SPEECH DELIVERED TO THE NATIONAL ASSEMBLY ON 10TH JUNE, 1993 BY THE HON. MUSALIA MUDAVADI, MINISTER FOR FINANCE, REPUBLIC OF KENYA, WHEN PRESENTING THE BUDGET FOR THE FISCAL YEAR 1993/94

(1ST JULY, 1993 TO 30TH JUNE, 1994)

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Mr. Speaker, Sir,

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

1. INTRODUCTION

Mr. Speaker, today I present the first budget of the Seventh Parliament and the last budget of the third decade since we attained our independence. During these three decades the economy of Kenya has experienced good times and bad times; times of growth and times of hardship. One constant factor, however, has been the development of resilience of the economy built up through prudent economic management over the years. In the last few years structural adjustment policies have further strengthened our economy to withstand external and internal shocks and yet register modest rates of growth of GDP. Mr. Speaker, it should be remembered that much of this period, especially since the late-seventies, was characterised by regular quick disbursing balance of payments support from multilateral and bilateral donors. This support was withdrawn in November, 1991 and since then severe strains have emerged on the economic scene. While 1992/93 may have been 'annus horribilis' for our economy, few familiar with this country's tenacity would bet that 1993/94 will not be our 'annus mirabilis', in which we will emerge bruised and changed, but still with some strength and hope.

Mr. Speaker, my budget today contains policies and programmes aimed at bringing about "ECONOMIC RECOVERY THROUGH FISCAL AND MONETARY DISCIPLINE", which indeed is the theme of this Budget. We will continue vigorously the process of liberalisation of the economy, but the first and foremost objective of this budget is to bring down the rate of inflation. The second essential precondition is the maintenance of peace and political stability in the country. Higher levels of real economic growth and therefore of employment and incomes, are dependent basically on the progress made in securing these two areas. In Kenya's present circumstances patriotism demands that economic issues be debated in this Parliament in the spirit of national interests rather than party politics. Solutions to our economic problems will require co-operation and not confrontation. We shall need to pull together to grow.

Mr. Speaker, as is conventional, I shall begin with a review of the world economic development and performance for the future, the Sub-Saharan African scene and our own current domestic economic position and prospects for this year and beyond. I shall then discuss the 1992/93 budget out-turn and the 1993/94 forecast. Finally, I shall introduce specific taxation measures and other changes.

2. THE WORLD ECONOMY

Mr. Speaker, it is difficult to review the prospects for our economy without first examining the outlook for the world outside. Developments abroad have a profound impact on Kenya with its highly open economy. As you all may remember, the world economy in the latter part of 1992 was characterised by flagging consumer and business confidence, weak economic activity especially in Europe and Japan and major upheavals in the Exchange Rate Mechanism of the European Monetary System. Despite encouraging signs of increased growth in the United States, these developments had cast new doubts on the prospects for recovery in the industrial world after almost two years of weak growth or recession in many countries. Industrial production had fallen in many of the world's largest economies. In Italy it fell by 2 percent, in France by 2½ percent, by 6½ percent in Germany and by 7 percent in Japan. Monetary conditions in these countries generally eased on evidence of slow growth and weak inflationary pressures. Most of these countries had allowed the automatic stabilisers to work, but hardly any country had any room for discretionary easing of fiscal policy. Only in the US and France did fiscal policy maintain a broadly neutral stance through recession.

Mr. Speaker, in the United States economic activity is expected to strengthen in 1993 as households return to more normal spending patterns, as financial positions improve, and as the economy responds to the lowest short-term interest rates in thirty years. In Japan, however, the prospect of recession is high with GDP declining by 0.75 percent in the latter part of 1992. Output had fallen in France, but growth in 1993 is expected to be somewhat higher. In Germany which is still struggling with the costs of reunification, real output is projected to rise by only 0.5 of 1 percent in 1993. In contrast to these European countries, GDP in UK rose slightly in the second half of last year. The depreciation of sterling and the further reduction in interest rates since sterling was withdrawn from the Exchange Rate Mechanism, are expected to stimulate both external and domestic demand during the course of 1993. According to the European Commission's expectation, UK will be the fastest growing of all the major European economies both in 1993 and 1994. For the group of smaller European countries like Sweden and Finland, economic conditions weakened considerably during the second half of 1992 and are expected to remain subdued or weaken further.

However, there still appear to be downside risks to the projections for GDP, especially in Europe and Japan. For Europe, the recent exchange market turbulence and continued uncertainty about the ratification of the Maastricht Treaty may adversely affect confidence and delay recovery until the prospects for European Monetary Union become clearer.

An additional important downside risk is the possibility of a failure to conclude the Uruguay Round of multilateral trade negotiations.

Mr. Speaker, the adverse impact on the developing countries of the slower growth now projected for the industrial countries in 1993 and of weaker world commodity prices is expected to be partially offset by the beneficial effects of lower world interest rates and, for oil importing countries, by somewhat lower oil prices. The outlook for several Eastern European countries appears to be improving. However, it is worth noting how unfortunate the Bosnian situation is due to ethnic conflict. The economic situation in the former Soviet Union has continued to deteriorate. However, the impact of debt-restructuring in some of the Eastern European countries and the promise of massive economic aid to the former Soviet Union from the G7 countries may bring about a turnaround in the growth prospects of these economies. The countries of Sub-Saharan Africa are naturally concerned that the diversion of foreign aid and private investment from the developed world to the economies of Eastern Europe and the former Soviet Union, will inevitably be at their expense. I appeal to donor countries not to forsake Africa at this crucial stage in the economic development of this continent.

Turning to Asia, real output is projected to increase at 6½ percent in 1993, roughly similar to the average growth over the past five years. This is traced to a general surge in consumption and investment, as well as to a sharp increase in exports, which in the newly industrialised economies of South-East Asia rose about twice as fast as world exports, in 1992. In China, economic growth has gathered momentum as a result of the implementation of bold reform policies in recent years. The growth last year was a remarkable 12.8 percent and it is projected to remain high at nearly 9 percent in 1993. Mr. Speaker, Asia represents an example and an opportunity to us. We should aim to emulate their economic performance and seek new markets in these growing economies.

3. THE SUB-SAHARAN AFRICAN SCENE

Mr. Speaker, the African region and specifically Sub-Saharan Africa, continued to perform poorly. After 1989 incomes continued to fall with Sub-Saharan Africa recording an economic growth rate of only 0.9 percent in 1992. The growth in 1991-1992 has been restrained by weak external demand, by a deterioration in the terms of trade of nearly 12 percent, reflecting a sharp decline in commodity prices, by stagnation in agricultural output, by a devastating drought in southern and eastern Africa and by civil disturbances afflicting a few of them and exacerbating the already heavy burden of refugees. For the least developed African countries, there has been slow progress in alleviating the debt burden, which still remains stubbornly high. Real output is projected to grow by 3½ percent in 1993 because of somewhat improved external environment, including an end to sharp terms of trade declines that occurred in 1991 and 1992. In addition, there will be beneficial effects of continued structural adjustment efforts in several countries. On a per capita basis, however, only a marginal improvement in output and nutritional status is expected in 1993.

Mr. Speaker, Africa is dependent more than any other region on official aid flows. The World Bank, UN and OECD countries all agree that such flows will remain sluggish. Financial inflows while still positive, have been low and virtually stagnant in recent years. There is, however, some glimmer of hope that the United Nations and the Global Coalition for Africa in conjunction with the Japanese government, may influence and reverse this trend. They are planning a conference designed to affirm the need for the international community to give strong assistance to African countries in the face of competing global demands for aid. One other issue likely to be addressed at this conference will be the need for regional cooperation and integration. To stop the marginalisation of Africa, self-reliance as opposed to self-sufficiency is appropriate. To achieve the goal of self-reliance, the World Bank would no longer dictate development plans to African countries, while their future programmes will be aimed at African capacity building to help African countries to help themselves. Another major route to achieve self-reliance will be through regional trade. We have not had any peace in South Africa, Zaire and Somalia. Zimbabwe on the other hand has recently nationalised its land. For Kenya it is essential to explore trade potentials with these countries but until their political consolidation is complete and conditions stabilise, trade with them will be risky. As far as our southern and western neighbours, Tanzania and Uganda, are concerned, we welcome their prosperity. Their currencies are gaining in strength in relation to the Kenya shilling. In February this year, one Kenya shilling was equivalent to about 10 Tanzanian and 33 Ugandan shillings, whereas now it is equivalent to 6 and 20 shillings respectively. This is a welcome development since Kenyan products will be more competitive, thus enhancing our intra-regional trade.

4. THE DOMESTIC ECONOMY

Mr. Speaker, the performance of the domestic economy in 1992 has been very poor. As Hon. Members will have seen in their copies of the Economic Survey for 1993, the rate of growth of real GDP was 0.4 per cent, the worst in the history of independent Kenya. The reasons for this stagnation have been detailed in the various Chapters of the Economic Survey. I would like to draw your attention to the following major ones; First, the poor rains. The total amount of rainfall was much below normal and its distribution over time and regions was unfavourable. What made the situation worse was that last year was the third year in a row of unsatisfactory weather activity. Second, the intermittent ethnic clashes in parts of the country which interfered with normal economic activities in crucial stages of the production cycle for extended periods. Third, the fear of instability and general climate of uncertainty in the minds of businessmen and investors during the phase of transition to multi-party democracy which led to a sharp fall in investment. Fourth, the continuing suspension of quick disbursing aid flows from donors which forced the country to run into external debt arrears and led to a sharp fall in the availability of foreign exchange for imports of machinery, equipment and essential intermediate goods. Fifth, the continuing fall in the country's external terms of trade which exacerbated the scarcity of foreign exchange. Sixth, some further flight of capital on account of the general uncertainty mentioned above.

Mr. Speaker, one can make the list longer. Given all these adverse developments, it is not surprising that the growth rate had fallen to 0.4 per cent. Other countries, - both developing and developed - recorded similarly poor performance in 1992: the U.K had a growth rate of -0.5 per cent, the rest of the OECD excluding the USA, Japan , Germany and France had an overall average growth rate of -0.2 per cent, sub-Saharan Africa excluding Nigeria had a growth rate of 0 per cent. Rather, it is a matter of relief that the growth rate was not actually negative, as had been widely feared. This, Mr. Speaker, is an evidence of the resilience that the Kenyan economy has acquired over the last few years of structural adjustment.

Agriculture

Mr. Speaker, agricultural income in real terms fell by a little over 4 per cent in 1992. This fall in agriculture was again the worst in the history of independent Kenya, the fall in the drought year of 1984 having been marginally less at 3.9 per cent. The decline would have been even worse but for some recovery in the output of major crops like maize and coffee in the second half of the year. The production of maize, for example, had registered a fall of 5 per cent during the first half of the year, but recovered substantially in the second half so that the output for the year as a whole was about 7 per cent higher than the level of 1991. Coffee output also recovered during the second half to record a marginal growth of 1.5 per cent for the full year. Output of various other crops like tea, wheat, sugarcane, pyrethrum, sisal and dairy products fell to various extents compared to their 1991 levels. The reasons for the fall in output were poor rainfall and disruptions caused by clashes, together with some problems associated with payments and marketing systems. There was a steep fall of 35 per cent in the application of fertilizers, due both to reduced availability and high cost. The acreage planted by farmers has also been coming down in the case of a number of crops, including coffee.

Industry

Turning to industry, the overall output of manufacturing registered a marginal growth of 1.2 per cent, while real value added in all other areas in the industrial sector, namely mining and quarrying, building and construction, and electricity and water went down. Within manufacturing, there was a significant contraction of 6 per cent in food processing, due mainly to a fall in output of the related agricultural products. Other areas of significant contraction in manufacturing output were petroleum products, transport equipment and metal products, - non-availability of imported inputs being the major reasons in these cases. On the other hand, there was significant growth of over 13 per cent in the production of beverages and tobacco, fuelled mainly by good export performance. Other manufactured products which did well due to growth in export demand were leather and footwear, paper and paper products, plastic products and clay and glass products. Mr. Speaker, strong performance of these non-traditional export industries in an otherwise dismal economic landscape is a clear indication that the structural adjustment measures implemented in the field of external trade and finance are bearing fruit. The decline in building and construction was the inevitable consequence of the economic downturn that had set in from around 1990, coupled with the severe compression in development expenditure in successive budgets of the Central Government. The decline in electricity and water was to a large extent due to the drought-like conditions that prevailed for much of the first half of the year.

Service Sectors

Mr. Speaker, when agriculture and industry languish, the service sectors of the economy cannot do well. Thus major sectors like trade, transport, dwellings and "other services" recorded only marginal rates of growth. The only sector with strong performance was finance, which registered a growth rate in contribution to real GDP of nearly 7 per cent. This is attributed to heightened financial activity, especially in the second half of the year, following reforms and liberalization covering both domestic and external financial sectors. The real GDP from Government services registered a growth of 2.4 per cent, due mainly to increased level of activity called for by preparations for and conduct of the general elections of 1992.

Saving and Investment

Mr. Speaker, under the circumstances prevailing in 1992 as I have described above, it is no wonder that the activities of saving and investment were also depressed. National savings as a proportion of GDP at market prices were around 15 per cent in 1990 and 1991. In 1992, the ratio fell sharply to 12 per cent. The high rate of inflation prevailing in 1992 pushed up the share of household income that had to be spent on essential items of consumption, which ate into the margins available for saving. Moreover, most interest rates remained negative in real terms during 1992, thus failing to provide stronger incentives to save. The fact that the interest rates remained negative in real terms despite being fully liberalized in 1991, is an indication of the inadequate development and the segmented nature of the financial sector in Kenya. Reforms and regulatory measures being put in place recently will help in removing some of these shortcomings. More comprehensive institutional development and a growth in financial awareness among the people will, of course, come about more gradually. Meanwhile, monetary policy measures have been put in place to push interest rates up to make them reflect the true cost of capital.

Along with saving, gross fixed capital formation or investment recorded a substantial drop of over 9 per cent in 1992. This decline came on top of another decline of 3 per cent in 1991. Mr. Speaker, a drop of this order is not surprising, in view of the continuing depressed state of both the domestic and the world economy, the acute shortage of foreign exchange and the pervasive gloom and uncertainty of 1992. Fiscal austerity on the part of the Government, together with tight controls on loan-financed investment projects in the parastatal sector, led to a sharp drop of about 14 per cent in fixed capital formation in the public sector. In contrast, the fall in private sector investment was a more moderate 5 per cent. The share of the private sector in total fixed capital formation had fallen from 59 per cent in 1988 to 50 per cent in 1990. Over the last two years, the ratio recovered - reaching 55 per cent in 1992. This, Mr. Speaker, is consistent with the Government's objective of putting increasingly more productive resources at the disposal of the private sector.

Employment and Wages

Mr. Speaker, the poor overall growth in GDP in 1992 was reflected in sluggish growth in employment. Wage employment in the formal sector of the economy increased by a mere 1.4 per cent, with the rate of growth in employment in the private sector being faster (1.7 %) than in the public sector (1.2 %). It is of interest to note that the growth in employment in the public sector was entirely concentrated in the Teachers' Service Commission (TSC), where employment grew by 7.1 per cent, while in other areas it declined, including employment in the Central Government. The fact that the rate of growth in employment in the formal sector exceeded the rate of growth in output implies that there was a fall in average labour productivity. Productivity fell not because workers became less efficient; but mainly because output was constrained by other factors - such as bad weather, socio-political disturbances and the shortage of essential inputs like water, electricity, imported materials and other intermediate goods. Per capita wage earnings in the modern sector increased by 12 per cent. With the average rate of inflation at 27.5 per cent, this implied a sharp fall in real average wage earnings of more than 12 per cent. On the other hand, because of the fall in average labour productivity which I have just referred to, unit wage cost of output rose by about 13 per cent. Such a rise in unit wage cost of output has been a major factor pushing prices up, and thus generating inflation.

Mr. Speaker, here is a major policy dilemma created by high inflation. If nominal wages do not rise in proportion, real wages fall, which translates into economic hardship and deprivation. If on the other hand, nominal wages do rise in step with inflation, unit labour cost rise, since productivity growth hardly ever exceeds low single digit rates. The rise in unit labour cost leads to further a rise in prices, which nullifies part or all of the benefit the workers expect to derive from the higher wages. Mr. Speaker, such a policy of upward adjustment of wages to catch up with inflation may lead to a process in which inflation feeds on itself. Because prices have risen, wages rise. And because wages have risen, prices rise again. The only way out of this vicious wage-price spiral is to maintain tight restraint on nominal wages for long enough to allow inflation to subside. Once the battle of inflation control has been won, real wages may begin to rise in step with growth in labour productivity, without creating any upward pressure on prices.

Balance of Payments

Mr. Speaker, I turn now to the outturn of the country's balance of payments in 1992. The balances of visible and invisible trade improved considerably in real terms, due mainly to the fact that while the volume of imports fell, the volume of exports remained stable. Import volumes fell by about 4 per cent in aggregate, continuing the trend of decline that had set in from 1990. The fall was due to familiar reasons such as the generally depressed state of the economy, the high cost of imports, and the shortage of foreign exchange created mainly by the suspension of quick-disbursing aid flows. The volume of exports excluding petroleum products registered a growth of 4 per cent - due mainly to growth of non-traditional manufactured goods exports, which grew by 11 per cent. Earnings from tourism remained flat in foreign currency terms, implying a volume decline of about 3 per cent. This was due to the continuing recession in industrial economies, competition from other centres of tourist attraction and some adverse publicity in the foreign press on the security situation in Kenya. Overall, the current account deficit improved markedly from 2.4 per cent of GDP at market prices in 1991 to 1.2 per cent in 1992.

While the current account improved, the capital account put up a dismal performance. For the first time in history, the total net capital inflows on an <u>accrual</u> basis was a large negative figure - that is a net outflow - of K£ 265 million. This happened because while the gross outflow remained large due to the repayment obligations on outstanding debt, gross inflow fell sharply. Inflows on government account fell due to suspension of donor aid. Strict limits were also imposed by the Government on external borrowing by parastatals, - because of their inability to service existing debt. The inflow of private foreign capital was also very low due to well-known reasons such as the recession in the industrial economies, the emergence of Eastern Europe as a competing destination for direct foreign investment, and the climate of uncertainty prevailing in Kenya during the period of political transition.

However, the <u>actual</u> net capital inflow still turned out to be positive, since the country was unable to meet the external payment obligations and ran up a debt service arrears of K£ 591 million during the year. Thus the <u>actual</u> overall balance in the balance of payments turned out to be a surplus of K£ 158 million, instead of a deficit of K£ 433 million which would have been recorded had no arrears been accumulated. The positive overall balance together with valuation adjustments allowed the country's foreign exchange reserves to go up by K£ 240 million during the year, even after making a net repayment of about K£ 130 million to the International Monetary Fund.

Mr. Speaker, looking at the developments in the balance of payments area during 1992, one can see that our policies of export promotion and liberalisation of the trade and exchange regime have begun to yield results. For it is these policies that created the necessary incentives and environment to sustain the observed growth of earnings from exports of non-traditional goods and from other items of invisible trade. These earnings were essential to prevent the balance of payments from collapsing in a year in which gross capital inflows virtually dried up.

Money, Credit and Prices

Mr. Speaker, it is well known that money supply increased sharply during 1992. Its annual rate of growth reached about 35 per cent, a rate that has not been observed in any other recent year. Among other things, this rapid growth in money supply has been fuelling the inflation which we have been experiencing in recent months and weeks. It is worth noting that the growth rate accelerated sharply in the second half of the year; the growth during the first six months up to June was at a modest annual rate of less than 12 per cent. The accelerated growth in the second half was due to three major factors: (i) Extensive use of the pre-shipment export credit facility which had been in existence for some time (ii) the purchase of foreign exchange by the Central Bank of Kenya from the inter-bank market at substantially higher than official rates which resulted in the creation of high powered money, and (iii) the attempt to bolster up a number of weak banks and other financial institutions through liberal advances and overdraft facilities; unfortunately, these institutions did not respond. As Hon. Members are aware, the pre-shipment export credit facility has since been discontinued, action has been taken on a number of weak banks and financial institutions, and the Central Bank has been using monetary policy instruments aggressively to mop up excess liquidity from the system.

Mr. Speaker, the growth in credit during 1992 was at a moderately low rate of 15 per cent. Within this aggregate, credit to the Government and other public institutions fell by 3 per cent, while credit to the private sector increased by 27 per cent. Mr. Speaker, as will be recalled from our past two budgets the emphasis has been placed on the private sector initiatives as the main motive force for economic growth and development, the Government undertook trying to minimise its own recourse to the domestic banking system for credit - leaving greater room for growth in credit to the private sector. Indeed, the share of the private sector in total bank credit has been going up steadily - from 56 per cent in 1990 to 58 per cent in 1991 and 65 per cent in 1992. This trend will continue, as the Government will endeavour to reduce the budget deficit progressively and to limit domestic financing of the deficit to non-inflationary sources.

Inflation

In 1992 the price level rose by historically record proportions. The average weighted inflation for Nairobi was 27.25 percent compared with 19.62 percent the previous year. I must emphasise to the Hon. Members of this House that we are talking about changes in price level rather than the basic instability associated with inflation. There were two major steps in the price level last year, one in March and one in May. The March increases were associated with the drought conditions experienced early in the year which caused the prices of many basic foods to rise by over 80 percent due to shortages. I am pleased to remind you that many of those prices came down later in the year when the crop situation improved, but by that time the May revision of the controlled price of maize had already occurred thereby concealing to some the extent reduction in the price of milk and vegetables.

The increase of maize price in May was to remove the subsidy which the maize farmers country-wide, were giving to the urban dwellers. Since by far the bulk of Kenya's population is rural-based the increase in maize price which increased farmers' incomes, more than compensated for the increase in urban food prices experienced by the very small minority that did not have rural roots to compensate for their own increase in cost of living.

To substantiate the point which I am now making, Mr. Speaker, if we look at price changes between June and the end of December they only rose by 3.4 percent. On an annualised basis, that would have been an inflation rate of 7 percent only.

I am aware that the Hon. Members are very concerned about the inflationary pressure to which the economy was exposed early in this year. As I will point out later in my speech, we have been taking aggressive measures to curb those elements, such as speculation and excessive liquidity, which might give rise to an unstable price rise. I am confident that continued efforts in this direction will bear fruit and, although such things as changes in the rate of exchange and cost of capital, are making life expensive, we have in fact managed to constrain the speculative elements and I have no doubt that the annualised inflation over the last quarter of 1993 will be below 10 percent.

Prognosis

Mr. Speaker, 1992 turned out to be a year of extremely poor growth in real Gross Domestic Product. It grew by 0.4 percent which was below the target of 2.0 percent. The poor performance of the economy to some extent was attributed to poor rains, adverse terms of trade, the decline in tourism, intermittent ethnic clashes, but mainly due to the shortage of foreign exchange and the uncertainty attached to it. I would like to assure the Hon. Members that the foreign exchange flows will be resumed, because I have a strong programme for the economy. Already some of the quick disbursing programme finance has started flowing in.

Mr. Speaker, the Government's fundamental task is to provide a clear and practical policy framework to ensure success for our strategy for high and sustained economic growth. This strategy rests on three key principles. These are: **firstly**, that it is absolutely vital to lower the inflation rate through the continuation of tight monetary and constrained fiscal policies. **Secondly**, that higher growth with efficiency will come from the private sector rather than from the public sector. And **thirdly**, that export-led growth with a market oriented economy will generate a speedy recovery.

Mr. Speaker, our target rate of growth of GDP in the coming year is 3 percent. As far as the budget deficit is concerned, the target is K£ 550.0 million or about 3 percent of forecast GDP at market prices. Although 1992/93 has not been an easy year, we are determined to ensure that our economy turns around and is back on the path of robust growth by this time next year. Towards this objective, I want to assure this House that we intend to continue along the path of structural adjustment at a steady pace. Adjustment policies are designed to create new opportunities for the private sector to expand and grow. We intend to continue to open new growth opportunities for the private sector both in the field of exports and in the domestic market.

5. <u>THE POLICY FRAMEWORK</u>

Mr. Speaker, as I have mentioned more than once already, the Government is committed to building strong foundations for recovery and sustained growth. These foundations rest, as it were, on seven pillars of wisdom. These are: **sound monetary policy, liberalised trade regime, lower taxes and tariffs, efficient and effective tax administration, export incentives, parastatal reform and improved infrastructure.** I would like to assure this House that by the end of 1993, I would bring down the rate of inflation substantially, stabilise the exchange rate, control and lower the budget and balance of payments deficits, stimulate further exports and privatise and divest additional parastatals.

Mr. Speaker, the closely contested elections of last December have mandated the KANU Government to implement the policies framed in its Manifesto. This Manifesto is a multi-dimensional statement of commitment to the welfare of the peoples. It requires, therefore, the close co-operation with all the divergent views expressed by the opposition which is seeking to ensure that any actions outlined in this Budget will truly enhance the welfare of the peoples, not just in the short run but in the long-term too. Good governance, besides providing peace, stability and security, guarantees a respect for the rightful use of freedom which implies duties to all other citizens. The Government has the job of serving the people so as to transform the economy in such a way that economic management will be through an enhanced environment rather than direct intervention. This can be seen through such measures as parastatal reform and privatization, through the liberalization in the foreign exchange regime and the transformations which make for a market oriented set of signals.

This Budget will continue, therefore, the policies outlined in Sessional Paper No. 1 of 1986, on Economic Management for Renewed Growth. Rural-urban balance is a critical way of providing welfare services to the greatest possible number since by far the majority of our population have rural roots. In consequence we must take measures to support the natural resource development in a sustainable way. With this in mind the Government has begun the preparation of a three year Development Plan.

Mr. Speaker, a combination of events on the monetary front led to a substantial growth of money supply towards the end of last year, which generated further inflationary pressures. Once the inflation cancer spreads into the economy, it can only be cured at great costs and like cancer it must be cured immediately. History is full of examples of countries where inflation has undermined the very fabric of democratic societies. The short-term prospects for adjustment in the economy can be easily nullified by inflation. The objective of Government policy is to bring inflation down to an annual average rate of less than 10 percent during the last quarter of this calendar year and to keep it down.

Turning to the exchange rate, Mr. Speaker, our policy is to move towards further harmonisation of the exchange rate. To attain that, the Central Bank of Kenya (CBK) must intervene in the inter-bank market, which means that it has to build up its foreign exchange reserves. One of the objectives of controlling the domestic inflation in the economy is to put a halt to the continuing depreciation of the exchange rate and ultimately, bring about conditions which may allow it even to appreciate. It is expected that the Central Bank of Kenya intervention in the foreign exchange market would bring about this stability.

Monetary Policy

Mr. Speaker the critical objective of Government's monetary policy is to bring sustained stability to the economy which requires not only bringing down consumer price inflation, but also keeping it down. This will be brought about through, among other things, substantial reduction in the rates of growth of money and credit. With the appointment of the new Cabinet at the beginning of this year, we have been able to undertake a number of very strong economic measures. In the financial sector we have aimed at the restoration of financial discipline by a two-fold strategy. On the one hand we have greatly strengthened the use of monetary policy instruments designed to control liquidity and credit, while on the other, measures have been introduced to ensure prudential management of the financial sector.

To bring the money supply under control, the cash ratio was raised from 6% to 8% and the penalties for failing to meet this target were increased. Furthermore, the Central Bank together with the Treasury, have been working through open market operations to dry up excess liquidity. This has included selling five times the normal amount of Treasury Bills on the weekly auctions with consequential rise in the rate of interest. The average interest rate has risen from 20% to over 50% during this period. These measures were supported by the discontinuation of overdrafts at the Central Bank and of the preshipment financing facility. Consistent with this monetary policy stance, it has been necessary to reduce the rate of expansion in the net domestic assets of the banking system, including setting specific limits to lending to the Government. I am convinced that before long we will experience an improvement in our control over inflation.

At present, the financial system functions under a fairly liberalised environment. The growth in the number of institutions together with the adoption of appropriate financial reforms, like the removal of control on interest rates, have enhanced the development of a competitive banking industry. However, there has been a number of institutions which have been suffering financial distress because of mismanagement and poor credit policy. Some of the affected institutions have been operating with cash reserve positions far below the statutory requirement. To enforce the cash ratio, we have introduced a doubling of penalties after 15 days, and those banks which still fail to meet the ratio after 30 days will be put under statutory management. If the financial health and viability of these banks cannot be restored within a reasonable period, their licences will be revoked. In addition prudential guidelines will be strengthened further and today I am gazetting the revocation of all exemptions under the Banking Act and introducing an amendment which will limit the application of section 53 of the Banking Act so as to ensure that inefficient institutions are not able to hide behind such exemptions. Banks which wish for exemptions under the amended Act should reapply. The Government's intention is to inculcate the type of discipline whereby when you go out to borrow from these institutions, you are told of the collateral which you must provide before you can borrow.

As far as the prudential supervision of the financial institutions is concerned, Mr. Speaker, statutory managers have been installed in a number of weak ones while 12 insolvent ones have been liquidated. All of these are indigenous institutions. The Government is distressed by this performance, since so many depositors had trusted them and in which so many have seen their savings vanish. The Government expects the indigenous financial institutions to demand adequate collateral for loans. Non-bankable risk should be handled through the Development Finance Institutions (DFIs). The Government will not condone unsecured loans and it will not hesitate from realising collateral in case of default. As Hon. Members are aware, the Government has directed the National Social Security Fund (NSSF) that it will be allowed to invest its funds in Government paper alone. Therefore we do not expect the weak financial institutions to ask for NSSF funds to support them financially, because the answer will be a definitive NO.

The CBK has initiated special audits for a number of banks and Non-Bank Financial Institutions (NBFIs) so as to provide the necessary information for them to be reviewed by the Special Investment Committee. In order to make certain that we will see financial discipline in the NBFIs we will strictly enforce their liquidity ratio, requiring them to report every 10 days. This measure has been very successful in bringing these institutions into line. Their data have now to be made available within two days if they are to avoid sanctions whereas previously information was delayed by as much as 14 days. From what I have described, it should be clear that we have instilled tight discipline in the financial sector. The importance of a strong financial market and particularly of a disciplined financial sector cannot be overemphasised.

Mr. Speaker, in addition to tight discipline, close co-ordination between the CBK and the Treasury is essential for the effective conduct of monetary policy. The principal objects of the CBK are to regulate the issue of notes and coins, to assist in the development and maintenance of a sound monetary, credit and banking system in Kenya conducive to the orderly and balanced economic development of the country and the external stability of the currency. It is very important that the CBK's paramount objective should be recognised as the control of the rate of inflation.

Mr. Speaker, many overseas investors who have had borrowing facilities from the domestic banking system have had the value of these eroded by the current inflation. While we would wish companies that are subsidiaries of major international corporations to bring in additional foreign exchange, we are aware that corporate policy may not permit this. I am therefore supporting a proposition to expand these companies' domestic borrowing ceilings. But I bear in mind that they will have to compete with other borrowers locally at much higher domestic interest rates than they would have been able to borrow from overseas on the basis of their companies' goodwill.

Fiscal Policy

Mr. Speaker, in controlling inflation, tight monetary policy must of course be supported by a tight fiscal policy as this year's theme asserts. In the past we have contributed to the acceleration of inflation through large budget deficits. In 1992/93 we have once again tried to control the deficit, through both raising of additional revenue and strict control on expenditure. But once again we have failed to control it. Our deficit target for 1993/94 is about 3.0 percent of GDP. I would like to stress that the control of public expenditure cannot be achieved simply by setting targets. We must commit ourselves to the requirement that a continuous examination of each and every department's expenditure and all the functions of Government is carried out. Previously, many of the comments of the Controller and Auditor General regarding unauthorised expenditures have been dismissed lightly. The need to enforce budgetary discipline is of extreme importance. Therefore, accounting officers who incur unauthorised expenditures, will be on their own and failure to provide reasonable explanation will face serious disciplinary actions.

Civil Service Reform

Mr. Speaker Sir, the long-term control of the Budget depends on civil service reform. I say this because the civil servants have responsibilities to the citizens of this nation, which they can only carry out if they have the funds necessary for them to fulfil their duties. There are few things more frustrating than being unable to work when one is willing to. With this in mind, we need to increase the operating and maintenance funding to those Ministries which are responsible for the up-keep of the infrastructure of the economy in all of its characteristics. We spend considerable sums on training civil servants but are not able then to pay them salaries which are competitive with the private sector. Hence there is a loss of continuity among ministerial staff. These unfortunate facts can only be addressed by increasing taxation or by decreasing the demands upon the limited available funding. On the tax side I will seek to gain revenues through efficiency which will, among other things, cause those who have unfortunately resorted to bribery, to pay their due taxes to the Government. On the expenditure side, we must control the growth of the civil service and in fact reduce staffing - but demand higher performance from those who remain. Hon. Members will have observed in their copies of the Economic Survey that the number of civil servants in Central Government in fact declined last year as also have those working in parastatals and Local Government.

Public Investment Programme

As far as Development Expenditure is concerned, Mr. Speaker, we must raise its efficiency through proper resource utilisation. At present, available resources are spread too thinly over an overextended project portfolio, causing unacceptable delays, cost escalation and unpaid bills. The only answer is to concentrate on a smaller number of core and high priority projects which can be provided with adequate funding and be completed quickly. This will call for the reallocation of some resources from projects of lower priority and a restriction on the introduction of new ones. In this respect, the Public Investment Programme is now playing a central role in facilitating the planning and evaluation of the Government's development portfolio prior to the annual budget process.

Mr. Speaker, a further critical review of the public sector project portfolio was carried out earlier this year by the Government Project Review Committee. It examined the core and high priority development projects of all ministries and made recommendations for speeding up their implementation and improving project management and control. The findings of the Committee are being examined and will be incorporated into the coming Public Investment Programme and subsequent budgets, so that the number of projects in our portfolio is reduced and financial resources are concentrated on completing projects quickly. Therefore a more comprehensive review will be undertaken of all development projects and capital investments of all State Corporations, including those that are not dependent on the Government budget but which borrow heavily from the banking system.

Taxation Structure

Mr. Speaker, for a number of years now, the tax structure has been moving towards lower tax rates and broader bases, particularly in the area of indirect taxes. Revenues from indirect taxes on consumption have risen in the last decade from 42% to 54% of total ordinary revenue. This means that the burden of taxes on investment has correspondingly decreased. The tax structure has also been restructured with an emphasis on the promotion of exports. This has improved the economic efficiency of the tax system, while maintaining yields of ordinary revenues at around 22% of GDP.

In the forthcoming fiscal year, Mr. Speaker, we are faced with a difficult task. To contain the deficit and reduce the debt burden, ordinary revenues will have to reach 23.9% of GDP. A revenue yield this high was last achieved in 1980/81. To reach this revenue target I am not going to fall into the trap of increasing tax rates on those already paying tax. Higher tax rates would only serve to undermine our goal of higher economic growth. I intend to keep on the path of lowering and rationalising tax rate structures, but I shall seek to broaden the base in two ways. First, I shall legislate further base expansions. Second, and more importantly, I am going to make the tax system more effective by giving the revenue departments additional ways and means of tightening enforcement measures, speeding up collections, and identifying tax evaders. I shall not seek to increase the tax burden on those who are already bearing their fair share.

Budget Deficit and its Financing

Mr. Speaker, as I said earlier the control of Government expenditures and the budget deficit are critical requirements for maintaining macroeconomic stability and promoting growth processes. In the past we had managed to finance substantial portions of budget deficits through external project and programme loans which were largely concessionary. The economic effects of such financing were positive as these amounted to the use of foreign savings to finance our development. However, when programme finance was cut off, we had to resort to domestic borrowing to finance expenditures. This pattern of financing results in an upward pressure on domestic prices, as well as on the price of foreign exchange. Thus our fiscal policy will be geared towards reducing budget deficit drastically, so that we curtail net domestic borrowing and only borrow to redeem the maturing loans in any given year. This will enable us to create more room for the growth of bank credit to investors in the private sector, who are expected to provide the main thrust for economic growth and development.

Price Decontrol

Mr. Speaker, I now turn to the issue of price controls. There are now only two items, namely a set of petroleum products and pharmaceutical products used for cancer, AIDS, hypertension and diabetes, under the General Price Control Order and one item, namely maize and maize flour, under the Specific Price Control Order. By the end of 1993/94, price control on all items will be abolished. Hon. Members will recall that in 1988 this House passed the Restrictive Trade Practices, Monopolies and Price Control Act, which reconstituted the old Price Control Department into a competition-monitoring authority whose duties, among other things, included overseeing activities of businesses in the market place. Its objective has been to ensure that no consumer, producer or trader is exploited in the liberalised market economy. With the removal of import licensing requirements, local industry will be exposed to competition. It is therefore appropriate that the emphasis be shifted from monitoring price control to combating restrictive trade practices. It is the Government's intention to review this legislation with a view to strengthening and making more effective the Monopolies and Prices Commission which enforces this Act so as to contain and grapple with malpractices by unscrupulous commercial and industrial enterprises which have lead to the escalation of prices.

External Debt

Mr. Speaker, let me turn briefly to the problem of external debt arrears which I have mentioned a few times already. At the end of 1992, Kenya's outstanding external debt stood at a little over SDR 4 billion or US $5.6 billion. On the basis of exchange rates of that time, this amounted to K£ 10.2 billion. About 88 percent of this total was medium and long-term debt to the public sector, comprising of the Central and local Governments, the Central Bank and the parastatals. The rest was private and short-term debt. The total outstanding debt at the end of 1992 amounted to 76 percent of GDP. Interest and redemption obligations on the debt amounted to around 34 percent of the country's total earnings from exports of goods and services.

However, there are some ameliorating features of our debt structure. 58 percent of the debt outstanding at the end of 1992 was owed to multi-lateral finance institutions and another 28 percent to bilateral donors, making up a total of 86 percent. Well over 50 percent of the total debt was concessional in character. The terms of new commitments have improved steadily over time, with the average interest rate coming down for 6 percent in 1984 to 2.5 percent in 1992 and the average maturity going up from 24 years in 1984 to 35 years in 1992.

Mr. Speaker, Kenya has always attached high priority to meeting her external debt service obligations. Despite high exposure to debt and despite the slowing down of overall economic growth and deteriorating balance of payments outturns since 1989, the country remained current in debt service payments until the middle of 1991. However, the situation changed dramatically in the second half of 1991, when external capital inflows slowed down considerably, leading up to the complete freeze on quick disbursing aid flows in November 1991. By the end of the year, debt service arrears of about K£ 300 million or SDR 150 million had been accumulated. It is worth pointing out that the actual inflow of external capital to the public sector in 1991 had fallen short of the amount expected in the earlier part of the year by SDR 170 million which was larger than the debt arrears accumulated during 1991.

Mr. Speaker, as Members are aware, arrears of debt service payments have continued to grow through 1992 and up to the present time. By the end of 1992, debt service arrears stood at SDR 332 million and there were arrears of current payment obligations of about SDR 64 million. As against these total arrears of SDR 396 million the fall in gross capital inflows to the public sector during the two years 1991 and 1992 from the levels visualised in early 1991 amounted to SDR 560 million. What I am suggesting, Mr. Speaker, is that had the inflow of external resources continued on its normal trend, we would have remained current in our debt service payments even today.

The reality, however, is that the arrears have been accumulated and they are big. Mr. Speaker, it is a matter of highest priority on the part of Government to clear the arrears. We shall pay off the arrears as soon as possible, after meeting all current payment obligations, including all current debt service dues. A committee consisting of officials from the Central Bank and the Treasury has been monitoring the arrears. Mr. Speaker, with the recent resumption of quick-disbursing aid flows, and with strong adjustment policies already in place we hope to be able to get out of the arrears tangle in the not-too-distant future.

Export Promotion

Mr. Speaker, recovery and sustained growth rest on export incentives. I would like to highlight the growth of our exports, especially non-traditional ones, which has assisted somewhat in solving our balance of payments problems despite adverse terms of trade and the absence of programme finance. In the absence of growth of traditional exports and the subsequent shortage of foreign exchange to buy essential imported inputs, our economy would have suffered much more than was the case, thanks to the expansion of non-traditional exports which grew by 11% last year. This therefore indicates the importance of a strong export programme to achieve not only a sustainable long term balance of payments position, but also stimulate economic growth that will strengthen the value of our shilling and once again make Kenya a low inflation economy.

I am confident that our economy will become more export oriented. In support of this I wish to highlight that we have made major transformations to the economy in recent years. At the macroeconomic level, we have now liberalised the entire trade regime, removed all but three of 241 price controls and have allowed the rate of exchange to become market oriented. As for the export sector per se, as this House is aware, we have had in place for sometime now six principal export incentives, namely export compensation, duty/VAT remission, export processing zones,the manufacturing under bond, the Kenya Exporter Assistance Scheme (KEAS) and the Kenya Export Development Support. The time has now come to make further improvements to the policy environment affecting our exporters.

Mr. Speaker, export compensation was introduced many years ago, primarily to compensate exporters of eligible products for the additional input costs due solely to the imposition of import duties whose burden was pretty high. However, in recent years the operation of this scheme has been greatly criticised, its administration has proved costly and its impact on export price competitiveness has been limited. In addition, some of our trading partners in Africa have labelled the compensation as a straight subsidy and therefore have taken punitive retaliatory measures against our exports. Furthermore, over a number of years the incidence of import duties have been reduced. These considerations have led the Government to take the view that this facility has outlived its usefulness. In the last three years the percentage compensation rate has been reduced and now stands at only 10%. Along with this facility we had also introduced the facility known as duty/VAT remission administered by the Export Promotion Programmes Office (EPPO) of the Treasury. These schemes are mutually exclusive. The duty/VAT remission scheme has been operating well and is an adequate alternative arrangement to the export compensation scheme. I have therefore decided to abolish the export compensation scheme altogether from 1st September, 1993. This allows exporters sufficient time to quote their net export prices and to make the switch to the duty/VAT remission scheme.

Mr. Speaker, last month, regulations governing the application of the EPPO duty/VAT remission were liberalised, extending the duty and VAT free importation facility currently enjoyed by direct exporters to indirect exporters as well. Indirect exporters are defined as importers who do not import for export directly on their own account but who sell the imports after processing for incorporation in some direct export.

Approval for indirect exporters is given by the EPPO on the basis of a joint application by the indirect and the direct exporters, and the liability for accounting for the duties, etc. is remitted on the imported raw material content, which is passed to the direct exporter with the transfer of goods. They, many a time, are able to source their imported supplies cheaply because of their specialised knowledge of markets and because of quantity discounts on large volumes. The liberalised regulations will encourage direct exporters to take advantage of the reduced cost of inputs from local sources as provided by these indirect exporters with a remission of duty and VAT on import content. I am sure this scheme will generate more exports and value added locally, and create additional employment while enhancing foreign exchange and attracting more investment into the country.

Another feature of our export promotion that needs encouragement is the processing of raw materials for exports, owned by an overseas client and purchased with his own foreign exchange from abroad, by a local manufacturer on the basis of 'contract manufacturing'. Today I am announcing that the CBK will abolish the 2% fee charged by it on all EPPO imports for use in domestic manufacture, where the raw materials are owned outside of Kenya and the manufacture is done under contract to the foreign owner of the goods. I am confident that a lot of overseas clients will take advantage of this relief to have their goods processed in Kenya, since now it will be less costly to do so.

Mr. Speaker, I now wish to refer to the operations of establishments in the Export Processing Zones (EPZs). These zones have proved to be a powerful engine for export growth currently generating over 1,000 jobs. To date the Government has approved six private sector zones, in addition to the public sector zone at Athi River. Altogether, 13 companies are presently operating successfully under EPZs and 5 have been given approvals to commence operations. Phase I of the Athi River Zone will become fully operational by next month and already 100 applications for space are being processed. However, certain anomalies have been detected from the operation of the EPZ Act. Currently, the eligible export-related activities undertaken within the zones are restricted to manufacturing and/or commercial activities. I am, therefore, proposing an amendment to the Act to permit the extension of eligible activity to include export related services other than commercial activities such as consultancy, information services, brokerage and repair services, whether these are provided to other EPZ companies, or sold abroad, or indeed provided against foreign exchange to customers operating within the Kenya customs territory.

Mr. Speaker, the Government is aware that some companies are attracted as enterprises in our export processing zones because their export focus is in Africa, particularly to the PTA region and they regard access to Kenyan domestic market as a significant factor in their overall exporting strategies. At present the access to the Kenyan market by EPZ companies remains open provided all duties are paid and normal Customs controls are complied with. However, I am conscious of the need to ensure that the special tax and other privileges enjoyed by the EPZ enterprises, should not be allowed to give these companies an overwhelming competitive advantage over companies currently operating within the Customs territory. The Government's intention is that the EPZ companies should focus their sales efforts abroad and that their sales into the local market should constitute a small proportion of their overall sales. I am therefore proposing that the Customs and Excise impose a 5% surcharge in addition to normal import duties and VAT, on the value for duty of all sales of goods by EPZ into the domestic market. This will apply during the accounting periods that the EPZ enterprise is exempt from income tax. This measure will provide a level playing field for both the domestic and EPZ enterprises with respect to Kenya market.

Mr. Speaker, I turn now to export promotion through Manufacturing Under Bond (MUB). Since 1988, 21 enterprises have commenced operations and the impact of the programme has remained modest in relation to expectations. With the current restriction that all sales other than waste and rejects must be made to export markets, it has been found that the enterprises operating under MUBs are not sufficiently motivated to explore alternative marketing arrangements aggressively, since the cost to them of export failure is high. The great majority of them limit their exports to contract manufacturing where a single buyer absorbs all or most of the production and where the primary consideration is the cost of the cheap labour. Consequently, margins are low and export initiative tends to be blunted. To overcome this restriction while maintaining the focus of MUB activity firmly fixed on export promotion, I propose the extension of the surcharge to be levied by Customs and Excise on the value for duty of all sales of goods into the domestic market in addition to normal import duties and VAT. However, as the MUBs will continue to pay income tax, the proposed tax would be lower than that applicable to EPZ enterprises. Accordingly the surcharge rate proposed is set at 2.5%. I am hoping that the removal of this restriction will enable the MUBs to develop additional exports.

Mr. Speaker, finally I would like to take as an example of what can be done, the Kenya Exporter Assistance Scheme, which was set up a bit over a year ago to provide grant assistance to exporters seeking new markets. It targeted on return of two US dollars for every one given out: to date they are recording fourteen dollars for each one granted. They have assisted 130 companies and financed export efforts to 43 countries. They have supported market development for such new export ventures as jewellery, paint, plastic trays, furniture and computer software to give a flavour for the exciting diversity of what can succeed. I am sure that the horticultural support through Kenya Export Development Support will yield similar benefits.

Parastatal Reform

Mr. Speaker, in the last several budget speeches, the problems of the parastatal sector were highlighted to this House and I continue to do so now. From 1986-90 productivity in this sector worsened by about 2 percent annually, while in the private sector it improved by 5 percent per annum during the same period. This meant that the parastatal sector used the resources at its disposal inefficiently, aggravated pressures on the fiscal deficit as a result of its demands on the exchequer and continued its statutory monopoly which stifled competition. These factors held back private sector development and decelerated economic growth. It was obvious therefore that more of the available resources were needed to be released to the private sector through a comprehensive parastatal reform and privatisation programme.

As was promised in the last budget speech, in July, 1992 the Government published a policy paper entitled 'Parastatal Reform and Privatisation Programme', This was designed to outline simultaneous progress on privatisation and divestiture of non-strategic parastatals and their reform together with the commercialisation of strategic parastatals. The core activities of these were to be retained under public ownership. I would like the Hon. Members to note the progress achieved so far in the reform of both strategic and non-strategic parastatals.

In the area of strategic parastatals we have been working particularly with the World Bank, so as to build up an orderly programme for the reform of these key institutions. Firstly, I am happy to announce that we have established monitorable targets on such organisations as Kenya Posts and Telecommunications, Kenya Railways, Kenya Power and Lighting Company and the National Cereals and Produce Board. These monitorable targets address not only staffing but also investment, debt service, revenues, etc., and should ensure that these organisations will not be able to disrupt the Budget. In the event of these measures being successful ways of inculcating discipline into these institutions, I intend to expand this to other strategic parastatals. I will also be bringing forward ways to ensure their managements will be held accountable.

Secondly, the newly established Department of Government Investments and Public Enterprises in the Treasury has completed the reconciliation of debts for most of the loans and investments made by the Treasury in these parastatals. Thirdly, a study for identification of direct and indirect subsidies and other financial flows from Treasury to the parastatal sector was completed and an action plan developed to gradually mitigate the subsidies by commercialising their operations. In addition, a preliminary design of a safety net at the national level has been developed and policy guidelines to operate it have been outlined.

As far as the non-strategic parastatals are concerned, I am aware that there is some concern about the slowness of our divestiture procedure, but we are excessively keen that there should be no possibility of our being accused, at some later date, of sales that were not fully transparent. But despite this careful approach we have successfully moved the programme forward. By April this year, the Parastatal Reform Programme Committee had accomplished privatisation of 4 parastatals through the Nairobi Stock Exchange, 5 through pre-emption rights and negotiated sale and 5 through receivership and voluntary liquidation, while 11 were struck-off the Registrar of Companies.

Mr. Speaker, as far as the strategy for restructuring strategic parastatals is concerned, it is important to note that it contains a major reform called the Corporate Governance System. The main thrust of the reforms under this system is to achieve firstly, the separation between ownership and management functions and secondly, enhanced autonomy and accountability. The success of the reforms will depend upon good practices and the necessary legislative framework. Therefore in the near future, I intend to introduce to this House relevant amendments to the State Corporations Act, the Exchequer and Audit Act and the Permanent Secretary to the Treasury (Incorporation) Act. These amendments will pave the way for the recruitment, appointment and dismissal of Board Members and Chief Executives through a professionally managed process. In addition, these reforms will also facilitate the introduction of performance linked award and sanction system for Board Members, Chief Executives and Senior Management of parastatals.

Mr. Speaker, I am also strengthening the fiscal discipline by announcing that all loans on-lent to them will from now on carry market rates of interest. In addition, they will pay a guarantee fee of 2% annually on outstanding debt to the Treasury when they borrow under Treasury's guarantee.

Subsidised debt and debt defaults have been identified to be the single most important subsidy to parastatals and the Treasury together with parent ministries, intends to enforce fiscal discipline by holding Boards of parastatals accountable for such defaults. The Treasury will also require the Auditor General (Corporations) and other auditors to clear the backlog and reconcile the parastatal accounts with the Appropriation Accounts, before the annual accounts are published. Moreover the report of the Auditor General (Corporations) will be the basis upon which the accountability of these parastatals will be determined. The reconciliation of accounts will eliminate excuses for withholding payments and reinforce financial discipline. Furthermore, all ministries and departments will be required to clear their outstanding debts for water, telephone and other utilities. In some cases, arrears now exceed the equivalent of three year's consumption and the Treasury therefore may withhold in future, funds allocated in budgets for ministries and clear these debts outstanding on their behalf.

Mr. Speaker, it is important to note that in this year's Finance Bill I am introducing measures whereby employees displaced under the parastatal reform programme will be assisted with safety net payments and related tax benefits such as tax exemption on severance payments, tax free early pension payments and a limited tax free gratuity payments on a case by case basis, once specific parastatals, time limits and other special conditions are established.

Agricultural Reform

Mr. Speaker, agriculture remains the backbone of the Kenyan economy and the severe constraints of inadequate rainfall, insufficient foreign exchange and adverse terms of trade have not spared this sector. In addition, certain structural rigidities like poor marketing, payment and pricing systems have affected this sector adversely. Since these problems have constrained this sector's growth potential for some time, the policy response prescribed requires a long term perspective and indeed a difficult adjustment process. The three main areas which need special attention are food security, agricultural inputs and pricing policy.

Sustainable domestic food self-sufficiency remains the primary objective of Kenya's agricultural development policy. A plan for attaining food security which depends overwhelmingly on government resources, is no longer sustainable due to budgetary constraints. An enhanced role of the private sector and a competitive free market for agricultural commodities is now being viewed as the key to the attainment of this goal. It is a fact that the marketing and pricing systems have been mostly controlled by Government and hence the Government's primary policy response will be accelerated liberalisation of the marketing system and price decontrols.

Towards this goal a major policy paper is being developed by the Ministry of Agriculture. The problems of food security are also inter-linked with the performance of the National Cereals and Produce Board (NCPB) which as I remarked earlier is now subject to monitorable targets.

Mr. Speaker, as far as agricultural inputs are concerned, the availability of fertilisers, chemicals, feeds and fuels, are considered the most critical. In 1989, a policy shift in marketing of inputs was accomplished with the decontrol of prices of fertiliser and of other inputs. Although, immediate price adjustments occurred in these inputs, the decrease in their application was attributed more to declining returns to investment in these inputs than to their relative prices. The issue of their affordability to the average farmer still remains unresolved. The solution to this problem will come mainly through pricing policy reform which is underway for most of the commodities. It is expected that once agricultural marketing and the pricing system are fully liberalised, producer prices will become more responsive to input costs to ensure adequate returns to investment in modern inputs.

Mr. Speaker, I now turn to pricing policy. Rapid implementation of price decontrol is in acknowledgement of the free market forces to determine prices and allocate resources efficiently. Although the nature of agriculture requires a long adjustment period before the results of liberalisation can be evaluated, recent experience suggests that there is some reason for optimism. For example, production of pigs, beef and milk have shown signs of recovery. It is too early to expect any supply response from the recently decontrolled prices of wheat and sugar but we are confident that farmers will benefit and respond appropriately. The process of liberalisation of maize prices will be undertaken gradually, to safeguard the interests of the consumer and allow for a smooth adjustment to changing prices. During the regime of price control, producer and consumer prices for most agricultural commodities had been set below their true market levels, thus constituting a disincentive to investment and growth. Price policy reform will therefore be the key ingredient of agricultural development strategy in the 1990s.

Small-Scale Industries and Enterprises

Mr. Speaker, Sessional Paper No. 2 of March, 1992 provides comprehensive policy guidelines for promoting the development of small-scale enterprises in Kenya. A database on institutions involved in small-scale enterprise development activities has been established. This facility is particularly important for the small-scale entrepreneurs wishing to know where to go for specific assistance. As far as ownership of industrial sheds is concerned, over 60% of the sheds constructed for small-scale and Jua Kali enterprises have had their ownership transferred to the target beneficiaries, and some of the entrepreneurs can now use the facilities as collateral to secure loan from the banking sector. Progress has also been realised in sensitising the banking sector to be more receptive to the needs of the sector and there are special credit programmes in all the major commercial banks and financial institutions to assist this sector.

Rural-Urban Balance

The strategy of rural-urban balance has been in place since 1986. This strategy implemented through the District Development Committees, the Rural Development Fund, the Rural Trade and Production Centres with some inputs from local authorities has not been very successful. However, wage employment has increased between 1987 and 1992 somewhat. For example, in Kericho employment grew by 24 percent during this period. This indicates that the policy of rural urban balance has had some impact. The number of urban centres has increased tremendously in the past few years. The urban population has increased equally substantially. However, a large part of this population has concentrated in Nairobi and Mombasa. The Government will, therefore, put special emphasis on greater co-ordination between development of local authority and rural development programmes. This would entail the provision of infrastructure, the priority of which will be based on the elevated status of local authorities. Towards the objective of controlling expenditures at district levels, the accounting officers in various ministries will have to make sure that the message of accountability also reaches the operations of the District Development Committees.

Education

Mr. Speaker, I would now like to consider the education sector which has faced many challenges amongst which the main ones are the rapid increase in enrolments at all levels, the wastage of resources due to high level of drop-outs and the financial constraints. The Government has consistently pursued policies aimed at expanding, strengthening and reaffirming the spread and quality of education. Its overall objective is to provide education to all so as to improve the quality of life of Kenyans in general. Therefore the measures adopted range from waiving school fees in primary schools and strengthening the adult literacy programme, to construction of boarding schools in Arid and Semi-Arid Land (ASAL) areas. However, the Government is very much concerned about the high public expenditure on education and, therefore, has introduced cost sharing at all levels. It has confined the provision of

grants to poor students, especially those in the universities, whose parents cannot afford university fees and to the disadvantaged groups such as the physically handicapped. The Government will continue to assist students to pay for their higher education through loans, scholarships, grants and bursaries but this assistance will be made available in cases of financial need. The needy cases and the amount of assistance to be given to each student will be determined through a means-testing.The loans given to the students will attract interest rates which will be reviewed annually, with a view to progressively eliminating subsidies and make the interest rates positive in real terms.

To administer the loan scheme, the Government is going to establish an independent body, with corporate status and sufficient legal backing. In addition, in conjunction with international donor agencies, it will continue providing facilities and text books for mathematics, English and science to the selected primary schools in the ASAL districts.

Mr. Speaker, in order to improve the quality of education, the Government will continue to review the 8-4-4 education system curriculum content with a view to ensuring that it is relevant to the changing needs of this country. It will also continue to expand teacher training so that untrained teachers can be trained and those who were initially trained for the old system be retrained. Towards this objective, the Government in conjunction with financial assistance from donors, has already embarked on retraining of trained teachers so that they improve their skills in teaching sciences, practical subjects and languages. The Government will continue to encourage such co-operation with NGOs, donors and international agencies in mobilising resources for the development of the education sector.

Health

Mr. Speaker, turning to health services, per capita health expenditure in Kenya has shown a downward trend over the last few years. We are committed to maintain health care expenditures in real terms in line with inflation and population growth and we anticipate offering a much better health care service in 1993/94. The need for curative services is immediate and undeniable. When people are sick, they need treatment for sickness and this cannot be denied. The government facilities need to respond to these demands. However, there is a need to shift because preventive services are much more cost effective in saving lives and alleviating suffering. Curative health services accrue exclusively to individuals and therefore it is feasible and efficient to impose user charges for those who are able to pay. Our policy is to use user charges to actually increase health care spending per person, and also to increase them, so as to buy additional drugs and medical supplies to fund preventive services in the local areas to some extent. To alleviate the burden of these user charges on the poor and other vulnerable groups, a system of exemptions and waivers have been introduced. The Government will carefully monitor the effectiveness of both the collection of user fees and the exemption and waiver system, while reviewing fee rates periodically and adjusting them in line with inflation and the individual's ability to pay.

Mr. Speaker, an alternative to shifting responsibility for curative services to individuals is to expand the population covered by national health insurance. The National Hospital Insurance Fund (NHIF) is the main health insurer in Kenya, covering about one million members who, together with their families, make up about 8 million eligible members. The NHIF fees are based on a graduated scale dependent on salary while benefits are limited to a maximum flat amount to cover all expenses incurred per day for in-patient charges which vary by institution. Major health care expenses such as operation costs, are not covered. There is no coverage for either catastrophic health insurance or out-patient treatment. The possibility of replacing compulsory membership in the NHIF with approved private health schemes will therefore be examined for certain large groups of private sector employees. The majority of Kenyans are not covered by any form of health insurance and so a means must be found to induce them to join such schemes and thereby finance a larger share of curative services out of insurance.

Mr. Speaker, the cost and availability of medicines has created a lot of concern recently, particularly with measures to liberalise the economy. The Ministry of Health has been given its own tender board for the procurement of drugs. Therefore, it will be expected that drugs, will be sourced competitively with local producers benefitting from their rendering concession. Increasingly, private and public institutions are sourcing their supplies of medicines, quality surgical instruments and machinery from developing Asian countries like China and India, because these items are manufactured in those location under licence and are much cheaper than sourcing them from the traditional European suppliers.

6. FINANCIAL OUTTURN 1992/93

Recurrent Revenue

Mr. Speaker, I now turn to this year's Budget Out-turn. In the original budget for 1992/93 ordinary revenue was estimated at K£

3,106.9 million, net of export compensation payments. Another K£ 88.3 million were expected to be available from Appropriations-in-Aid, making up total available recurrent revenue of K£ 3,195.2 million. The ordinary revenue was to comprise of K£ 1,074.8 million from VAT, K£ 922.0 million from Income Tax, K£ 734.5 from Customs and Excise, and K£ 375.6 million from all other taxes, dividends and fees. Mr. Speaker, the revised estimates for 1992/93 show that I may realise a total recurrent revenue of K£ 3,292.1 million, which is K£ 96.9 million higher than the original estimates.

The actual total collection under ordinary revenue is likely to be substantially higher by K£ 93.3 million, while total collection under Appropriation -in-Aid is expected to be higher by K£ 3.6 million. Within the total of ordinary revenue, there have been some differences in the performance of different taxes. Mr. Speaker, I mentioned before that the overall growth in economic activity in 1992 was way below our modest expectation of 2.6 percent. The 4.0 percent decline in volume of imports in 1992 was anticipated. However, we had expected a rebound of imports from the beginning of 1993 which did not take place.

These factors tended to depress the collection of revenue. On the other hand, growth rate of the GDP deflator at 18.0 percent. turned out to be higher than our original expectation of 15.0 percent. In addition, there have been very substantial changes in the nominal exchange rate recently which have raised significantly the shilling value of imports for the last few months of the current financial year. Finally, the efficiency of tax collection has improved further, thus continuing a trend which was observed during the last two fiscal years.

Mr. Speaker, I now expect to raise K£ 1,070.9 million from VAT, K£ 975.0 million from Income Tax, K£ 755.0 million from ~~Customs and Excise, and K£ 399.3 million from other~~ sources in 1992/93.

Recurrent Expenditure

Mr. Speaker, as the Hon. Members are aware, this House recently approved the Supplementary Appropriation Bill to meet additional expenditures during the current year on account of elections, salaries and allowances for teachers and civil servants, and some high priority expenditures on internal security, particularly to deal with the influx of refugees. As shown in the Financial Statement, this year's recurrent expenditures will therefore increase by about K£ 155.5 million.

As far as Consolidated Fund Service payments were concerned, I anticipate a substantial increase of about K£ 755.0 million over the levels we had planned in the beginning of the year. Of this, K£ 238.0 million represents the additional domestic interest payments that the Treasury will be making this year due to the recent sharp rise in interest rates following attempts by monetary authorities to mop up excess liquidity from the domestic credit market. This is a price the Government has to pay to control inflation. Foreign interest payments are expected to increase by about K£ 219.0 million compared to the planned level due to the depreciation of our currency.

In addition, Excess Votes and Under Issues relating to previous years had to be financed amounting to K£ 73.4 million.

Mr. Speaker, I therefore expect this year's gross recurrent expenditures, together with Excess Votes and Under Issues to be K£ 5,197.6 million, compared with an expected total recurrent revenue of K£ 3,292.1 million. Thus there will be no surplus in the recurrent account to finance development expenditures.

Development Expenditures

Mr. Speaker, continuing a system that was developed during the last financial year,the Treasury has been monitoring the revenue collection and expenditure trends very closely with a view to controlling the budget deficit and domestic borrowing. One factor that tended to push up the deficit was a shortfall of about K£40.0 million in the actual realization of programme grants during this year. In an attempt to keep the deficit down, development issues were released to the Ministries only when cash was available in the Exchequer. However, Ministries were given authority to overdraw their cash books to meet expenditures on very high priority projects and programmes. As a result of such tight monitoring and control, I expect the Gross Development Expenditure this year to be limited to around K£ 1,088.2 million, which is K£ 244.4 million less than what was approved in the Supplementary Appropriations.

In addition, I had to finance Excess Votes and Under Issues under the development vote of about K£ 83.5 million.

As a result of these developments namely a shortfall in the realization of programme grants, a very large increase in domestic and foreign interest payments, and supplementary recurrent expenditures, I expect this year's budget deficit to escalate around K£ 725.0 million or about 5.0 % of the GDP.

7. FORECAST OUT-TURN FOR 1993/94

Expenditure

Mr. Speaker, as I had mentioned before, the most important short-term economic objective of the Government is to reduce inflation. It is only through achieving this objective that we can stabilize the economy, strengthen the Shilling, promote investment and exports, and renew the growth process in the economy. To reduce inflation we must reduce the growth of money supply; this in turn means that we have to adjust our expenditures to the resources available and not resort to domestic borrowing on a large scale to finance the budget deficit.

Thus during 1993/94 there will be very little real growth of recurrent and development expenditures. All Ministries and Departments will confine their expenditures to the most important and unavoidable activities and programmes. No funds will be made available for starting new services or projects.

Mr. Speaker, in framing the recurrent expenditure proposals for 1993/94, the Government had to make enough allocations for the increases in salaries and allowances of civil servants and teachers, as well as for the payment of the third and final phase of the increases awarded by the Mbithi Committee.

Mr. Speaker, the expenditure proposals I am making this year are different in many respects from the past budgets. Although there is a decline in the volume of Ministry expenditures in real terms due to our concern for reducing inflation, a number of changes have been put in place to improve the allocational aspects of the budget which will contribute to a more productive use of the available resources. Without going into too many details, I would like to highlight some of the more important changes that have been incorporated in the budget.

Hon. Members will recall that H.E. The President has expressed his concern repeatedly on the social consequences of economic adjustment and on the need for the Government to take special measures to protect the welfare of the poorer sections of our society. In line with this concern, substantial budget provisions have been made in the estimates to implement a number of programmes to ease the burden of economic adjustment, especially on the vulnerable sections of our population. These include an allocation of K£ 110.0 million in the recurrent estimates for implementing a number of special programmes such as paying bursaries for fees in secondary schools for children of poor parents, increasing supply of drugs and other material for health services in rural areas, improving maintenance of water project in rural areas and providing for food security (for the supply of maize), particularly in the arid and semi-arid regions. A further allocation of K£ 35 million has been made in the development estimates for site and service improvements for housing the urban poor, and rural industrial development and employment generation programmes for the development of Jua Kali enterprises including investment in infrastructure.

Secondly, with this budget, the Government is making a beginning to rebuild our physical infrastructure, especially the road network - including the upgrading and improvement of rural access roads, particularly those that will enhance the quicker marketing of our agricultural and livestock produce. A special allocation of K£ 25 million has been earmarked for this purpose. I intend to introduce a dedicated fuel tax for road maintenance in the future. I hope that there will also be substantial additional funding for this programme through grants and soft loans from the donor community.

Thirdly, the development budget I am proposing for 1993/94 also includes a provision of K£ 100 million for distribution of maize by the NCPB. As the Hon. Members are aware, the Government would have moved ahead in liberalizing maize marketing, but for the adverse rainfall patterns during the last two years leading to a shortage of maize. This is indeed a reflection of our commitment to ensure the adequate availability of our staple food, at reasonable prices to the wananchi.

Fourthly Mr. Speaker, the Government is committed to bringing about a major restructuring of the civil service to make it more productive and to release financial resources for public investments. The restructuring which will be implemented in the next financial year is also a very important national programme for improving public sector efficiency. The budget for 1993/94 has allocated a sum of K£ 76.6 million to implement the first phase of the Civil Service Reform, particularly to provide a viable safety net for such civil servants and employees of State Corporations who may be rendered redundant.

Mr.Speaker, as I said earlier, the expenditure proposals being presented today also provide for the payment of the third and final instalment of salary increase to civil servants as per the recommendations of the Mbithi Committee. However, this increase in salaries which will become effective from 1st July, 1993 is meant to compensate for past inflation. Therefore the Government has also earmarked an additional K£ 100 million in this budget for providing relief from the recent increase in prices. The details of the proposed increases are being worked out and will be finalised very soon. I am confident that these measures will give considerable relief to Government employees and will encourage them to work even harder.

Apart from the above major allocations, the budget I am proposing also reflects a substantial level of assistance by the international donor community for general budget support through the resumption of quick-disbursing balance of payments assistance as well as for implementing a number of very high priority national projects. I would, therefore, request the Hon. Members to join me in expressing our gratitude to the foreign governments and bi-lateral and multi-lateral institutions that have promised financial support to our developmental efforts.

Programme grants and loans are projected to increase from K£ 333.1 million this year or about 5.4% of the total Government expenditures to K£ 880.2 million or 11.2% of the total expenditures. I am sure that as the year progresses more such programme assistance will be received easing our foreign exchange situation as well as reducing the domestic borrowing by the Government to finance the budget deficit. Mr. Speaker, this is indeed a very strong reflection of the confidence that the international donor community has in our Government, particularly in the manner in which we have implemented major political and economic reforms within a very short period.

Mr. Speaker, although the Hon. Members will have adequate opportunity to discuss the various projects under the different votes, I would like to highlight some of the major donor-financed projects included in the budget, merely to illustrate the main thrust of our development efforts.

Perhaps the most important programme that will be financed next year is the Drought Recovery Programme which is being implemented with assistance from the World Bank and for which an allocation of K£ 18.53 million has been made in the budget. This programme which is already being implemented by the Office of the President is yet another reflection of the Government's commitment to provide quick assistance to relieve the economic hardship of people in the drought affected regions. Mr. Speaker, this allocation is in addition to the K£ 10.98 million financed by a World Food Programme grant for food assistance to children in primary and pre-primary schools in such areas.

Mr. Speaker, the single largest allocation in the Development budget for next year is for the procurement of equipment for the Kenyatta National Hospital with generous grant assistance for which an allocation of K£ 39 million has been made. The Nairobi Water Supply project being implemented with financial assistance from a consortium of donors is the second largest project for which an amount of K£ 38.34 million has been set aside in the budget for further expenditures during 1993/94. Large investments totalling about K£ 72.93 million are also included in the development budget for preservation of wildlife and the management of protected areas with financial assistance from yet another broad based consortium.

Mr. Speaker, in line with our national commitment to develop human resources, the development budget has also set aside large sums for investments in the education sector. These include an allocation of K£ 22 million for the Universities Investment Project and K£ 13.8 million for the Sixth Education project, both financed by external concessionary loans from the World Bank. Other major allocations in the development budget include K£ 14 million earmarked for completing the construction of the Export Processing Zone at Athi River and K£ 19.5 million for Coast Water Supply Project.

As the Hon. Members might have seen from their copies of 1993/94 Printed Estimates, the gross recurrent expenditures of Ministries will be K£ 2,733.0 million, financed partly by Appropriations-in-Aid of K£ 155 million. The projected expenditures on Consolidated Fund Services payments are K£ 3,790.2 million, of which K£ 1,388.2 million is accounted for by internal loan redemption involving the roll-over of existing internal loans, becoming due for repayment in 1993/94. Foreign interest payments are expected to be around K£ 506.6 million and domestic interest payments will be of the order of K£ 884.2 million.

I shall also have to provide for Excess Votes and Under Issues relating to earlier years amounting to K£ 78.1 million. Thus the total gross recurrent expenditures in 1993/94 will amount to K£ 6,601.3 million.

Development expenditures in 1993/94 will be around K£ 1,289.5 million, which includes an Appropriations-in-Aid of K£ 675.3 million. In addition, I will have to finance Excess Votes and Under Issues of K£ 214.7 million pertaining to previous years, making the total expenditure in 1993/94 on development account K£ 1,504.2 million.

Thus a total gross expenditure of K£ 8,105.5 million will have to be financed during 1993/94, and I shall now go into how I propose to finance these expenditures.

External Revenue

Mr. Speaker, the international donor community has continued its support for our efforts for the rapid development of the nation, by committing assistance in the form of concessionary loans and grants. As I have mentioned already, the suspension of quick disbursing programme aid from the multilateral donors which was imposed in November 1991 has been lifted recently. Thus in 1993/94 we expect a total external assistance of K£ 1,827.2 million. Of this, about 33 percent or K£ 601.1 million will be in the form of project and programme grants and the remainder in the form of project and programme loans. Thus I will be able to finance 22.5 percent of the total expenditure from external resources.

I shall now turn to how I intend to raise the balance of K£ 6,278.3 million.

Domestic Borrowing

Mr. Speaker, I have stressed before our objective of bringing down the level of borrowing from domestic sources for financing the budget deficit, so that more resources can be left at the disposal of the private sector. The gross borrowing from domestic sources planned for 1993/94 is K£ 1,809.1 million, which is about the same as the expected gross borrowing of K£ 1,810.9 million for this year. It should also be noted that K£ 1,388.2 million of this gross borrowing will be directed towards recycling maturing debt and another K£ 293.2 million will be accounting adjustment for expenditure already incurred, leaving a **net** borrowing of only K£ 127.7 million, compared with an estimated net borrowing of K£ 874.3 million during the current financial year.

Again, consistent with our policy of reducing the inflationary impact of the budget deficit, we propose to raise all of the additional domestic loans from non-bank sources.

Internal Revenue

Mr. Speaker, the economy has performed poorly in 1992. For reasons already stated, I do not expect significant recovery to begin before the end of this calendar year. Our current forecast is a real growth rate of 3.3 percent during the financial year 1993/94, compared to a forecast level of about 1.0 percent for 1992/93. The implicit GDP deflator is expected to be somewhat lower in 1993/94 at about 15.0 percent compared with 17.0 percent for 1992/93. On this basis, I expect to collect, at present rates of taxation, a total ordinary revenue of K£ 4,109.0 million, **net** of export compensation payments. Appropriations-in-Aid will provide another K£ 95.0 million.

Thus I shall raise a total of K£ 7,840.3 million from all these sources. I have, therefore, a gap of K£ 265.2 million to be financed through additional tax measures. The rest of my speech will deal with how I intend to do this.

8. TAXATION PROPOSALS

Mr. Speaker, I have already appraised the House on the economic outlook of the industrialised and newly industrialised countries, the potential in the Sub-Saharan region and the prospect for growth in our own country. I have also formulated a policy framework that will reverse the inflationary trend, encourage export-led growth and facilitate market-based efficiency: these will encourage higher growth by way of the private sector.

Mr. Speaker, the tax proposals I announce today are part of our continuing **tax modernisation** exercise which is aimed at reforming Kenya's taxation system. This programme, to a large extent, has rationalised import duties, excise rates, VAT and income taxes. Additionally, it has introduced computerisation within the revenue collecting departments aiming at furthering efficiency in tax collections, sharpening work incentives and improving efficiency in the economy by identifying and removing tax based distortions. I would like to record that in the current financial year, the revenue collection performance has been so good that tax collection has been above target despite the absence of foreign inflows and the depressed state of the economy.

I have indicated to this august House that I have a financing gap of K£ 265.2 million. I now turn to my taxation proposals to close this gap. These proposals include underwriting the necessary tax effort to raise additional revenues and continue the modernisation of the tax system.

Mr Speaker, every taxpaying Kenyan would prefer that I close this gap by raising more revenue out of the existing tax bases rather than increasing tax rates on those Kenyans that are already bearing a heavy burden. Our revenue departments have been doing an excellent job to date; they have been collecting over 160 shillings for every shilling of operating expenditures based on funding of well below one per cent of their tax collections. It is clear that by increasing their level of funding that significant increases can be gained in revenue yields. Tax collection requires that tax officers have the tools and resources at their disposal to do their job effectively and efficiently. They also need funds to supply the taxpaying public with improved information services on the operation of the tax systems to reduce their costs of compliance.

Mr Speaker, the funding of the revenue departments in recent years has been falling and is significantly below internationally accepted levels for efficient tax collection. To begin to rectify this situation, I have struck a bargain with the Commissioners of the revenue departments that they will give Kenya an even more effective and fairer tax system, if I guarantee them an increased funding level of a minimum of one percent of their target revenues. I have already instructed the Treasury to make all the arrangements so that the supplementary funding is fully available to the revenue departments by the 1st July. The new fiscal year will see not only a modernised tax system, but a rejuvenated and effective one.

As is conventional, 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.

Customs Tariff

Mr. Speaker, the Finance Bill published today contains some important amendments to the Customs and Excise Act. I have classified them into two categories - those with no revenue implications and those that have. Some of the changes are aimed at correcting errors and omissions while others are aimed at rectifying a few anomalies. As is customary, I would like to deal initially with those amendments which have no direct revenue implications.

First, I refer to the amendment last year to Section 138 of the Act which has been misinterpreted. The amendment was intended to cover only raw materials and component parts for use in the manufacture of insecticides, fungicides and similar products as well as manufacture of agricultural and horticultural implements. Instead the law was interpreted to include importation of prepared insecticides and fungicides. The revised proposals therefore exclude importation of such manufactured items as was originally intended.

Second, currently under the law import duties are payable from the date of importation where a condition for temporary importation has been contravened and goods must then be re-exported within twelve months unless the Minister directs otherwise. Many cases of misuse have been reported in which people have imported passenger cars and commercial vehicles for temporary use, while looking for prospective buyers thereby circumventing prohibitions and restrictions. I am therefore proposing a punitive measure when an importer contravenes the condition of temporary importation of goods.

Third, under the present law, construction projects belonging to diplomatic missions or the United Nations and its specialised agencies, have had their materials and equipment exempted from duty under Section 138 of the Act and not under the Third Schedule, since the materials and equipment are always imported by the contractors. Following the amendment of Section 138 of the Act last year, no provision exists for remission of duty to cover such cases. It is therefore proposed that such goods will be allowed to be imported under "Diplomatic Privileges" in the Third Schedule of the Act, where specific exemption will be granted by the Treasury following a written justification and recommendation in each case by the Minister for Foreign Affairs and International Co-operation.

Fourth, under the existing law exemption of import duty is permitted in respect of official aid funded projects. However, confusion has arisen as to the scope of this exemption. Some official aid institutions provide funds on a grant basis, others on concessional terms, and the rest on commercial terms. Since it is wrong to allow duty exemptions on imports for projects funded by costly commercial loans, I am proposing an amendment which limits duty exemptions to imports under projects funded by grants and concessional loans, where concessional loans have a minimum of a 25% grant element, while imports funded by commercial loans even if provided by official aid institutions are treated as regular imports and subject to customs duty. Already the current law establishes a relief of all but a minimum import duty rate for imports of machinery and equipment if funded by commercial loans, provided that the projects using them generate or save foreign exchange.

Fifth, these existing provisions regarding the application procedure for the minimum duty rate on investment goods which are expected to generate or save net foreign exchange, need clarification. I am, therefore, proposing amendments so that the application be considered only if the investment goods have a minimum f.o.b. value of Shs. 5 million and are accompanied by proforma invoices from suppliers or other independent estimates of the value of the proposed imports, together with proof of the source and commitment of foreign finance, as well as a feasibility study of the investment.

Sixth, to date lubricating oils blended in bond in Kenya have been subjected to import duties based on the component oils and additives. This procedure has resulted in uncertainty and complications. I am therefore proposing to switch to the same procedure used for refined oil products, namely to tax the blended oil when brought into home use.

Seventh, under the present tariff structure, domestic producers have to pay import duties on inputs to publish books or to manufacture items such as agricultural equipment, fertilisers or pharmaceuticals, which if they are imported are duty free and zero rated under the VAT Act. Therefore, the domestic producers of these duty free items are at a competitive disadvantage compared to importers and are essentially faced with negative protection. In addition, the delay in refunds from the VAT Department exacerbated this disadvantage. The result is that it has been cheaper to import the finished products than to produce them locally. After consultation with the private sector, I am, therefore, introducing today the <u>Essential Goods Production Support Programme</u>. This programme will allow domestic producers of duty free goods as well as goods to be supplied to aid funded projects or the Kenya Armed Forces to import raw materials duty and VAT free. This programme will be administered by EPPO in parallel with the duty/VAT remission scheme for direct imports for export production.

Eighth, at present, transit fraud is a major mechanism for avoiding import controls and evading import duties and taxes, hence transit controls on goods arriving by land and sea need urgent tightening. The present time limits are too generous; an initial 90 days can be extended to a full year. Most genuine transit shipment take less than two weeks to leave the country. It follows that the fraudulent importer has abundant time to avoid customs control and divert goods onto the local market. To eliminate this I have proposed amendments which will reduce the time limit for transit goods to 45 days from the date of entry with a possible 45 day extension granted by the Commissioner based on suitable justification together with a physical examination of the goods in question.

Ninth, the present Customs and Excise law has a provision for sharing data with foreign Customs Departments for the purpose of revenue protection, but no provision exists for sharing these data with other local revenue departments, for statistical or revenue protection purposes. This is a serious shortcoming. Both the Income Tax and VAT Acts have explicit provisions for mutual sharing of information and I am proposing a similar provision in the Customs and Excise Act.

Mr. Speaker, I now turn to changes that have direct revenue implications.

First, I am continuing with the rationalisation of the import duty rate structure started a few years ago. I would like to point out that Tanzania and Zambia now have only three rates. While I do not yet think it appropriate to match their performance, I propose to reduce the current number of duty rates from 9 to 6. In the process the top two tariff rates of 60% and 50% will be lowered to

40%, the tariff of 40% and 35% will be lowered to 30%, and 30% comes down to 25%. The duty rates will now be 40%, 30%, 25%, 20%, 15%, 10% and zero. While rationalising the number of rate bands, I have reduced the average duty rate and narrowed their dispersion. While these measures will lower the high rates of tariff protection, the high foreign exchange rate will protect efficient local industries. High duty rates have been an incentive for smuggling which has seriously undermined the protective and revenue raising functions of the tariff. Mr. Speaker, while the decline in import duties lowers protection, it is important to recognise that the decline in the real exchange rate that we have experienced over the past year not only benefits export industries, but also protects import-competing industries as the real cost of imports is raised.

Second, a major reform I propose, which will have far reaching revenue implications, concerns the rate of exchange at which imports will be valued for duty purposes. The recent introduction of 50 percent foreign exchange retention accounts for exporters has given rise to two rates: the official CBK exchange rate and the interbank rate. We are, therefore, forced to determine the correct rate of exchange for duty purposes. The amendment I am proposing to the Customs and Excise Act stipulates that the exchange rate for customs valuation purposes will be the weighted average of the official and the market rates in the previous week. The weights will be specified by regulation and will change from time to time in line with the liberalisation programme. Initially, today, I am gazetting a 75% weight for the official rate and 25% for the interbank.

Third, I have been informed that undervaluation of imports has become widespread and one of the main methods of duty and VAT evasion by importers. Cases of undervaluation of up to 90% have occasionally been detected, while more modest undervaluations are regular, particularly for imports with high duty and tax rates. It is therefore necessary to ensure that the correct value of each import, in foreign exchange terms, is assessed for duty purposes. I am therefore proposing to improve customs valuation supported by the external services of preshipment inspection (PSI) companies. Already, as part of the liberalised import procedures, the Clean Reports of Findings (CRF) are supplied by PSI companies to Customs. These CRF values, will form the minimum customs value. Towards this objective, the Treasury will soon enter into new contracts for the services of the international trade surveyor companies. Appointment will follow a competitive a bidding procedure and should lead to more efficient and effective preshipment inspection, thereby enhancing revenues. This is already envisaged in the Central Bank circulars put out at the time of the removal of import licencing. Improved valuation, Mr. Speaker, also strengthens the protective effects of the import duties for domestic producers and helps protect them against dumping - where I would point out we have effective legislation in place. In addition, the budget of the Customs and Excise Department will be increased to allow them to strengthen their valuation capacity, and to use and manage the PSI process effectively.

Fourth, mineral fuel oils are important to the economy in two fundamental ways. They are a primary source of energy, and they are also a major source of tax revenue. With mineral fuel oils being subject to price controls, these oils have been subject to specific tax rates. Unfortunately, with the increases in the general price level in the economy, the revenues from sales of these oils have not been keeping pace with the growth in the economy. Given the severe fiscal demands, I am obliged to propose increases in the taxes on mineral fuel oils. The combined import duty and VAT on petrol and automotive diesel will increase by Sh 1.80 per litre and on all other fuel oils by Sh.1.00 per litre with one exception.
I am pleased to announce that there will be no increase in the taxes on illuminating kerosene in order to protect the lower income groups. However, because of the rate of exchange changes, it has been necessary to raise the base price of refined oil products, which together with this change in specific rates will cause the prices to rise to, for example, Shs 27.64 for premium petrol, Shs 27.12 for regular petrol, Shs 22.81 for diesel and Shs 16.91 for kerosene In addition, the price of jet kerosene will remain at the reduced level of 95 US cents per gallon introduced in February to boost international air traffic to Kenya. This same price will apply to all domestic users of jet kerosene. In order to help sustain the tax yield from oil products over time, I am proposing to introduce an alternative **ad valorem** import duty and VAT rates on mineral fuel oils.

In the area of taxation of lubricating oils, the extended use of specific import duties and VAT rates has led to a fall in revenues and to uneven taxation of the different types of lubricating oil. To rectify this problem, I am proposing to introduce a uniform import duty rate of 20% and the standard VAT rate of 18% across all lubricating oils.

Fifth, the volume of raw cotton grown in Kenya is not sufficient for supplying the textile and clothing industry. The spinning industry therefore has to import raw cotton to supplement the domestic supply. The current duty rate on raw cotton is 25% but it was found necessary to allow some cuts to this duty to give a bit of relief to the industry. I now propose to support this industry which has a lot of export potential, without fully exposing our cotton growers to international competition, by lowering the duty on raw cotton to only 10%.

Sixth, computers are playing an increasingly important role in all aspects of the economy. To further boost the use of these productivity enhancing machines, I am proposing to lower the duty rate on computers to 25%. In addition, students returning to Kenya after a study period of at least 9 months will be permitted to bring back one personal computer and printer duty free.

Seventh, speciality steels are an important input in the local manufacture of cutting tools and other items. I am proposing to lower and rationalise the duty on a range of speciality steels at 15%.

Finally, Mr. Speaker, in recent months I have heard a lot of complaints about aircraft, both large and small, avoiding Kenya and registering and operating from neighbouring countries where the import duty is zero while we were charging 30%. In the nature of the international mobility of aircraft and their effective ability to avoid paying duties many countries have recently dropped all duty on them. Obviously this is bad for Kenya's tourist trade and export promotion efforts, not to mention the flying doctor and other medical services and refugee support services. Accordingly, I am proposing that all aircraft be made duty and VAT free.

The measures I have proposed relating to import duties will become effective at mid-night tonight and will provide the Exchequer with an extra revenue of K£ 69.2 million.

Value Added Tax

Mr. Speaker, I would like to turn to the Value Added Tax reforms. It has been four years since this indirect tax replaced the Sales Tax. Over this period we have extended the number of manufactured goods and the number of services liable to VAT. The general idea is that in the long run, as we make more and more goods and services subject to VAT, the rates of tax will come down. Under present circumstances, while relief is provided under import duties, revenue considerations preclude me from extending such general relief under the VAT. However, I am proposing to further rationalise the tax and to highlight anomalies which need to be corrected.

First, a confusion noted under the VAT Act relates to the precise tax period. It has not been clear whether the definition refers to one calendar month. A proposed amendment removes all possible confusion.

Second, complaints have been raised that VAT on interest is charged for the late payment of a bill. Under the law there is no question of any interest payment because the VAT is due and payable whether the supplier has been paid by his customer or not; furthermore, the VAT Act excludes financial charges in the case of hire-purchase. Therefore to avoid further confusion, I have proposed that interest for late payment shall be excluded from the taxable value for VAT purposes.

Third, about 90% of the VAT revenue is collected from less than 10% of the taxable persons. The small manufacturers and suppliers of services contribute very little to the total revenue. On the other hand, because of their large number they demand a lot of effort from the VAT Department in terms of registration, control and handling of many small returns, while for many small enterprises VAT takes up a great deal of their time and can be a particular source of worry. The best way to help them is to keep them out of the VAT system altogether. In addition, the current level of inflation has automatically increased the annual turnover of many small enterprises causing a vast number to be eligible to enter the VAT net. To avoid this I am, proposing the VAT thresholds be increased to Shs 600,000 from Shs 300,000 for manufacturers and to Shs 1.5 million from Shs 600,000 for retail trade, designated goods and all taxable services including hotels and restaurants.

Fourth, under the present VAT legislation only persons exporting taxable goods can apply for voluntary registration. Obviously, the intention has been to include all exports and zero rate all exports whether taxable or non-taxable. Hence I am proposing an amendment which enables all exporters of goods or services, whether taxable or not, to apply for voluntary registration for VAT purposes.

Fifth, a number of large Kenyan corporations have been behaving in an irresponsible manner as collection agents of VAT. They have been delaying paying over the VAT collected from Kenyans to the Treasury for excessively long periods. To help rectify this situation, I am proposing to introduce measures to allow the Commissioner in selected cases to require that payment of VAT to the Treasury be immediate upon collection.

Sixth, some areas of uncertainty and abuse concerning the timing of the registration of businesses for VAT have been brought to my attention. The amendments that I am proposing clarify and bring greater certainty to the registration process, recognise three situations: first, businesses that apply for registration within the required 30 days from becoming taxable; second, businesses that apply late; and third, businesses that the Commissioner has to register compulsorily. In the first case, where a business applies for registration on time, the Commissioner will now be obliged to supply a registration certificate within 10 days either directly or by registered mail. In the second case, that of late application for registration, the effective date of registration will now generally be the 30th day after the business became taxable, but a default penalty of ten thousand shillings will be charged for late applications. In the third case where the Commissioner has to resort to compulsory registration procedures, a default penalty of fifty thousand shillings will now be charged and the business will be disqualified from claiming input tax deductions prior to the date of becoming registered, while nevertheless still having to pay the output taxes from the date from which the business should have been registered.

Seventh, the present law allows the registered taxable person to submit his return and payment at the latest on the last working day of every month. But this results in a clear discrimination between such a person located in Nairobi, who can actually come in and hand over the return at the very last moment and the person residing outside, who has to rely on the Post Office to send his return. To remove this anomaly it is proposed that a return and payment sent by mail will be deemed to be received at the date shown on the postmark, provided it was posted on or before the 25th of the month. If the postmark is not legible, the return is deemed to have been received three working days before they actually arrive.

Eighth, there is a growing tendency among registered taxable persons to submit VAT returns on time to avoid the automatic payment of late filing penalty but to omit the cheque for payment of the tax due. To discourage this practice I am proposing that the penalty also apply to VAT returns not accompanied by payment.

Mr. Speaker, I would now like to deal with those proposals which will have important revenue effects. These measures are proposed within the context of our broad taxation objectives of continuing the rationalisation of the VAT rate structure and the expansion of its base. Since the introduction of the VAT in 1990, the percentage of items at the standard rate of 18% has risen from almost 50 to 74, while the number of rates has been reduced from 15 to 6, while the highest VAT rates have been lowered from 210% to 75%.

My first measure will, achieve further rationalisation of the VAT rate structure. In this Budget I am proposing to reduce the number of rates from 6 to 4, by deleting the current rates of 75%, 50% and 30% and by introducing a new rate of 40%. Hence the only rates remaining will be 40%, 18%, 5% and zero.

I refer to rationalising the high rate VAT items. These items generate very little revenue even though the tax rates have ranged from 30% to 75%. Large tax revenues are usually raised from high tax rate items where the high tax rate element is captured by excise duties. I consequently propose to simplify the high rate VAT structure. I have lowered a number of items to 18%. The rationale is that VAT works better the more goods and services become taxable at the standard rate. Therefore, the percentage of items at the standard rate will now be 76. I am also guided by the need to encourage local industry, such as leather goods manufacturers, to register for VAT and to enter the formal sector. I have unified all other high rates at 40%. In the process I have ensured that all high VAT rates are lowered and all 30% rates are raised, thereby offsetting somewhat the reduction of import duties from 60% and 50% to 40%. All other items with high VAT rates are converted to excise duties.

Third, the VAT measures proposed also include moving a number of exempt goods and services to the standard rate of 18% or to zero rate them. Presently newsprint and newspapers are exempt from VAT and I am proposing that newsprint be made subject to VAT at 18% and newspapers be zero-rated. The newspaper publishers will be eligible to deduct input tax, including input tax on newsprint, this should actually result in lowering newspaper prices.

Fourth, currently sugarcane and other molasses are exempt from VAT. In order that these products get input deductions, I am proposing to rationalise taxation of all sugar related products. Molasses like jaggery is used in making traditional liquor and since jaggery is already taxed at 18%, molasses should also be taxed at a similar rate. However, molasses is also used in animal feed preparations and in order to prevent the 18% VAT raising the price of such feed, I have also proposed a new tariff category for animal feeds prepared from molasses, which will be zero rated for VAT.

Fifth, turning to the rationalisation of taxation on construction services. The construction, demolition, repair of buildings and other structures make up a significant segment of the economy. Currently under the VAT some construction contractors are taxable whilst the rest are exempt. A problem arises with VAT exempt building contractors since they cannot deduct any input tax including that on machinery and building materials. Consequently, the VAT included in the price of building and building repairs ends up in the price of many goods including exported goods. Here we have a tax on tax situation. Therefore I am proposing to make all construction services subject to VAT. This will make the tax treatment of the sector more equitable and efficient.

Sixth, problems arise where contractors purchase building materials but cannot claim input deductions for the VAT already charged on the materials. To rectify this I am proposing to add certain building materials to the designated goods list which will make them taxable through the retail level. These designated goods will include amongst other items, timber, cement, paint, electrical wiring and certain fixtures.

Seventh, Mr Speaker, the taxation of prerecorded music has long provided problems because the pirated recordings escape taxation while the registered music recorders pay tax. To put the taxation of prerecorded music on a fairer basis, I propose to make records, compact disks and prerecorded tapes designated goods so that they will be taxable at the retail level whether or not tax has been collected at the stage of production or importation of the recording.

Eighth, to continue the expansion of the VAT I am proposing to include a number of additional services. In line with the changes I am proposing for construction contractor services, the services relating to repair, maintenance and hiring or leasing of all machinery and equipment are proposed for inclusion in the Third Schedule. Already the rental and repair of designated goods are taxable services. This will equalise the treatment of all machinery and equipment.

Ninth, Mr Speaker, I am proposing to virtually complete the coverage of the VAT in the area of road vehicles. The hiring and leasing, and the repair and maintenance of vehicles will become taxable in line with all other machinery and equipment. Transportation of goods (excluding unprocessed agricultural produce) will become a taxable service. Already where goods transportation service are supplied by existing registered taxpayers in the supply of taxable goods, or where transportation costs are included in the price of an import, these services are taxable. Where goods transportation has been supplied by a transportation company, however, they have been exempt. This exemption has meant that the taxes already paid on the inputs into the transportation service become effectively built into the transportation cost, raising the costs of both imports and exports. With the zero rating of exports this new measure will help make Kenyan exports more competitive by lowering transportation costs.

A further step in the taxation of road vehicles is that all parts will become designated goods. In other words, parts will become taxable through to the retail level. In line with this change, the tax rate on Completely Knocked Down Kits (CKDs) of vehicles for assembly in Kenya will now be taxed at the standard rate, but, given this lowering of the tax rate, the assembly of road vehicles in bond will be discontinued. Vehicle assemblers will henceforth be treated like all other manufacturers under the VAT. I am, however, pleased to announce that the import duties on CKDs will be lowered to 20% and on chassis frames to 15% to assist local assemblers to maintain their competitive position against imports.

Mr Speaker, I also propose to simplify greatly the taxation of road vehicles under the VAT. All passenger cars and minibuses will now be subject to the standard rate of VAT of 18%. I will be proposing certain additional luxury excise duties on the larger passenger cars and minibuses. I shall detail these proposals under the amendments to the excise duties.

Mr Speaker, with-this wider coverage and simplified taxation of road vehicles, parts and related services, I am able to relax the prevailing stringent restrictions on the deduction of vehicle taxes where these have been inputs into taxable businesses. While some of these restrictions have been justified to prevent abuse of the VAT system through personal use of road vehicles, others have been justifiably criticised as unnecessarily raising the costs of doing business. Accordingly, I am proposing that for road vehicles, other than passenger cars and minibuses, input taxes arising from the purchase of these vehicles, their parts, and the hiring or leasing, and the repair or maintenance of these vehicles will be deductible where the vehicle is used primarily for business purposes. Restrictions will be maintained, however, on input taxes arising from the purchase of passenger cars and minibuses and the related parts and services. Such input taxes will only be deductible inputs into providing car or minibus hire services, and repair and maintenance services.

Tenth, Mr Speaker, I am proposing to expand the taxable services, particularly where these services compete with similar services provided by hotels. To date, all services provided by hotels have been subject to VAT. Where some of these services have been provided by other types of business, however, they have been exempt. To equalise the treatment, I am proposing to expand the taxable services to include conference services, dry cleaning, laundry and other cleaning services, and services provided by beauty parlours, hairdressers and health clubs. To assist the hotel industry further, Mr Speaker, I am proposing to relax the input deduction rules for hotels. With the switch of hotel services from the previous Hotel Accommodation Tax to the VAT, input deduction were initially disallowed. To assist the hotel sector to lower its costs and assist in the recovery of the tourism sector, I am now proposing to allow input deductions to be taken where these apply to the provision of taxable hotel services.

Mr. Speaker, changes in tax rates and administrative provisions will be effective immediately, whereas changes and additions to the designated goods list and to the taxable services will become effective on the 1st September. All in all, I shall collect K£ 47.3 million from these VAT changes.

Excise Duties

Mr. Speaker, I would now like to tackle excise duties where I have proposed some major changes.

First, I shall deal with the issue of value for excise duty on domestically manufactured goods. Traditionally many excisable items were subject to specific, rather than *ad valorem*, rates of duty and were under price controls. Now nearly all their prices are decontrolled and they are subject to *ad valorem* rates. Hence, their valuation for excise is a very critical issue. There has been a temptation to omit certain cost elements such as distribution costs to avoid some burden of excise duty. To prevent undervaluation of sales for excise duty purposes, a more comprehensive definition of value for excise duty is required that includes all the costs which are directly related, such as packaging, advertising and distribution, but excluding normal volume discounts or the cost of returnable containers. Consequently, I am proposing a definition of ex-factory price which includes all appropriate direct costs.

Second, cigarettes are currently subject to three different excise duty brackets depending on their ex-factory price. These brackets have to be adjusted from time to time to reflect changes in level of inflation. With the current inflation rates, the cigarette companies adjust their prices frequently and each price increase cause cigarette brands to shift up from low duty bands to higher ones. As a consequence the cigarette companies have to apply frequently to the Treasury to get their tax bands adjusted. To solve this and to reduce the price pressure on cigarettes, a new excise duty structure is proposed based on the length of a cigarette. The length has been identified as an objective non-price-based criteria that separates the luxury cigarettes from the low priced ones. The lengths are international standards and are not varied easily or cheaply. Accordingly, I have proposed that excise duty brackets be switched from the three price-based bands to two length-based bands. The proposed new structure will have two excise duties - one of 120% for a cigarette the length of which does not exceed 72mm and the other of 140% for longer cigarettes. Besides this change, in order to offset the proposed lower import duties on cigars, cheroots and cigarillos I am proposing that the present excise duty of 25% on them be raised to 30%.

Third, I refer to the earlier rationalisation of taxation of sugar which I proposed; at present sugar is subject to a specific excise duty of Shs 1.5 per Kg but exempt from VAT. Since sugar is no longer subject to price control, the specific duty is lowering revenue elasticity and since it is VAT exempt, sugar producers are unable to get input deductions and therefore tax on tax prevails. There is no need to make cane sugar subject to excise when excise should be reserved for high tax rate luxury consumption items. Accordingly, it is proposed to replace the excise duty on all sugar and sugar related products with the standard VAT rate.

Fourth, to offset the decrease in the import duties, I am proposing to increase the excise duty on spirits from 55% to 60% and cider and similar products, from 25% to 30%.

Fifth, the consumption of soft drinks and Chibuku and similar beverages is sensitive to the price levels. To assist the maintenance of market share and tax revenues from these commodities I am proposing to lower the excise duty on soft drinks from 35% to 30% and on Chibuku, etc., from 25% to 20%.

Finally, I come to the indirect taxation of assembled motor vehicles.

Mr Speaker, I have already outlined to this House my proposals for the expanded and simplified taxation under the VAT at the standard rate for road vehicles, parts and related services. Hon. Members will be aware that to-date passenger cars and minibuses have been subjected to a wide range of tax rates increasing with the engine capacity of the vehicle. These high rates have been gradually reduced and rationalised over recent years. I am now proposing the final step in this rationalisation process. In order to maintain higher tax rates on the larger luxury class vehicles, I am proposing to introduce an excise duty in addition to the standard VAT rate. An excise duty at the rate of 20% will be charged on all passenger cars and minibuses with engine capacities in the range from 1,801cc to 2,500cc, and at a rate of 40% on all passenger cars and minibuses with engine capacities exceeding 2,500cc. These measures taken in conjunction with the lowering of the top import duty rate to 40% will generally lower the taxes and moderate the prices of passenger vehicles. In fact, the combined import duty and VAT rate on cars and minibuses with engine capacities below 1,801cc will decline by between 16 and 32 per cent. Those with larger engine capacities will receive more modest relative tax breaks.

CURRENT TAX STRUCTURE

ASSEMBLED CARS

Capacity	*Import duty*	*VAT*	*Combined*
1,800cc and less	50%	18%	77%
1,801cc-2,000cc	50%	30%	95%
2,001cc-2,250cc	50%	50%	125%
2,251cc and above	50%	75%	163%

ASSEMBLED MINIBUSES

Capacity	*Import duty*	*VAT*	*Combined*
1,500cc and less	40%	30%	82%
1,501cc-2,000cc	50%	30%	95%
2,001cc-2,250cc	60%	30%	108%
2,251cc and above	60%	50%	140%

PROPOSED TAX STRUCTURE

ASSEMBLED CARS AND MINIBUSES

Capacity	*Import duty*	*Excise duty*	*VAT*	*Combined*
1,800cc and less	40%	0%	18%	65%
1,801cc-2,500cc	40%	20%	18%	98%
2,501cc and above	40%	40%	18%	131%

The changes in excise duties will be effective from mid-night tonight and will generate K£ 58.9 million for the exchequer.

Income Tax

Mr. Speaker, in the case of income tax one of the main objectives of our tax modernisation programme has been to eliminate tax rules which distort investment decisions and adjust the individual tax burden to take account of inflation so as to promote individual incentive and enterprise. I will deal initially with proposals which primarily affect administrations.

First, problems have arisen when applying the legislation regarding investment. In the past, the investment deduction has been of dubious value as an incentive. The primary reason for this unfortunate failure relates to uncertainty and delays in gaining approval for the deduction. Over the past few budgets, efforts have been made to remove these uncertainties and delays. The incentive is now available to all investments in manufacturing and not only to completely new investments at new sites using new equipment. However, some uncertainties in definitions remain particularly regarding what is eligible as "installed machinery and equipment". This has been traditionally taken to mean assets that are bolted down or attached to the plant in some fashion. This is often no longer the case with modern equipment. Therefore I propose the removal of physical attachment as a legal requirement.

Another area of uncertainty has been in the scope of coverage of investment deduction with respect to hotel buildings. I am introducing proposals to clarify that all buildings directly related to the functions of a hotel shall qualify.

Second, under the existing law the amount of loss or gain is determined on the basis of the official exchange rate prevailing at the time of the acquisition or disposal of an asset or liability. Now that transactions are based on market exchange rates the magnitude of any gain or loss determined under the present law will be incorrect. Given the exchange rate fluctuations in recent months, these gains and losses can be large. Accordingly, I propose an amendment to reflect the exchange rate applicable at the time of the transaction.

Third, last year legal and other costs incidental to issuing shares, debentures or similar securities offered for purchase to the general public, were made tax deductible to encourage the issuance of equity shares and tradeable securities. In some cases a company may make the legal arrangements to authorise the issuance of shares ahead of actually issuing them. I, therefore, propose that the expenses related to the authorisation of shares be made deductible.

Fourth, with the introduction of the Certified Public Secretaries Act, I am proposing to add certified public secretaries to the Fourth Schedule of the Income Tax Act.

Fifth, with the introduction of the compensating tax and dividend tax account in 1992, a few anomalies have arisen that require clarification. One is that the accounting period for the dividend tax account should correspond to the accounting period for the company except for tax payment which will qualify up to the filing date for self-assessment taxes. The other is that where shares are issued in a fashion disproportional to current share holdings a dividend may be assessed. This same result can also arise from issuing rights to buy shares in a disproportional fashion. Hence this clarification is proposed.

Sixth, in recent years the penalties and interest on overdue income tax have been raised and rationalised. There are two basic penalties for overdue tax payments. One is the general penalty of 15% and the other is a special penalty for overdue instalment payments also of 15%. The latter allows for a 10% error in payments. Added clarity is required to ensure that the general penalty is not charged over and above the instalment tax penalty, and that outstanding penalties and interest on instalment taxes are assessed at the time of final self-assessment of taxes. I have accordingly proposed relevant amendments clarifying the law. In addition, penalty for failure to file a tax return shall now also apply to failure to file an instalment return.

Seventh, I refer to the Personal Identification Number (PIN) which was introduced last year and suspended this year. PIN is a unique taxpayer identification number which is used in all countries with computerised tax systems. It serves as a taxpayer file reference number which allows all documents, data and tax payments and refunds concerning a taxpayer, to be automatically filed in his computerised file. For this process to work all tax related documents need to show the PIN to allow data entry into the computer system. It can also be used to identify potential taxpayers and identify undeclared income. The use of a PIN as both a file reference and for broadening the tax base is essential. To reactivate it, I am proposing to remove the suspension from some activities. Therefore, PIN should be used on all Income Tax, Customs and Excise and VAT documents as well as third party insurance policies for vehicles, excluding farm tractors, effective 1st August, 1993. Therefore, I urge you from today to apply for and collect your PIN from the Income Tax Department.

Finally, I would like to highlight a change I am proposing to the minimum income limit for reporting benefits. Under the present Act to reduce administrative burden there is a limit of Shs 40,000 per year on the amount of income required before employee benefits have to be calculated and reported for tax. This amount has not been raised for over ten years. To take account of the inflation, I propose this limit to be raised to Shs 80,000.

Mr. Speaker, I now turn to those specific measures which will have direct revenue effects.

First, I refer to this Parliament's decision to cancel the Presumptive Income Tax (PIT), early this year. The removal of PIT will not cancel the obligation of an individual farmer to pay income tax. If the PIT is cancelled now or during the remainder of the calendar year, it is possible that an individual farmer of a product subject to PIT could be caught having to pay the tax twice. To avoid this situation PIT will be cancelled effective 1st January, 1994.

Second, in considering changes in the individual income tax rate structures, the primary concern is the protection of low-income individuals from the effects of inflation. I, therefore, propose to increase the single and family relief by 25%. This will mean that the single relief will go up from Shs 1,452 in 1993 to Shs 2,424 in 1994, while family relief will go up from Shs 2,904 to Shs 3,636 over the same period. This measure will remove about 150,000 low income tax payers from the Income Tax roll altogether.

Third, the recent high inflation has resulted in individuals' income being taxed at higher tax rates while their purchasing power has been reduced. In order to counter this I propose that the tax brackets be widened by about 14%, from K£ 2,640 to K£ 3,000 with the following effect on the rate structure:

Current Brackets (K£)	Proposed Brackets (K£)	Rates (%)
First 2,640	First 3,000	10
2,641 to 5,280	3,001 to 6,000	15
5,281 to 7,920	6,001 to 9,000	20
7,921 to 10,560	9,001 to 12,000	25
10,561 to 13,200	12,001 to 15,000	35
Over 13,200	Over 15,000	40

Fourth, in 1990 the instalment tax was introduced to phase in the current payment of income tax by businesses. All other income taxpayers already pay their taxes as their income is earned. With current levels of inflation, delays in collection of income tax are very costly to the Treasu_y. Accordingly, to help lower my debt burden, I am proposing that the phase-in of the instalment tax payments be somewhat accelerated by introducing two new instalment tax due dates. In addition to the instalment tax now payable at the end of the third quarter, instalment taxes will now become due at the end of the second and fourth quarters as well. Starting this year, for businesses with accounting periods commencing after 1st January 1993, 20% of the instalment tax will be due at the end of the fourth quarter in addition to the 60% that was already due at the end of the third quarter. Next year, a 15% instalment payment will be become due at the end of the second quarter in addition to the 60% payment at the end of the third quarter and 25% payment at the end of the fourth quarter. This phase in will continue through 1996, when 50% of the instalment tax will be due by the end of the second quarter and 25% at the end of each of the third and fourth quarters. To protect businesses primarily earning their income from farming from cash flow problems, such businesses will be limited to two instalment tax payments in the third and fourth quarters.

FOR PERSONS ACCOUNTING PERIODS COMMENCING ON OR AFTER	PROPORTIONS OF THE FULL AMOUNT OF INSTALMENT TAX PAYABLE BY THE LAST DAY OF THE FOLLOWING MONTHS IN THE CURRENT YEAR OF INCOME:		
	SIXTH MONTH	NINTH MONTH	TWELFTH MONTH
1st January 1990		15%	
1st January 1991		30%	
1st January 1992		45%	
1st January 1993		60%	20%
1st January 1994	15%	60%	25%
1st January 1995	30%	45%	25%
1st January 1996	50%	25%	25%

FOR PERSONS ACCOUNTING PERIODS COMMENCING ON OR AFTER	FOR PERSONS WITH MORE THAN TWO-THIRDS OF THEIR INCOME AGRICULTURAL, PASTORAL, HORTICULTURAL OR SIMILAR ACTIVITIES, PROPORTIONS OF THE FULL AMOUNT OF INSTALMENT TAX PAYABLE BY THE LAST DAY OF THE FOLLOWING MONTHS IN THE CURRENT YEAR OF INCOME:		
	SIXTH MONTH	NINTH MONTH	TWELFTH MONTH
1st January 1990		15%	
1st January 1991		30%	
1st January 1992		45%	
1st January 1993		60%	20%
1st January 1994		75%	25%

Fifth, I wish to continue the switch of the taxation of pension income to a system with tax deductible contributions and taxable pensions by gradually raising the deductible limits and exposing a larger share of pension income to tax. With inflation averaging about 10%, this process would take about 15 years starting in 1991 for a full switch over. During the first five years, the deductible limits would increase with inflation. Thereafter they would move up more rapidly to reach their desired real levels. If inflation was higher, this process would have to be accelerated. With inflation running at over 40%, I propose that the deductible limit be raised from Shs 12,000 to Shs 18,000 per year.

Sixth, under a pension fund, pension benefits are received as a periodic pension with up to Shs 150,000 tax exempt plus a maximum lump payment of Shs 360,000 tax free. When a pension beneficiary dies, his heirs receiving any pension benefits qualify as a group for the same tax exempt pension and lump sum amounts as the deceased would have had. Under pension rules, however, a pension fund is permitted to pay a lump sum to the estate of the deceased. Therefore, at present only Shs. 360,000 would be tax free out of this lump sum payment and the heirs will not have access to the Shs 150,000 tax exempt amount. This is unfair because pension savings will have been accumulated out of after-tax income and the beneficiary and his heirs will have lost this tax exemption because of death and the design of the pension rules. I, therefore, propose that a special exemption be added for lump sum payments of pension benefits to estates of the deceased. This exemption should equal the capital value of the Shs 150,000 exemption received over their pensionable lives. Taking an average inflation rate of 10%, the capital value of the annual Shs 150,000 is approximately Shs 1 million. Hence the combined exemption rounded up will be Shs 1.4

million and will become effective from 1st January, 1992 to cover known outstanding cases.

Seventh, under the current law a withholding tax is charged on all insurance commissions paid to insurance agents, with the exclusion of insurance brokers. A number of very large insurance arrangements is made by one-deal brokerage companies. In these instances a brokerage business is set up for one deal only. Normally, the instalment tax would capture a share of the profits of an ongoing business, but in the case of a one-deal short-lived business, no instalment tax is payable. Hence I am proposing that insurance premiums earned by brokerage businesses for insurance policies be subject to withholding tax.

Eighth, I refer to the issue of insurance reserves. General insurance companies are allowed to take a reserve against unexpired risks in estimating their taxable income. When an insurance company receives a premium the risks insured may not have expired by the end of the accounting period. Hence, the company is allowed to take a reserve against the expected future claims in order to better match its costs against its revenues. Insurance companies world-wide tend to over-reserve for tax purposes in order to defer their taxable income. If their business is growing, this can result in a permanent deferral. It has been noted that Kenyan insurance companies are claiming very high reserves. Accordingly, I am proposing an amendment that will require the reserve levels to be based on actuarial principles and the estimates of the ultimate settlement amounts to be discounted to the current accounting period.

Finally, I come to the taxation of Kenya Reinsurance Corporation (Kenya Re). Currently, it is exempt from income tax, stamp duty and has to be offered 25% of all insurance business in Kenya. There is no fundamental economic reason why Kenya Re should be exempted from taxes payable by other insurance or reinsurance companies. I am therefore, proposing that the company be made taxable effective 1st January, 1994 and that its accounts for its first taxable year be prepared as though it had always been taxable.

Mr. Speaker, the additional revenue from the income tax measures proposed is estimated to be K£ 74.7 million.

Miscellaneous Taxes/Revenues

Mr. Speaker, finally, I would like to turn to two miscellaneous taxes and charges. One is the Airport Service Charge. This charge on domestic flights is Shs. 50/- and on overseas flights it is US$ 20 per air ticket. The charge for the local flights has fallen drastically in real terms since it was introduced in 1988. I am therefore proposing to raise it to Shs. 100/- per ticket. The charge for overseas flights paid in foreign exchange by residents is awkward, time consuming and is of no balance of payments benefit. I am therefore proposing that the US$ 20 charge be payable in equivalent Kenya shillings by Kenyans or Kenya residents. In addition, as part of the rationalisation of tax administration, I am amending the Act to make the Commissioner of Customs and Excise responsible for collection and administration of this charge. These amendments will be effective from 1st July, 1993.

The second is the reinsurance premium tax which was initially set in 1992 at a low rate of 2%, while its inevitable early teething problems were being solved. The effective income tax rate of the premium taxes is currently about 20%. To bring it more in line with the company tax rate of 35%, the reinsurance premium tax rate should be increased. I am accordingly proposing to raise the tax rate to be 4%, with effect from 1st January, 1994.

Mr. Speaker, I expect to raise K£ 15.2 million from these few measures.

9. CONCLUSION

Mr. Speaker, Kenya has embarked on this budget exercise with very many constraints. We have to revive an economy, the growth of which is very depressed and sluggish, combat an unprecedented rise in inflation, curtail a high budget deficit, reassure a weak and nervous financial sector faced with a high interest rates and a weak currency. To overcome these constraints, we have had to adopt deflationary measures. The deflationary pressures should therefore come from soaking up excess liquidity in the economy and lowering the budget deficit. The reduction in the deficit should come from cuts in spending, particularly on other than ongoing projects and on recurrent expenditures related to other than operating and maintenance costs and additional revenue through taxation, and particularly through efficient administration and collection. Soaking up excess liquidity will bring down the rate of inflation. The Government must attain the goal of lower inflation and it is that which will turn the economy around with minimal pain.

Mr. Speaker, I beg to move.