Kenyan economy. For all these reasons, private capital inflows are highly welcome as an added source of growth.

Agriculture

Mr. Speaker, agriculture and livestock continue to be the mainstay of our economy, accounting for about a third of Gross Domestic Product, employing about 70% of the working population and generating approximately 64% of total export earnings with coffee, tea and horticultural products contributing the largest share. Given its central role, it is important that we continue the sound policies which we have formulated to stimulate growth in these sectors, with a view to meeting the national objectives of maintaining food security, increasing income and employment opportunities, developing rural areas and small towns and raising foreign exchange earnings.

Mr. Speaker, last year I announced reforms regarding the Kenya Meat Commission and the National Cereals and Produce Board. I now want to refer to the restructuring exercise for the Cotton Seed and Lint Marketing Board and the Agricultural Finance Corporation. The former which has been restructured is performing satisfactorily while the latter is being transformed into an Agricultural Development Bank, with a wider scope to extend credit to farmers.

In the case of tea and coffee, committees have been appointed to make their administration more responsive to farmer needs, particularly to ensure prompt payment. The expansion, rehabilitation and restructuring are underway in the sugar industry. No other major policy changes are envisaged in the agriculture and livestock sectors.

Mr. Speaker, I now wish to elaborate on three areas: food security, cotton industry and fertiliser.

Firstly, food security remains a major plank of our agricultural policy. In this respect measures have been taken to stimulate national food production by improving grain marketing system. Critical to this improvement has been steps to ensure timely and adequate payments to farmers. It is noteworthy that improved marketing has meant that these higher payments have not led to higher consumer prices. Furthermore, the Government will review the number of Licensed Buying Agents, to foster efficiency through competition.

Secondly, cotton production has declined mainly as a result of the financial and liquidity problems of the Cotton Seed and Lint Marketing Board as well as an administered producer pricing system. In order to streamline the marketing system, an auction system similar to that used for coffee and tea will be introduced. Farmers will receive the first payment on delivery with a bonus payment depending on market conditions. Furthermore, in future the Board will concentrate its activities on regulation and administering the auctions and farmer payments. This means the ginneries will be restructured, and Cooperatives and private individuals will be encouraged to own and operate them. These measures, I am sure will rejuvenate cotton industry and contribute to the welfare of cotton farmers and the prosperity of the textile industry.

Finally, Mr. Speaker, fertiliser is the dominant farm input used in the country and the use of it is expected to rise rapidly in the current Plan period. In view of the central role that this input plays in increasing production, the Government decontrolled its prices. Thus the competitive environment should ensure efficient distribution. It is remarkable, that prices of fertilisers decreased by 23% after price decontrol despite some farmers' fears that they would not. In the decontrol process, cooperatives and indigenous businessmen are expected to play a leading role.

Rural Urban Balance

Mr. Speaker, I now wish to turn to the Government's Rural-Urban Balance Strategy. This strategy rests on the recognition that the key to stimulating agricultural production and creating jobs in rural areas is for the Government to adopt policies and finance investments, that enhance the effectiveness of the linkages, or webs of interchange, that exist between farms and the suppliers, manufacturers, businessmen and artisans in the towns. I wish to report to this House the progress made to date in supporting such linkages and the steps we plan to take over the coming year to reinforce that progress.

Infrastructure is necessary to stimulate the development of productive enterprise in rural areas with untapped potential. This is being provided among other ways, through the Rural Trade and Production Centre (RTPC) programme. Construction, valued at some Ksh. 150 million, is now being undertaken in 7 of the 8 towns selected for the programme's pilot round. A further 9 RTPCs have been selected for target intervention. With this programme now established Government will energetically seek donor support for the District Development Fund to finance its expansion and speedy implementation. The Nyayo Shed programme, which provides shelter for jua kali artisans, has already constructed or is in the process of constructing such facilities in 38 towns in 23 Districts, to the value of over K£ 1 million. The programme is to be expanded, with all new facilities resulting from a very careful needs assessment.

The Government's comprehensive programme for small-scale enterprise development has been launched and many initiatives are now starting with the objective of creating an enabling environment for the sector. These are to be implemented through a partnership of Government, the private sector and non-government organisations. An important contribution to the success of the programme is the initiative of H.E. the President in establishing the Rural Enterprise Fund to provide loans to small- scale rural enterprises. The Fund, to be administered through every DDC and with total initial capital of yet another Ksh. 150 million, will provide a major boost to the sector. Continuing Government support for youth polytechnics and other training institutions will ensure that the small-scale enterprise sector's need for artisans with appropriate skills will be met.

Mr. Speaker, encouraging though this progress is, our limited resources must be more exactly focussed if Government interventions are to enhance the climate for employment generation. I am therefore, proposing an additional approach be introduced into the planning of support in this area. Using expertise drawn from both the public and private sectors, selected "webs of interchange" will be investigated and critical interventions identified. These webs of economic interactions or linkages run from raw material supplies to individual finished products, they extend between agricultural and industrial enterprises, formal and informal sectors, large and small producers and rural and urban areas. To spearhead and coordinate this initiative, a small highly professional secretariat will be established in the Ministry of Planning and National Development. It will be provided with the necessary funds to carry out the investigations and finance pilot follow-up actions. The conclusions of these studies will be used in the formulation of Government policy, the identification of needs for infrastructure and other support, establishing loan targets for the Rural Enterprise Fund and other investment programmes.

Mr. Speaker, the Government is deeply conscious of the magnitude of the tasks ahead if employment opportunities are to be provided to the rapidly expanding labour force. However, our commitment to pursue these issues and problems was demonstrated by H.E.the President when he recently announced the establishment of a Presidential Commission on Employment to review the present situation thoroughly and to make recommendations upon future employment strategies. The conclusions of the Commission are eagerly awaited.

The rural-urban balance strategy, as I have outlined it, will go far in addressing these problems. By encouraging small enterprise development outside the major urban centres and providing infrastructure and other inducements to increase the attractiveness of the smaller urban centres to investors and entrepreneurs, a more balanced national development will occur. Put simply, by brightening the prospects for prosperity in the smaller centres and rural areas, we will turn down the brightness of the "big city lights" and so avoid compounding the problems already manifest in our largest cities.

5. FINANCIAL OUT - TURN 1989/90

(a) Recurrent Revenue

Mr. Speaker, I would now like to turn to the 1989/90 Budget out-turn. The recurrent revenue was expected to be K£ 2,040.9 million from ordinary revenues plus Appropriations-in-Aid of K£ 125.0 million making a total of K£ 2,165.9 million. The ordinary revenues were to comprise of K£ 471.6 million from Customs & Excise; K£ 639.7 million from Income Tax; K£ 668.2 million from Sales Tax/ VAT and the balance of K£ 261.4 million from other taxes, charges, dividends and fees. Mr. Speaker, revised estimates show that I may realise a total recurrent revenue of some K£ 2,080.4 million.

There will be shortfalls in Income Tax and Sales Tax/VAT which will amount to approximately K£ 42 million and K£ 34 million respectively; while Customs & Excise will fall below the original target by K£ 29 million. These shortfalls are partly due to a slightly slower growth of the economy compared with expectations this time last year and partly to major changes in the tax system introduced in the form of the presumptive income tax and the value added tax. Collections under these new taxes were somewhat below estimates due to initial administrative delays as well as time lags involved in the tax laws. The collection of other taxes and revenue, on the other hand, is likely to exceed the target by over K£ 22 million.

Therefore, I expect to raise K£ 442.8 million from Customs & Excise: K£ 598 million from Income Tax: K£ 634.6 million from Sales Tax/ VAT and K£ 283.5 million from other taxes and revenue.

(b) **Recurrent Expenditure**

The 1989/90 Printed Estimate of Recurrent Expenditure was K£ 1310.4 million, excluding Appropriations-in-Aid. Consolidated Fund Services were to take another K£ 977.8 million, making a total recurrent expenditure K£ 2288.2 million.

As the House will recall, there were a number of reasons which forced the Government to seek Parliamentary approval for Recurrent Supplementary Appropriations amounting to K£ 64.5 million. The main considerations were the need to cater for increased expenditure on salaries for the defence forces, higher enrolment in universities and expenditures related to national security. I had also to finance Excess Votes and Under Issues amounting to about K£ 46.0 million. The expenditure on Consolidated Fund Services is also likely to go up by about K£ 3.7 million, mainly due to higher in interest rates on Government borrowing.

Mr. Speaker, I have already mentioned the shortfall in revenue collections and our determination to keep the overall budget deficit under control. When confronted with these additional demands on resources, we had, therefore, to effect economies in other areas. I therefore, expect this year's gross recurrent expenditure including Appropriations-in-Aid to be K£ 2,472.9 million, compared to an expected total recurrent revenue of K£ 2,080.4 million. I will therefore, have no surplus in the Recurrent Account to transfer to the Development Exchequer.

(c) **Development Expenditure**

This year's Printed Development Estimates projected gross expenditure of K£ 922.1 million, including Appropriations-in-Aid of K£ 552.7 million. Earlier this year Hon. Members approved gross Development Supplementary Estimates of some K£ 88.3 million, to cater for additional capital expenditures in the education sector, in areas related to national security and for increased expenditures on a number of ongoing projects. There will also be Excess Votes and Under Issues in the Development Account amounting to K£ 28.9 million. Again, I have had to enforce cuts in some areas to accommodate these increases. Overall, I expect net issues for development to amount to about K£ 366.6 million during the current fiscal year.

On the basis of these preliminary estimates, I expect the overall Budget deficit this fiscal year to be around 4.2 % of GDP. I now turn to the forecast out-turn for 1990/91.

6. FORECAST OUT - TURN 1990/91

(a) **Expenditure**

Mr. Speaker, as Hon. Members have already seen from their copies of the 1990/91 Printed Estimates, the Gross Recurrent Expenditure of Ministries is estimated at K£ 1,615.9 million, with Appropriations-in-Aid of K£ 172.4 million, giving a net expenditure of K£ 1,443.5 million. This will represent an increase of 12.6 % over the 1989/90 revised recurrent expenditures, excluding Appropriations-in-Aid. I am happy to inform the Hon. Members that local Appropriations-in-Aid to finance such expenditures will go up from a revised figure of K£ 93.5 million this year to K£ 104.2 million next year. Consolidated Fund Services will take another K£ 1,283.9 million.

Therefore, total Gross Recurrent Expenditure will amount to K£ 2,899.8 million in 1990/91.

Development Estimates for 1990/91 call for a gross expenditure of K£ 970.6 million, including Appropriations-in-Aid of K£ 528.7 million. This development expenditure will amount to an increase of 14.7 % compared to the revised estimates of the current year. This increase will allow us to further budget rationalisation by absorbing external grants and soft loans in the Budget. It will also increase the inflow of external resources to support our balance of payments.

Apart from all these expenditures, I shall also have to finance an additional K£ 89.4 million of Excess Votes and Under Issues relating to previous years.

Mr. Speaker, I will not analyse further the details of either recurrent or development expenditure at this stage. I shall hold the matter in abeyance until we come to debate the spending allocations of the Ministries in the Committee of Supply.

It suffices to note that I have to finance a total gross expenditure of some K£ 3,959.8 million. The rest of my speech will outline how I propose to do this.

(b) **External Revenue**

Mr. Speaker, I have indicated that the Government is committed to the Budget Rationalisation Programme, this will improve the efficiency of public expenditures through the optimal utilisation of existing capacity, it will also give priority to completing ongoing projects. Within these criteria and in the light of the sound economic policies and cordial international relationship which Kenya has been pursuing, foreign donors have pledged to assist us with an amount equivalent to K£ 1,031.1 million in the course of the forthcoming fiscal year. Of these external inflows, about 40 % will be in the form of grants and 60 % in the form of project and programme loans. Mr. Speaker, these are indeed very large amounts and I would ask Hon. Members to join me in expressing our gratitude to those foreign governments as well as the bilateral and multilateral institutions which have consistently assisted Kenya. Thus I expect to finance about 26 % of my total expenditure from external sources. As usual the main burden of financing government expenditures will fall on Kenyans, and I now turn to how I intend to raise the balance of K£ 2,928.7 million.

(C) **Domestic Borrowing**

Mr. Speaker, I have already indicated my intention to reduce the growth in money supply. I have also indicated that, to achieve this reduction in money supply, I need to borrow more from non-bank sources. Given this position, I propose to raise some K£ 500.7 million from local borrowing. This money will be raised by means of Treasury Bonds and Treasury Bills and will mainly come from non-bank sources. Since I will be repaying K£ 323.3 million of maturing local debt in the course of 1990/91, the net internal borrowing will amount to only K£ 177.4 million.

(d) **Internal Revenue**

Mr. Speaker, my expectations regarding the economic outlook for 1990/91, suggest that the economy is likely to grow by approximately 5.2 % next fiscal year. On the basis of this projection, I estimate that ordinary revenue, at present rates of taxation, will provide some K£ 2,256.6 million. Appropriations-in-Aid will provide another K£ 118.0 million.

Thus, I will raise a total of K£ 2,374.6 million from these sources. I have, therefore, a gap of K£ 53.4 million to finance from additional taxation. The rest of my Speech will outline the measures to obtain this extra revenue.

7. TAXATION PROPOSALS

Mr. Speaker, I have already outlined the performance of the world economy, the signs of positive growth of output and exports in Sub-Saharan Africa, the continued high growth of the Kenyan economy and the policy framework adopted to enhance economic growth through export promotion. Especially, I have emphasised the restructuring of the highly protected import substituting manufacturing sector, into a competitive export oriented one, which will stimulate an expansion of output and employment. I have just informed the House that I have to finance a gap of K£ 53.4 million. I now turn to the taxation proposals and as usual, I would ask, Mr. Speaker Sir, that the rest of my Speech be regarded as Notice of a Motion to be moved before the Committee of Ways and Means.

(a) **Customs Tariff**

Mr. Speaker, the Finance Bill published today contains some amendments to the Customs and Excise Act. I have classified these into two categories - those with no direct revenue implications and those that have. Some of these amendments correct errors and omissions while others have rectified a few anomalies. I will deal initially with those changes which have no direct revenue implications.

First, a major amendment proposed in the Bill is to Section 43 of the Act. At present this Section allows the transfer of goods between bonded warehouses and as the law stands now, there is no provision under which goods already imported and stored in bond can be utilised by bonded factories. This is a major omission because many bonded factories may require to procure raw materials urgently for manufacturing goods for export in order to meet the delivery orders on time. For these reasons I have proposed that the law be amended to authorise the transfer of goods from a bonded warehouse to a bonded factory.

Second, under existing law if an importer fails to re-export transit goods within the stipulated time, such goods are deemed to be restricted or prohibited. This law was intended to ensure that people do not abuse transit facilities and enter the goods for home use. Unfortunately some people have found a loophole and are importing prohibited goods especially vehicles for home use by circumventing the transit provisions. Such people import goods on transit permits using the names of companies or persons from neighbouring countries. Once goods reach Kenya, the Kenyan importer files a suit in High Court seeking to attach the goods in transit, for an unpaid debt purported to be owed by the neighbouring country's importer. These importers do not then file any defence against the Court Order directing them to release the goods to the plaintiff. In other cases, these importers readily accept the liability and their goods are then attached. Since the plaintiff in such a case has the choice of auction, he appoints an auctioneer who in collusion with him, sells these goods. He then uses the Court Order to obtain the letter of release. Hence in both cases the goods are entered for home consumption. I intend to plug this loophole Mr. Speaker, by proposing an amendment to Section 16 of the Act. The amendment requires that such goods be purchased or sold only on condition that they will be re-exported within the transit period. Failure to comply with this provision will result in the goods being condemned.

Third, in the case of imported goods seized as liable to forfeiture, Section 202 requires the Commissioner, on receipt of a claim for restoration of seized goods to either restore the goods, or institute proceedings against the owner, or advise the claimant, in writing, to institute proceedings within two months. However, the Commissioner is not required to give any notice if the person is prosecuted within this period. Problems have arisen where the owner of the goods is prosecuted but the case is subsequently withdrawn. If two months have elapsed since the seizure of goods, the Commissioner has no alternative but to restore the goods even where the legality of importation of seized goods is in doubt. Consequently, this Section has caused some operational problems. I am, therefore, proposing an amendment to Section 202 of the Act to enable the Commissioner to require the owner to institute proceedings within two months from the date of withdrawal of such a case.

Fourth, the practice of holding imported goods in bonded warehouses by importers for a period of 12 months, with a further extension of 12 months, is fairly widespread. In the past when the import licencing system was less automatic and more discretionary, such lengthy periods of bonding imported goods was justified. Now that this has become more efficient and transparent, there is no further need for holding such inventory in bond for long periods. In fact, many people have deliberately misused these facilities by merely holding goods in bond, for speculative purposes. This is a misuse of our foreign exchange with a view to obtaining higher prices for goods when released from bonds. To discourage this practice, I have reduced the period for holding such goods in bonded warehouses from 12 months to six months.

Mr. Speaker, I would now like to turn to those amendments which have significant structural and revenue implications. As I have stated earlier, we are in the process of transforming our industrial sector towards a competitive and export oriented one. It is mainly with this in mind that I am proposing changes in the Customs Tariff.

First, I would like to remind the Hon. Members of our policy of replacing quantitative restrictions by tariffs. The implementation of this policy has proved successful. Indeed we no longer receive complaints about delays in import licensing. In this Budget, I have taken yet another step in this area by moving a large number of Schedule IIIC items to IIIB while increasing their tariffs. This move will further enhance the transparency of our import licencing system.

Second, I would like to recall that in my last Budget Speech, I lowered the import duty rates on raw materials and intermediate goods by an average of 5% as part of the process of rationalisation of rates. In this Budget, I propose to lower the duty by yet another average of about 5 percentage points, on imported raw - material, intermediate goods and spare parts which at present are dutiable at rates ranging from 10% to 100% in Schedules I,II,IIIA and IIIB. This duty reduction on inputs should lower the cost of manufacturing and raise the competitiveness of local goods in the export market.

Third, I have abolished the top rate of 135% on dutiable items and placed them on a category carrying a duty rate of 100%. This measure should reduce smuggling and other evasive activities and in the process raise revenue through compliance.

Fourth, a number of imported goods whether assembled, partly assembled or unassembled still carry the same rate of duty, while others similarly classified have rate differentiation. Therefore, as part of the rationalisation process, I am proposing to lower the duty rates on unassembled cooking appliances using gas and solid fuel from 80% to 55% while partly assembled or assembled ones from 80% to 75%. Similarly, for cooking appliances using liquid fuel, I am proposing to lower the duty from 50% to 35% for the unassembled ones and from 50% to 45% for assembled and partly assembled ones.

Fifth, Mr. Speaker, as this House will recall, on a number of occasions His Excellency the President has expressed a lot of concern on issues relating to afforestation, science laboratories under the 8-4-4 system of education and accidents caused by vehicles on our roads. Therefore, in this Budget I would like to make proposals to support these three areas.

Mr. Speaker, large scale afforestation is absolutely vital in order to arrest wide scale soil erosion and to maintain an ecological balance. In support of this programme, I am lowering the duty on imported wood pulp from 20% to 10%. Mr. Speaker, this reduction should lead to the protection of our forests from being decimated as our demand for paper products increases.

To facilitate the promotion of well equipped laboratories and encourage the teaching of science subjects under the 8-4-4 system of education, I am proposing the lowering of duty on ceramic ware for laboratory use from 25% to 15%.

Our road vehicle drivers need to be cautioned regarding the speed with which they drive. To reduce the road carnage caused by vehicles travelling at very excessive speeds on our roads, I am proposing the removal of duty on the importation of speed governors for motor vehicles, to encourage their widespread usage.

Sixth, since the theme of this Budget is export-led growth, a number of items with export potential need to be given special encouragement. One such item is raw hides and skins as inputs for the production of leather goods. In order to stimulate leather processing locally and also attract supply from neighbouring countries, I am proposing the abolition of duty on raw hides and skins which at present are dutiable at 10%.

Seventh, in furthering the harmonization of the duty structure for vehicle parts and accessories, I am proposing a reduction of duties on friction material to manufacture spare parts from 40% to 25%, while retaining the duties on shock absorbers, brake-linings, gearboxes, radiators etc., intact at 30%. This measure should encourage the local manufacture of such spare parts.

Finally, duty on capital goods. In 1986 we introduced an import duty exemption on industrial machinery upto a maximum value of Shs. 5 million for small-scale industries being located in rural areas. This value limit was doubled in 1987 to Shs. 10 million. The value limit is obviously inadequate on account of rising prices of plant and machinery in industrialised countries. In order to maintain the level of incentive in real terms so that more small-scale industrial activities are attracted to rural areas, thereby promoting our rural urban balance strategy, I am proposing that the duty exemption on machinery value be doubled to Shs. 20 million for rural investments.

Mr. Speaker, the measures I have announced with respect to customs tariffs will cost the Exchequer some K£ 32.0 million in lost revenue.

(b) **Excise Duty**

Mr. Speaker, I would now like to turn to excise duty. As the Hon. Members will recall in early April this year, I pre-empted the action of hoarders who stockpile cigarettes and tobacco in anticipation of increases in their prices. By raising the tax ahead of the Budget I prevented a loss of potential revenue. Another excisable item is beer. Kenyan beer still remains among the cheapest in the world. In order to increase revenue from this luxury item, I am proposing to levy an additional excise duty of 25 cents per ½ litre bottle of beer and stout and 15 cents for the smaller bottle like Export.

These measures on excise duty will take effect from midnight tonight and, together with the measure taken in April, will provide the Exchequer with an additional welcome revenue of K£ 25.5 million.

(c) **Value Added Tax (VAT)**

Mr. Speaker, Hon. Members will recall that in the last Budget I introduced the Value Added Tax to replace the Sales Tax, because our economy had become more sophisticated. I would now like to inform the House that despite some initial problems, the VAT is now being administered fairly well. In this process we have discovered some loopholes which the measures I am proposing on VAT will correct. As is the practice, I would like to deal first with those amendments which have no direct revenue implications.

Mr. Speaker, first under Section 57(3) of the VAT Act, any good exempt under the Third Schedule to the Customs and Excise Act, is deemed to be exempt from VAT. This provision was derived from the Sales Tax Act. However, it is inappropriate to tie the exemptions from VAT to the Customs and Excise Act because VAT covers services as well as goods. Furthermore, there are goods which are liable to VAT but are exempt from import duties. For these reasons I am proposing a

Schedule of exempt institutions and the extent of exemption of goods and services under the VAT Act.

Second, under the Sales Tax Act, the Commissioner had powers to issue a registration certificate to a person who had not registered and who in his opinion should have done so. Under the VAT Act, this power for compulsory registration is not provided for and in order to force people to register for VAT, I am proposing an amendment to Section 6 of the Act giving the Commissioner such powers.

Third, since the VAT went into operation a major problem has surfaced in the treatment of taxable persons who also carry out some non-taxable activities. As the law now stands, a registered person is required to pay tax on all his activities, including those that are not taxable when carried out by non-registered persons. Consequently, a non-registered person has a competitive advantage. In order to remove this unfair competition, I am proposing an amendment to Section 6 of the Act to provide for discretionary partial registration.

Fourth, in order to avoid charging VAT, a number of companies have resorted to supplying raw materials to a manufacturer, who provides a manufacturing service, to undertake production on their behalf. Currently manufacturing service is not taxable under VAT and therefore even registered manufacturers take advantage of this loophole and avoid paying VAT by contracting out the manufacture of taxable goods.I am therefore proposing that the supply of contract manufacturing service be made a taxable service, under the Third Schedule of the VAT Act.

Fifth, the establishment of Export Processing Zone (EPZ) implies that enterprises operating within such a zone will have to be free of most taxes. The present VAT legislation does not have the relevant provisions. I have therefore introduced provisions in the VAT Act in order to treat trade between the EPZ and the rest of Kenya as export/import trade. Consequently, these enterprises will be exempt from VAT registration.

Sixth, at present Section 5 of the VAT Act is silent about value added tax on the importation of services into Kenya. This omission implies that imported services have an advantage over suppliers of local services. In order to treat both these categories on a par I am proposing an amendment to correct this anomaly.

Seventh, I am also amending Section 40 of the Act to provide for severe penalties against revenue officers who aid and abet in the avoidance of VAT.

Mr. Speaker, I would now like to deal with those changes which have revenue implications. As we restructure our economy by transforming our manufacturing sector from highly protected import substitution to export orientation, the Value Added Tax will assume increased importance in terms of revenue, while import duties will be relegated to play a minor role. It is with this in mind that the following changes are being proposed in VAT.

First, a major change in the Finance Bill relates to the rationalisation of the VAT rate structure. The Government is committed to a rate structure which is easier to administer with fewer categories of rates and contains no excessively high rates with little or no revenue impact. Towards this objective for all items other than vehicles. I propose to reduce the current 15 categories of rates above 17% to 6 only. In the process I have eliminated the following rates of 20%, 35%, 50%, 60%, 65%, 75%, 85%, 120% and 210%. Mr. Speaker, this is a major reform, which will have far reaching effect on trade and manufacturing.

Second, the general rate of Sales Tax, the forerunner of present VAT, has for a long time remained at 17%, while cost per unit of public outlay has continued to escalate rapidly. I am therefore proposing a marginal increase to a level of 18%.

Third, a number of VAT exempted goods will now be zero rated. This implies that any of the goods which constitute an input in the production of these zero rated goods, will be eligible for a tax offset. When goods are zero rated, they are free of tax. Under the Fifth Schedule of the VAT Act, export goods are zero rated. My attention has been drawn to the fact that failure to zero rate services means such services will be taxable on the non-resident and since non-residents will object to such a tax, Kenyan professionals will become less competitive and therefore lose business.

Fourth, currently under VAT a long list of goods are exempt. These exempted goods constitute raw materials and capital goods. In order to raise revenue which I have foregone by lowering import duties on the same categories of goods, I propose that some of these exempted goods should now attract a 5% VAT. As far as exports are concerned, this measure will not hinder their expansion because they are zero rated and therefore VAT claimable. This measure should require manufacturers to register for VAT and encourage the discipline of keeping proper accounts.

Fifth, Hon. Members will recall that last year, I lowered the sales tax on passenger cars with varying cylinder capacity and the combined duty and sales tax rates were reduced substantially. In addition, I also abolished the 17% sales tax on assembled buses of over 25 passengers. However, because of the high cost of passenger cars and minibuses resulting from the appreciation of the currencies of our major trading partners and the prevailing high interest rates, I am proposing to lower further the VAT rates for a certain categories of cars. With effect from midnight tonight, the VAT rates proposed for cars are as follows:

For 1500 cc and less - from 20 % to 18 %;
over 1500 cc to 1800 cc - from 35 % to 30 %;
over 1800 cc to 2000 cc - from 50 % to 45 %;
over 2000 cc to 2250 cc - from 120 % to 100 %;
and cars exceeding 2250 cc - from 210 % to 150 %.

I am also proposing to lower the VAT rates for most categories of minibuses with the exception of 1500 cc and less, which remains unchanged at 35%. The proposed VAT rate for minibuses are as follows:

Over 1500 cc to 1800 cc from 55 % to 50 %;
those exceeding 1800 cc to 2000 cc from 70% to 50%;
and those exceeding 2000 cc from 85% to 80%.

Mr. Speaker, the proposed measure is a substantial reduction which should be welcome.

Sixth, another charge which has remained unchanged for a long time is the fee paid for the letter of release when importing a vehicle. I am therefore introducing progressive fees. Accordingly, with effect from midnight tonight, the charge for the letter of release will be increased for cars of 2000 cc and less from shs. 5,000/- to shs. 10,000/-, for cars of over 2000 cc from shs. 5,000/- to shs. 20,000/-, while charges for all other vehicles and motor cycles will remain unchanged.

Seventh, I have received representation to the effect that the VAT rates are too high on milk and cream powder and other milk and cream concentrates specially prepared for infants. Consequently, prices of food prepared for infants remain very high. In order to ease this burden on the mothers, I am proposing to zero rate them. This measure will leave all other users taxable while at the same time maintaining low prices for infant foods.

Eighth, Mr. Speaker, our taxation policy must be aligned with our Rural-Urban Balance strategy. Therefore, in reviewing the VAT rates I have borne in mind the need to protect small scale industry, especially Jua Kali, with a view to stimulating its competitiveness. Towards this end, I propose to abolish VAT on acetylene and bakery machinery and parts. The removal of VAT will encourage small scale Jua Kali enterprises to make widespread use of acetylene and produce bakery machinery and parts at competitive prices.

Ninth, with our country's many hours of sunshine per day, clothes-dryers are an obvious luxury in Kenya and are therefore the right items to be removed from the list of exempted items. I am therefore proposing a VAT rate of 18% on clothes-dryers.

Tenth, I am proposing VAT exemption on several items including laboratory equipment, road and traffic signs and industrial compressors, these are basic items for schools, road safety measures and for industrial purposes respectively. The important role which these goods play is evidenced by this proposal to make them duty free.

The VAT measures I have announced today, together with those on beer announced in April which pre-empted the action of hoarders, will bring an additional K£ 52.2 million in revenue.

(d) **Income Tax**

Mr. Speaker, I would like to turn to income tax where I am proposing some major changes aimed at influencing the development of capital market, attracting investment, inducing additional exports, and enhancing revenue. As usual, I will deal first with reforms which have no revenue implications.

As the House will recall, we have embarked on the development of the capital market through the expansion and the deepening of the securities markets and particularly the stock market. The capital market will enable Kenyan companies to raise funds through equity or the stock market rather than by borrowing from commercial banks and through retained earnings.

One of the important investment intermediaries which will mobilise savings for investment in stocks, shares and securities is the Unit Trust. A Unit Trust is an investment fund in which individuals can purchase units or shares. The funds so raised by the Trust are invested broadly in the economy for the benefit of the unit holders. Hence, Unit Trusts enable small domestic investors who do not have the necessary knowledge to enter the stock market to benefit from such investments.

In order to expand the options for savings and investment for the average Kenyan, I am proposing amendments to both the Unit Trust and Income Tax Acts. The amendments will make the use of unit trusts an attractive way for Kenyans to invest widely in the economy. I shall now detail the tax changes that will make Unit Trusts financially attractive. At the same time, however, I am introducing changes in the regulatory framework for Unit Trusts that will help ensure the security of the funds invested in them. These Unit Trusts will be licensed and supervised by the Central Bank.

Mr. Speaker, I would now like to turn to those amendments relating to the capital market which have revenue implications.

Firstly, the withholding tax of 15% on dividends paid to a resident will be made a final tax, thus reducing double taxation and encouraging wider share ownership. The withholding tax of 15% on dividends will also reduce double taxation on intercorporate dividends.

Secondly, all dividend and interest income to Unit Trusts will be subject to withholding taxes of 15% and 10% respectively, which will be final and not subject to corporate tax. Consequently, Unit Trusts will receive all income flows tax paid.

Thirdly, where dividend and interest income is received by tax exempt persons such as the pension plans, these will not be subject to withholding tax.

Fourthly, stamp duties payable for retail share transactions quoted in the Stock Exchange, both for individuals and institutional investors, will be abolished.

Finally, legal fees and other costs of public issues of shares, debentures and bonds will be made a deductible expense so as to promote such public issues. I am confident that these reforms will make the Unit Trust an attractive vehicle for pooling investment funds of individuals.

Mr. Speaker, as I have already informed the Hon. Members, we are establishing Export Processing Zones for the purpose of attracting investment, especially foreign investment, creating employment and earning foreign exchange. To attract such investments, I am proposing a number of income tax reforms. Firstly, a tax holiday for the first 10 years and thereafter only 25% income tax for the next 10 years, for all enterprises locating in the Export Processing Zones. Secondly, payments from an EPZ enterprise to non - residents will be exempt from withholding tax during the first 10 years. Finally, tax accounts will be maintained in foreign currency subject to an agreement with the Governor of the Central Bank and the Commissioner of Income Tax. I am sure that such an attractive tax package, will pay dividends.

Mr. Speaker, I would now like to propose changes which are aimed at existing investors and individual tax payers. These measures will enhance equity and increase our tax revenue collections.

Firstly, under existing law, a businessman is required to pay part of his tax on business income three months after the end of his accounting year and the bulk of the tax six months later. Consequently, this mode of payment allows him an interest free credit of 9 months. However an employed person is required to pay the whole of his tax on his monthly salary by PAYE. Thus there is considerable inequity in the tax treatment of income. I therefore propose to introduce, a current payment system for business income, in order to remove this inequity. This system will require a business to pay 75% of its **estimated** tax for the year, at the end of the third quarter or the end of the ninth month of a firm's financial year. It will be phased-in over 5 years starting with 15% of the estimated tax in the first year, then 30% in the second year, 45% in the third year, 60% in the fourth year and 75% in the final year. It will commence in September 1990.

Secondly, the Hon. Members will recall that last year I lowered the corporate tax rate from 45% to 42.5%, in order to make Kenya an attractive location for investment. This year I am continuing this process by further lowering this tax rate from 42.5% to 40%. This is a major concession which should attract mobile international capital and it will also provide an offset to the measures I have just proposed on the current payment basis of corporate tax.

Thirdly, under the current penalty system, late payment of income tax carries a flat rate penalty of 15% on outstanding tax. Under this system the penalty remains the same whether the taxpayer pays the arrears now or later and therefore there is no incentive to pay early. I am therefore proposing in the Finance Bill a penalty of 15% on all late and underestimated taxes plus a 1.5% per month interest on all unpaid tax including penalties. In addition to these penalties, tax evasion is a criminal offence carrying a heavy fine and/or custodial sentence. I am directing the Commissioner of Income Tax to implement this provision without delay in his effort to collect taxes.

Fourthly, many high income employees have been receiving much of their income in lightly taxed benefits. These benefits should be subject to full taxation. I am therefore proposing to continue to raise the values to be required to be included in income for benefits such as cars. In addition, I intend to disallow the deductions of the cost of providing benefits such as vacation trips and club fees.

Finally, Mr. Speaker, I want to deal with the tax treatment of pension savings by Kenyans. Under the current system, pension contributions are not tax deductible and pension incomes are non-taxable. However, the time has come to start a gradual switch over, subject to limits, to a system where contributions will be deductible while pension income will be taxable. I therefore propose to introduce significant changes in this area.

Starting in 1990, contributions to registered pension plans and provident funds, made by employers or employees, will be deductible from taxable income subject to limits. The limits will start at low levels and will be increased over the years. Pensions will become taxable where they exceed the tax free pension limits. Mr

Speaker, I want to assure all Kenyans that when introducing the new system of taxing pensions, I have taken care to protect the tax free pensions of those Kenyans who have earned pensions based on non-deductible contributions. I am even going further today and am raising the tax free limit on pensions from its current level of K£ 5,000 a year to K£ 7,500.

Mr. Speaker, the change I have proposed in the taxation of pensions will have far reaching implications. It will encourage companies to establish pension plans and to contribute savings to those plans thus increasing domestic savings as well as mobilising the capital needed for investment to create jobs. The development of pension plans will also help assure the financial security of a growing number of Kenyans in their retirement. Mr Speaker, we will continue to work in the coming years towards improvements in the legislative framework for tax-assisted pension savings, that will allow the pension plans to grow and make pension membership open to an ever increasing number of Kenyans.

Mr. Speaker, I will raise some K£ 6 million from the proposed income tax measures.

(e) **Miscellaneous Taxes / Fees**

Mr. Speaker, along with the above tax reform, I have also reviewed miscellaneous taxes and fees and in this Budget, I propose only three changes. These are increases in licence fees under the Banking Act, for banks and other financial institutions by 15% across the board, the raising of trade licencing fees by 10% and, in order to discourage the export of scrap metal, I propose to increase the export duty on it from 10% to 20%.

Mr. Speaker, I intend to raise K£ 1.7 million from these changes.

(f) **Export Compensation & Duty Exemption**

Mr. Speaker, turning now to the promotion of export of non-traditional or manufactured goods, I am proposing changes to improve the existing system of export compensation. I am also proposing new measures to ensure that exporters can purchase inputs at world prices to compete in the international markets, and claim compensation from the day the goods are exported. In the Finance Bill, I have extended the list of eligible items for export compensation. There will still be need to produce a bank guarantee; failure to remit foreign exchange within the permitted period, will carry a penalty, which will be double the amount of compensation plus interest and the culprit will be liable for prosecution under the Exchange Control Act.

Mr. Speaker, the primary objective of export compensation is to compensate the manufacturer for duties and taxes paid on inputs used for the manufacture of exported goods. The items eligible for export compensation are selected on the basis of a set of impartial criteria. These are:

i) the goods should have at least 30% value added;
ii) the inputs used should be liable to at least 20% duty and not subject to either duty remission or refund;

iii) the goods should not be subject to international quotas or any other form of trade restrictions;

iv) the goods should not be prohibited for export purposes under any Kenyan law;

v) the goods should not be primary commodities;

vi) the goods should not be subject to royalties or export taxes; and

vii) the goods should not be raw materials or intermediate inputs which are high priority inputs and in short supply domestically or the local value added of which can be substantially enhanced by further processing.

Mr. Speaker, finally I am proposing the introduction of a Duty Exemption Scheme. Under this scheme, exporters will have access to duty free imported inputs in order to obtain them at world prices. This scheme will operate in parallel with the existing export compensation scheme but these will be mutually exclusive. Exporters of horticultural products will be the first to be eligible to apply for duty exemption on their inputs including packages and containers used for their exports. Other exporting sectors will be made eligible in the future. In addition, a duty drawback programme will be designed and introduced in 1991. Mr. Speaker, all these measures should enhance our exports of non-traditional items.

8. CONCLUSION

In conclusion, Mr. Speaker, in this Budget I have provided measures to continue the policies of structural adjustment as enunciated by our Sessional Paper No.1 of 1986; I have emphasised the goal of economic growth through export promotion; and I have outlined the measures towards its achievement.

I have also reaffirmed the Government's commitment to control the budget deficit and to stress the manner in which it will be financed. Through taxation measures under Customs Duties, Value Added Tax, Income Tax, etc., I have given the signals for the stimulation of the agricultural and manufacturing sectors towards export orientation. I have been generous in raising the value limit of industrial machinery eligible for import duty exemptions and thereby have made rural areas more attractive to small scale industries. I have adopted measures to encourage the rapid development of the capital market and the establishment of the Export Processing Zones. I have also introduced the duty exemption scheme while strengthening the existing export compensation scheme. Mr. Speaker, all these measures are aimed at encouraging exports, employment and growth.

These actions will consolidate the achievements under our structural adjustment policies and will ensure the dynamism of the economy as we enter the decade of the nineties.

Mr. Speaker, I beg to move.