REPUBLIC OF KENYA

Budget Speech

for the

Fiscal Year 1998/99

(1st July–30th June)

by

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SPEECH DELIVERED TO THE NATIONAL ASSEMBLY ON 11TH JUNE 1998, BY HON. SIMEON NYACHAE, MINISTER FOR FINANCE, REPUBLIC OF KENYA, WHEN PRESENTING THE BUDGET FOR FISCAL YEAR 1998/99

1ST JULY, 1998 TO 30TH JUNE, 1999

Mr. Speaker Sir,

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

Mr. Speaker, before I embark on my formal speech, allow me to pay tribute to H.E. President Daniel arap Moi for his continued concern of the welfare and wellbeing of every Kenyan. I also wish to take this opportunity to salute my predecessor, Hon. Musalia Mudavadi, for facilitating my settling down in the Treasury. Besides the detailed hand-over notes, Hon. Mudavadi has availed himself whenever I required to consult him on the difficult issues of public finances.

I. INTRODUCTION

As we close the fiscal year 1997/98, the country faces difficult challenges. The slowdown in economic growth which began in 1996 continued into 1997, and is likely to persist unless urgent measures are taken to tackle factors constraining growth. The excessively high interest rates, the poor state of our roads, power supply shortages, insecurity, and the adverse weather conditions, have all had their toll on investment and the overall economic performance. Furthermore, the suspension by the International Monetary Fund (IMF) of the Enhanced Structural Adjustment Facility (ESAF) loan in August 1997 also played a role in adversely affecting investors' confidence. The situation was worsened further by persistence of corruption which led to loss of government revenue.

Mr. Speaker, Honourable Members should note that, as a result of the slowdown in economic growth, unemployment and poverty problems have worsened. Therefore, as we examine the outlook for 1998/99 and beyond, and what we need to do to restore investor confidence and turn the economy around, it will be necessary to bear in mind these factors and circumstances.

Mr. Speaker, I do not intend to bore the Honourable Members with detailed analysis of the world economy. I will only make a few observations on the current crisis in the South East Asian countries which I consider to be of some significance to Kenya. Given that this region accounts for about 26% of our imports, the recent devaluation of its currencies is likely to pose serious challenges to our goods, both in the domestic and the regional markets. Indications from local industries suggest this may be happening already. It is therefore imperative that our industries take steps to adjust their operational costs in order to cope with the current competitive economic environment.

II. RECENT ECONOMIC DEVELOPMENTS

Mr Speaker, Kenyan's economic performance weakened further in 1997/98. Being an election year, the highly charged political environment resulted in a further slow down in investment and a considerable fall in economic growth to an estimated 2.3% in 1997 compared with 4.6% in 1996 against the original target of 5.3%. This compares unfavourably with 4% growth for the global economy, and 3.8% for the African continent. Deterioration in our infrastructural facilities, the persistent high interest rates, and insecurity which had a major toll on tourism, account for this weaker economic performance. This situation was compounded by the vagaries of weather, as the country experienced both drought and floods in the same calendar year. This double disaster had severe adverse effects on agriculture, which contributes a significant share of our gross domestic output. The lapse in the ESAF loan in 1997 also compromised our economic growth.

During the period immediately after the ESAF lapsed, external investors repatriated about US$250 million leading to a 20% depreciation in the shilling. Interest rates on Treasury Bills also shot up from 18% to 27%, reflecting a substantial risk premium investors required in the face of lost confidence. The upward pressure on interest rates was compounded by the sharp increase in government expenditure due to the huge salary awards to the teachers and the general election cost overruns. The wage bill did not only impact adversely on interest rates, it also made it difficult for the Government to fund adequately social services and operations and maintenance.

During this period, revenue performance could not remain on target due to reduced economic activities and lapses in revenue administration that led to diversion of uncustomed goods, such as petroleum products, electronic goods and tyres, into the domestic market. This, coupled with declining external receipts, made the Government resort increasingly to short-term domestic borrowing to finance its expenditure. To contain its borrowing, the Government instituted, in early March 1998, several critical fiscal measures. These included expenditure cuts amounting to Shs.4.5 billion, and revenue measures yielding Shs.5.4 billion.

Mr. Speaker, while these efforts have helped in tapering government borrowing requirements, we must now aim at eliminating the budget deficit and eventually running surpluses so that we can begin to repay the domestic debt, bring interest rates down and ensure private sector receives adequate credit without compromising monetary policy.

Turning to the balance of payments, the overall position in 1997 was weaker than targeted because of net capital outflows that arose from market instability in the second half of 1997, and a larger than projected current account deficit which increased from Shs.4.2 billion in 1996 to Shs.22.2 billion in 1997. This deterioration was mainly due to strong import growth, while exports stagnated.

Mr. Speaker, on the inflation front, I am happy to report that because of the tight monetary policy stance maintained by the Central Bank during this period, we managed to contain the underlying inflation rate within the single digit range.

III. THE CHALLENGES AHEAD

Mr. Speaker, as honourable members can now appreciate, we are faced with a daunting task of how to achieve faster economic growth, preferably in excess of 7% p.a., which is necessary to create enough jobs for the growing labour force and reduce poverty on a lasting basis. To increase economic growth, there must be, amongst other things, an increase in private investments. This will occur only if we take strong measures to (a) reduce domestic debt and interest rates; (b) improve physical infrastructure, particularly roads, which, in their current state, are a major constraint to growth; (c) improve the delivery of economic public services, such as telecommunications, power and water supplies; (d) improve the efficiency of the civil service and make it more friendly to the business community; (e) improve public security and administration of justice; (f) reduce corruption and evasion of taxes; and (g) improve relations with our development partners.

Mr. Speaker, this is a demanding task, which, I hasten to emphasize, cannot be dealt with effectively unless there is concerted efforts by all Kenyans irrespective of their political party affiliations. In this context, I urge all the honourable members, as representatives of our people, to stop the endless political distractions in preference for the pursuit of an economic agenda aimed at benefitting all Kenyans. We need to urgently build a national economic purpose around new ambitions for our country. If this is not done soon enough, those individual interests we seek to protect will be compromised. As has happened elsewhere, once the spiral of economic collapse starts, there is no way of knowing the direction it will take, when and where it will stop, let alone finding a quick fix. Let us not be like the Biblical man who had eyes but could not see and had ears but could not hear.

Mr. Speaker, I am convinced that we have the capacity to realize our economic goals. Given our diversified production base, strong entrepreneurial endowment, well developed financial markets, liberalized economic system and favourable geographical location, our economy can achieve high and sustainable growth if only we can attend to those factors pulling it down. We are in particular blessed with a hard working population that is not looking forward to handouts from the Government but rather for greater access to primary education, public health services, water supply, and better quality public. They just need an enabling environment within which they can find ways and means to earn an honest living.

IV. POLICY FRAMEWORK AND STRATEGY

Mr. Speaker, our new ambition is to achieve high quality and sustainable economic growth with stability based on an unshakable commitment to pursue consistently prudent fiscal and monetary policies and good economic governance. We have to avoid the stop-go tendencies that create uncertainties for investors. We have also to ensure the people's money is managed efficiently and in a transparent manner, the rule of law is effectively and fairly enforced, and that our people participate in decision making on economic issues that affect their lives. These are the salient features of good economic governance which should be the cornerstone of our economic management. It is in this regard that the Government plans to reactivate, in the course of the year, the Joint Industrial Consultative Council to provide a channel of communication between the public and private sectors.

Donor relations

Mr. Speaker, our relation with donors, especially multi-lateral agencies such as the IMF and the World Bank, is one of partnership. We are happy to work with them and benefit from their skills and world-wide experience. However, we should at all times endeavour to implement only those economic programmes that we have designed ourselves and are in the interest of our country and people. We should, in the process of designing our economic programmes, consult widely with all stakeholders in order to ensure Kenyans own such programmes. While donors can and do provide useful assistance, the responsibility for creating the change we desire rests with us. However, it is in our best interest to collaborate and work particularly with the Bretton Woods institutions because of their importance in the global-economic relations. What makes their role critical is that most donor countries and foreign investors require to know the rating, by these two institutions, of a country seeking financial support and debt relief from them before they can sanction it. Consequently, the snowballing effect when we disagree with them can be disastrous. An agreement with the two institutions opens many financial support doors, including quick disbursing funds and foreign direct investments.

Fiscal and Expenditure Policy

Mr. Speaker, the Budget I bring to the Parliament and country today begins the difficult task of fiscal adjustment that seeks to: (i) achieve a balanced budget; (ii) reduce government borrowing requirements and start to repay the current stock of short-term Treasury Bills; (iii) lengthen maturity of domestic debt by encouraging conversion of bulk of the Treasury Bills to Treasury Bonds; and (iv) achieve a reduction in interest rates. To achieve these objectives, we cannot avoid to implement painful measures that require reduction of expenditure to a level consistent with revenue receipts. In my view, this is the only way we can manage to reduce domestic debt and interest rates. In any case, given the current high tax ratio and the low level of economic activity the country is experiencing, raising taxes will be counter-productive. Mr. Speaker, the large short-term domestic debt continues to attract public attention and commentary. Externalization of this debt has become a popular suggestion. However, the reality is that before externalizing the debt, we need a stable and predictable macro-economic situation complemented by a positive rating or image on economic governance. Without these attributes, the debt can only be externalized at very high premiums which, when one considers the exchange risk, may be more expensive than what we are paying currently on the domestic debt. For these reasons, expenditure will bear most of the required adjustments.

In this context, Treasury, in consultation with the Ministry of Planning and National Development, has established the projects in the Public Investment Programme (PIP) that should be accorded priority, and accordingly, reduced the number to be funded in the 1998/99 Budget from 1072 to 664 only. The objective is to reduce the project portfolio to what can be fully funded. For low priority on-going projects that are sellable, we will consider selling them and use the resources so realized to pay off the short term debt. To ensure that the number of projects are only those within the financial and administrative capacity of the Government, a mechanism for project selection and approval will be introduced. Before any project can be included in the PIP and the annual budget, the design and implementation timetable will require approval by the Cabinet Economic Sub-committee.

Mr. Speaker, in order to effectively control expenditures commitment, it is important that we provide adequate and high-level technical and professional support to the Accounting Officers. In this regard, under powers vested in me by Exchequer and Audit Act, I am creating a new position of Financial Controller, in all Ministries and Departments, who will replace the Principal Finance and Establishment Officers (PF&EOs) in the Ministries. These controllers will be responsible for improving the financial management and control in Ministries, especially control of commitments. The Financial Controllers will be required to countersign with the Accounting Officers any new commitments Ministries enter into. Technically, the financial controllers will be under the control of the Permanent Secretary to the Treasury while administratively will be controlled by the Accounting Officer of the Ministry in which they are based.

Among other policy measures that are necessary in our quest for fiscal adjustment are: (i) enforcement of firm and impartial tax administration in which everybody pays his/her tax liability; (ii) continue to improve tax administration; (iii) speeding up privatisation; and (v) implementation of economic measures on the use of government vehicles, telephones and leasing of private residential accommodation.

With respect to tax administration, efforts to fight corruption and tax evasion will be intensified. Let me at this point thank H.E. the President for allowing Kenya Revenue Authority to set up its own Police Unit. To complement this, the Government has decided to give the KRA greater operational autonomy to ensure strict revenue administration without fear or favour, particularly on administration and control of transit trade. The Authority is expected to perform these duties in a fair, efficient and transparent manner, free from any interference. It is in this spirit that I propose to amend the KRA Act to strengthen its Board by reducing the number of ex-officio members from five to two, namely, the Permanent Secretary to the Treasury and the Attorney-General. The two will be in the Board in an advisory capacity and will have no voting powers, while the private sector members will be increased from five to seven. These changes will separate more distinctly the functions of tax policy and tax administration.

To restructure the maturity profile of our domestic debt, we plan to issue a registered two year Treasury Bond that will also qualify for income tax and VAT amnesty. Any person with income not previously disclosed for tax purposes will qualify for this amnesty on condition that the money is invested in Treasury Bonds with at least two year maturity. Those seeking amnesty will need to buy amnesty bonds and declare their value to the respective Commissioner. The amnesty bonds will be sold by the Central Bank and commercial banks and the sale will be open upto 31st December, 1998. The interest accrued will be paid on a half yearly basis with a withholding tax of 15%.

Monetary and Exchange Rate Policy

Mr. Speaker, to ensure inflation remains within the single digit level, the Central Bank will take steps to ensure the expansion in the money supply remains in line with the level required to support productive economic activities. I wish to emphasize that low and stable inflation is critical to investment and growth. It is for this reason that, the Government and the Central Bank are determined to meet the inflation targets. Broadly stated, monetary policy during 1998/99 will aim to: (a) contain growth in money supply to no more than 10%; (b) contain expansion in loans and advances extended by the banking system, including other public sector, to no more than 17.8%; (c) ensure that gross foreign exchange reserves held by the Central Bank are maintained at around the equivalent of 3.2 months of imports cover.

The Central Bank will use various tools of monetary policy to achieve these targets, namely, (i) open market operations to regulate changes in the reserve money; (ii) restrict its overnight lending to the commercial banks and use the facility only as a last resort to bridge short-term liquidity shortfalls; and (iii) stay out of the foreign exchange market. To help reduce interest rates, the Central Bank has agreed to adjust downward the cash ratio by about 3 percentage points in the course of the year. The reduction will be staggered in such a manner as not to compromise monetary policy.

However, honourable members should note that the success of monetary policy will continue to be closely related to fiscal policy. Therefore, a solution to the short-term government debt problem and its borrowing requirements will improve the environment for monetary policy. With this in view, we have programmed a reduction in government borrowing from the banking sector by at least 5%.

SECTORAL PERFORMANCE AND REFORMS

Agriculture

Mr. Speaker, let me now touch on some of the sectoral actions we intend to take in the course of the financial year. I will start with the agricultural sector which is the mainstay of our economy. In 1997, the sector suffered a major setback. Crop production declined by 30% with all cash and food crops registering substantial declines. This necessitated importation of large quantities of stable foods, especially maize and wheat, while food prices rose sharply. Factors which contributed and continue to affect productivity in this sector include bad weather conditions, high cost of inputs and finance, poor state of roads which have made collection and transportation of produce to markets both difficult and expensive, and competition from imports. Besides, farmers have recently experienced difficulties getting good quality seed maize.

The Government plans to take several measures both on tariff and expenditure sides to deal with this problem and improve prospects for 1998. **First**, we will review import and suspended duties on processed agricultural produce; **second**, to help the farmers during this difficult time, the presumptive income tax will be suspended; **third**, I give farmers access to chemical fertilizers together with a wider range of plastic sheetings for green houses free of customs duties. On the expenditure side, we have allocated more funds for road maintenance. In this connection, the Government has agreed with the European Union for a programme to provide matching funds to supplement cess collected from cash crops for improvement of rural roads. This will boost road maintenance in rural areas. Besides, the fiscal adjustment programme, which I present to the Parliament today, is aimed at reducing interest rates and, if adhered to throughout the financial year, will bring interest rates down to the benefit of this sector also. In addition, in the course of the year, the Government will develop a scheme that will provide some financial support to small scale food producers, particularly maize and beans farmers. I expect this scheme to be operational by early 1999.

Mr. Speaker, let me take this opportunity to thank both Kenya Breweries Limited and the British American Tobacco Company Limited for the continued support to barley and tobacco farmers through their contract-farming programmes. I appeal to the two companies to expand these programmes. I would also like to urge all other processors of agricultural produce, especially wheat millers, to initiate similar programmes. As I have indicated earlier, we can turn this economy around and realize our growth objective if we support each other to harness the available resources.

Public Sector Reform

Mr Speaker, the economic reforms we have so far implemented focused on the removal of controls on prices and imports, liberalization of marketing, and providing macro-economic stability that is necessary to spur private enterprise as the engine of economic growth. However, these reforms have not led to rapid growth rates sufficient to create employment, raise incomes and alleviate poverty. The reason for this is mainly that the public sector is still too large and inefficient to facilitate the desired high economic growth, partly because, as liberalization has taken place, public service has not been reduced commensurately. It is now necessary to down-size the public sector in accordance with the changed roles and, focus more on the core functions. This exercise should include local authorities which have been under-performing in their responsibilities.

Civil Service Reform Programme

Mr. Speaker, under the Civil Service Reform Programme since 1993, we have reduced the service by 54,000 or 20% through the Voluntary Early Retirement Scheme, natural attrition, restrictions on hiring and improved complement control procedures. Rationalization reviews have also been carried out in twelve ministries, aimed at redefining their objectives, functions and organisations, to achieve greater efficiency in service delivery.

Phase II of the Civil Service Reform Programme will focus on improvement, in close co-ordination with the development and implementation of the Medium Term Expenditure Framework. This Phase has four major components which will be implemented over the next three years. The first component involves a review of the functions of public sector to identify priorities and overlaps between various departments of government. All non-core functions will be divested or privatized, while the core functions will be allocated to ministries and/or departments of central government or to local authorities, as appropriate. In addition, functions will be identified that are suitable for assigning to semi-autonomous agencies or contracting out to the private sector.

The second component involves a review of staffing and the management of the expenditures on personnel. To meet the objectives of overall expenditure control, further staff reductions will be necessary to facilitate closing the considerable wage gap between civil service and the private sector. This will enable the civil service to attract, retain and motivate top quality officers. To achieve the desired level, an additional reduction of 59,000 staff will be necessary over the next three years. This will be achieved through a combination of pay-roll cleansing, natural attrition, voluntary and mandatory early retirement together with strict limits on new recruitment. To handle the staffing imbalances that will arise from the down sizing and reorganisation, the Department of Personnel Management will strengthen its redeployment services. Given the severe domestic debt problem and the resultant reduction in growth, which I have already appraised the House in some detail, it will be necessary to freeze pay adjustments in 1998/99 for all categories of public service, except for normal annual grade increment of about 4%.

The third component involves harmonization of pay and benefits. As the budget is restructured and staff reductions achieved, pay levels will be raised and current complex and anomalous system of payscales, allowances and benefits, restructured and rationalized. Benefits will be monetized to get a clean and equitable wage structure. In addition, a system of rewarding managers and professionals will be developed based on productivity and performance. I must stress, Mr. Speaker, that to improve efficiency in public sector requires hiring and promotion to be based on merit, that is, qualification and performance. Furthermore, the public pension scheme will need to be adjusted and brought closer to pension standards in the private sector. Consideration will also be given to introducing contributions to fund pension benefits. In early 1998/99 fiscal year, amendments to the Pensions Act will be brought to Parliament to remove anomalies in the case of early retirement and rationalize the pension benefits in the public sector. Finally, a permanent Civil Service Pay Review Board will be established with representatives of the Department of Personnel Management and Ministry of Finance to review the terms and conditions of public servants on a continuous basis.

The fourth component involves training and capacity building in the public service. Government training institutes will be rationalised and a new code of ethics developed for the public service. Human resource management capacity will be strengthened, and a performance appraisal system developed and implemented to assist promotions and training assessment.

Teachers Service

Mr Speaker, let me now touch on the teachers service. Following the Teachers' Pay Agreement of November 1997, annual expenditures on teachers' salary and allowances now exceed those of civil servants by some Ksh.4 billion. The overall agreement provided for pay increases up to 200% over 5 years beginning in financial year 1997/98. Continued implementation of this Agreement would lead to teachers' pay absorbing some 37% of expected total revenues. The problem of teachers wage bill, is compounded by the large teaching force which is now close to 260,000 staff. The combined public sector wage bill, assuming civil servants are given similar increment, would absorb 67% of total revenue. **When debt service is added within four years, wages and debt service would absorb more than 92% of total expected revenues, leaving less than 8% of government revenues for operations and maintenance and development expenditure. The economy would go into decline. Poverty and unemployment would increase.**

Mr. Speaker, this is a scenario we must avoid. We must do everything possible to contain the wage bill and debt service. We cannot afford to continue borrowing to pay wages and service public debt. If the economy is to recover, this situation must be reversed as soon as possible, otherwise the economy will continue to shrink. Accordingly, the Government has had to make the painful decision that the Teachers Pay Agreement be renegotiated. At the same time, the financial arrangements in the education and training sector will be reviewed to develop a more equitable and cost effective arrangement. In the meantime, amendments to the Teachers Service Commission Act will soon be tabled before this august House.

Mr Speaker, the number of teachers paid from the national budget has been growing faster than the number of pupils, and the pupil-teacher ratio has now dropped below what is regarded as optimal. This is already impacting negatively on the quality of education in that emoluments to teachers' account for over 83% of budgetary allocations to the Ministry of Education. This leaves very little money to finance other inputs to education such as equipment, supplies, facilities and support services. Mr. Speaker, it is not by accident that the quality of education is going down in this country. As long as this cost structure remains in place, the situation is likely to get worse, not better.

As is the case with the civil service, the government aims to reduce the number of publicly paid teachers by some 66,000 over the next three years. This will be achieved through payroll cleansing, natural attrition and voluntary and mandatory early retirements. There will also be a complete freeze on recruitment of teachers.

Privatization

The programme for privatising commercial, non-strategic enterprises continued during the current fiscal year. The most recent divestiture is the successful public floatation of an additional 25% of Government shares in the Kenya Commercial Bank. Arrangements for the privatization of Mumias and Chemilil sugar companies and the Kenya Reinsurance Corporation are at an advanced stage and sales will be effected by end of 1998. An additional 11 public enterprises have been identified and approved for divestiture in 1998/99.

Local Government Reform

As Kenyans are aware, local authorities are responsible for delivering many of the services closer to our homes and businesses. Clearly, there are major shortcomings in performance of their responsibilities. While several initiatives were included in the last Budget, progress has been less than satisfactory. Efforts to mobilize revenues, prepare and audit accounts need greater commitment than has been the case so far. Lack of accountability and transparency remains a major source of disappointment to residents of local authorities. The slow progress in these areas is also holding up establishment of healthy intergovernmental fiscal relations. I, therefore, urge all those involved in this programme to move with speed to establish sound accounting and financial management systems.

As promised in the 1997/98 Budget Speech, we will proceed to establish the Local Authorities Transfer Fund which will be funded by a share of income tax, when the legal and administrative machinery are in place. Disbursement out of the Fund will largely be conditioned on the targeted expenditure and revenue-raising performances by the local authorities. Such expenditures and revenues will have to be substantiated by audited accounts. Moreover, given the resource constraints of the public sector, local authorities will be expected to rationalise their expenditures and staffing levels in a similar manner as is being done in the central government. They will also need to prioritize their functions, and contract out the delivery of some of the services such as road maintenance, water supply, garbage collection, and health services to the private sector.

Mr. Speaker, let me emphasize that the Local Authority Transfer Fund will not be used to subsidize inefficiency or bloated staff complements. It will be used to provide a stable and low-cost revenue source to those local authorities that make the effort to reform and perform. One performance criteria that will be required of all local authorities from 1999 onwards will be to put in place a simplified and improved revenue collection system. To be eligible for these funds, local authorities will need to provide enabling environment for investments. Consequently, all local authorities will be required to issue only one business permit to a business enterprise. The fee for this permit will be structured either as a consolidation of all regulatory fees required for specified business activities, or a single fee charged in lieu of all such regulatory fees. While the license will be issued automatically upon registration and payment of the fee, businesses will still be required to comply with the health, safety, environmental and other regulations.

To improve the inter-governmental fiscal relations and also to start addressing the problem of cross-indebtedness, the Central Government will start a system of direct payments of the contributions in lieu of rates from the Treasury, subject to confirmation of the amount owed to each local authority by the Ministries of Lands and Settlement and Local Authorities. The amount owed to each local authority will be separately recognised in the Expenditure Estimates. Where a local authority owes the Treasury any money, its share of contributions will be paid net of such outstanding claims. This arrangement will help clear mutual indebtedness between the two levels of government and enhance financial discipline.

Financial Sector

Mr. Speaker, we can learn important lessons from the financial crisis in South East Asia that originated from weaknesses in the financial sector which were allowed to continue for too long. It is important that we learn from their mistakes and avoid a similar crisis in our financial sector. Of late, we have had incidents which highlight the need to tighten the law on banking, enhance disclosures and strengthen bank supervision.

Towards this end, the Central Bank will be empowered to promptly invoke the provisions of the Banking Act where directors are found to be in breach of the law. With this in view, appropriate amendments to the Banking Act have been included in the Finance Bill, which aim and foster a sound banking system and protect depositors' funds. In future, directors and senior management of banks and financial institutions will be required to ensure sound corporate governance is maintained in all their institutions. In other words, they must set a good example to the rest of their staff by ensuring that they practice accepted commercial and banking principles.

If the directors, owners and managers remain prudent, accountable and transparent, it will be possible for market forces to enforce discipline in the sector. In particular, the asset quality of banks will be scrutinised so that the problem of large non-performing assets, which results from poor credit administration procedures, is effectively addressed. In addition, bank auditors will be required to ensure adequate provisions are made for non-performing loans.

To enhance accountability, we will encourage independent rating of companies operating in the money and capital markets. As a start, the Capital Markets Authority and the Central Bank will continue to exercise due diligence to ensure adequate disclosures and credit-worthiness of issuers of commercial paper and corporate bonds. To enshrine and operationalize these principles, by the year 2000, no company will be allowed to issue public debt in form of commercial paper and/or corporate bonds unless it is rated by an independent rating agency.

Mr. Speaker, as part of our efforts to bring interest rates down, the Government will explore the possibility of introducing a low-denomination bond, with an attractive fixed interest rate, and make it widely available to small savers. This, by increasing competition in the market for government debt would be expected to have a downward pressure on interest rates.

Retirement Benefits Sector

Mr. Speaker, in a separate Bill published today, I have proposed various amendments to the Retirement Benefits Act which was passed by this house in August last year. Partial commencement of this Act has already started facilitating the creation of the Retirement Benefits Authority. The Authority which is in its formative stage, will monitor and help develop the retirement benefits sector, but will not control or administer individual retirement schemes or funds. The primary objective of the Authority is to ensure sound management of retirement schemes to enhance contributor confidence. The Authority will only oversee the interests of both scheme members and their employers with a view to increasing long-term domestic savings which are necessary for investments. The success of these schemes will help to lower the interest rates.

Transport and Communications Sector

Mr. Speaker, institutions in this sector continue to be of concern to stakeholders in the economy, principally because they have tended to impose additional costs to them. Efforts to reform the Mombasa Port have not been successful so far. In the coming fiscal year, the Government will take measures to improve performance of the following key institutions:

(i) Kenya Ports Authority

The Government will privatise the container terminal through concession to a private company. As regards the other specialized berths, their management will be liberalised to get the private sector more involved in their operations.

(ii) Kenya Posts and Telecommunications

Mr. Speaker, The Communications Bill has already been tabled before the House. Essentially, the Bill provides for splitting of the Kenya Posts and Telecommunications Corporation into three separate entities. These are the Postal, Telecom Kenya and an independent regulator. I urge the honourable members to deal with this Bill urgently, first, because efficient telecommunications services are necessary for the development of information technology; second, with globalization, local enterprises cannot access international markets unless telecommunications services are readily available at competitive costs; third, liberalisation of telecommunications services will open a large segment of services sector leading to opportunities for creation of jobs and generation of wealth; fourth, and perhaps most important, in the modern economy, services, which are transacted through telephone lines, constitute a large share of world trade; and finally, for the country to mobilise adequate financial resources and technology to provide services to the people already in the telephone waiting list, it will be necessary to attract private sector into telecommunications industry. Besides, Kenya is already behind in this sector and needs to catch up. The Government will, therefore, invite an international strategic partner into the telecommunication entity and also bring in public participation by part floatation through the Nairobi Stock Exchange.

(iii) **Road Safety**

Mr. Speaker, road safety remains a major concern to many Kenyans because of the pain and damage it causes to them. Hardly a day passes without a fatal accident on our roads. Most people believe this is caused by many unroadworthy vehicles that pose great dangers to other road users and the public. Most of the secondhand motor vehicles imported into Kenya, only find their way into the country after they are condemned in the countries where they were registered last. These vehicles pose a greater threat through the environmental damage they cause through pollution. To address this problem, the Government will, with immediate effect, require all secondhand motor vehicles, imported into Kenya, to meet the prescribed standards under the Traffic Act. To achieve this, the Pre-Shipment Inspection companies will be required to ensure they do not issue clean reports of findings if these standards are not met. In addition, the Ministry of Transport and Communications will in the course of the year, table a Traffic Amendment Bill, which will provide for regular inspection of all motor vehicles as a condition of Third Party Insurance. The proposed law will also authorize the Ministry of Transport and Communications to appoint competent private sector organizations as inspection agents. As these measures are expected to improve road safety, insurance companies will be expected to reduce motor vehicle insurance premiums in line with the reduced risks as and when these measures are operational.

Road Transport

Mr. Speaker, the poor state of disrepair on the roads is a critical and urgent economic concern. The Mombasa-Nairobi road, the economic life line for Kenya as well as many of our neighbouring countries, in its current state is a major hinderance to our economic recovery. Regional and rural access roads which are vital to growth in agricultural and tourism sectors, are in poor state. They are causing excessive damage to vehicles, and increasing shipping delays and transport costs. Overall the poor state of our roads is adding unnecessary costs to doing business in all sectors of the economy. This problem is partly attributable to poor workmanship which arises either from incompetence of technical officers or their collusion with contractors to ignore agreed specifications for personal financial gain. Restarting rapid economic growth, to a large extent, depends on effective rehabilitation and maintenance of the road system.

To address this problem, the government will take the following measures: **First**, under the emergency programme established with the assistance of donor agencies, a major effort to rehabilitate *El Nino* damaged roads, including the Nairobi-Mombasa road will be undertaken. **Second**, significant changes in the Road Maintenance Levy Fund have been introduced to increase the funding and improve its cost effectiveness. **Third**, collaborative efforts have been established through East African Co-operation to coordinate maintenance of the regional road network which is critical to improved economic co-operation and trade within the region. **Fourth**, the Government will enforce the axle loads and also ensure full compliance with technical standards during road constructions.

El Nino Emergency Fund

The Government has secured a special IDA credit for some US$40 million for Emergency Project to be managed under the Office of the President to rehabilitate rural roads and bridges, water systems and health and sanitation systems damaged by the El Nino rains. The World Bank has reassigned an additional US$37 million from the Kenya Urban Infrastructure Project to the Emergency Fund, while the African Development Bank is expected to provide another US$10 million for this project. Other donors are expected to join and support this emergency programme.

technology; second, with globalization, local enterprises cannot access international markets unless telecommunications services are readily available at competitive costs; third, liberalisation of telecommunications services will open a large segment of services sector leading to opportunities for creation of jobs and generation of wealth; fourth, and perhaps most important, in the modern economy, services, which are transacted through telephone lines, constitute a large share of world trade; and finally, for the country to mobilise adequate financial resources and technology to provide services to the people already in the telephone waiting list, it will be necessary to attract private sector into telecommunications industry. Besides, Kenya is already behind in this sector and needs to catch up. The Government will, therefore, invite an international strategic partner into the telecommunication entity and also bring in public participation by part floatation through the Nairobi Stock Exchange.

(iii) **Road Safety**

Mr. Speaker, road safety remains a major concern to many Kenyans because of the pain and damage it causes to them. Hardly a day passes without a fatal accident on our roads. Most people believe this is caused by many unroadworthy vehicles that pose great dangers to other road users and the public. Most of the secondhand motor vehicles imported into Kenya, only find their way into the country after they are condemned in the countries where they were registered last. These vehicles pose a greater threat through the environmental damage they cause through pollution. To address this problem, the Government will, with immediate effect, require all secondhand motor vehicles, imported into Kenya, to meet the prescribed standards under the Traffic Act. To achieve this, the Pre-Shipment Inspection companies will be required to ensure they do not issue clean reports of findings if these standards are not met. In addition, the Ministry of Transport and Communications will in the course of the year, table a Traffic Amendment Bill, which will provide for regular inspection of all motor vehicles as a condition of Third Party Insurance. The proposed law will also authorize the Ministry of Transport and Communications to appoint competent private sector organizations as inspection agents. As these measures are expected to improve road safety, insurance companies will be expected to reduce motor vehicle insurance premiums in line with the reduced risks as and when these measures are operational.

Road Transport

Mr. Speaker, the poor state of disrepair on the roads is a critical and urgent economic concern. The Mombasa-Nairobi road, the economic life line for Kenya as well as many of our neighbouring countries, in its current state is a major hinderance to our economic recovery. Regional and rural access roads which are vital to growth in agricultural and tourism sectors, are in poor state. They are causing excessive damage to vehicles, and increasing shipping delays and transport costs. Overall the poor state of our roads is adding unnecessary costs to doing business in all sectors of the economy. This problem is partly attributable to poor workmanship which arises either from incompetence of technical officers or their collusion with contractors to ignore agreed specifications for personal financial gain. Restarting rapid economic growth, to a large extent, depends on effective rehabilitation and maintenance of the road system.

To address this problem, the government will take the following measures: **First**, under the emergency programme established with the assistance of donor agencies, a major effort to rehabilitate *El Nino* damaged roads, including the Nairobi-Mombasa road will be undertaken. **Second**, significant changes in the Road Maintenance Levy Fund have been introduced to increase the funding and improve its cost effectiveness. **Third**, collaborative efforts have been established through East African Co-operation to coordinate maintenance of the regional road network which is critical to improved economic co-operation and trade within the region. **Fourth**, the Government will enforce the axle loads and also ensure full compliance with technical standards during road constructions.

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Road maintenance

Mr. Speaker, during the fiscal year 1997/98, over Shs.5.2 billion will be spent on road maintenance with some 70% of these funds coming from the road maintenance levy and the remainder from ordinary revenues. Next year, road maintenance funding will rise significantly to over Shs.6.5 billion with some Kshs.5.3 billion going to classified roads and the remaining Kshs.1.2 billion for roads maintained by local authorities. During the fiscal year 1998/99, road maintenance will be financed 100% from road levy and transit tolls. To simplify accounting and financial controls, improve transparency and reporting on use of these funds, the levy will be collected and deposited in a Fund in the Treasury. All disbursements will be made on the basis of approved road maintenance expenditure plans. Proposals to amend the Road Maintenance Levy Fund Act to allow the issuance of rules to improve the financial management and efficient use of these resources are included in the Finance Bill. Such rules will preclude conflict of interest between fund-managers and contractors, and also require the use of consulting contract managers, and completion of financial and technical audits on all projects. They will also require regular publication of planned and actual use of these funds. Any contractor who fails to meet the required technical standards will be expunged from future contracts under the Fund. Similarly, any public officer who fails to ensure proper work or is in involved in any irregularity, will be severely disciplined.

Mr. Speaker, to institutionalize road maintenance to get quality roads, the Government will establish an Executive Roads Board to plan and manage the national road network and to further improve professionalism and efficient use of these resources. Legislation will be brought to this House in course of the year to establish this agency. In the meantime and to gain greater input from the major stakeholders, an Advisory Committee, will be established shortly with representation from the public and private sectors, to advise on the best use of road maintenance funds.

Energy Sector

Mr. Speaker, in the past, the country did not devote adequate resources toE expand power generation capacity or modernize the national grid.

Consequently, electricity demand now exceeds supply and transmission is not efficient. To address the frequent power rationing and outages, several initiatives are planned in 1998/99 fiscal year. First, we expect construction to start on two more independent power producing units, namely, Kipevu II, a 75 MW, power plant and Olkaria III, a 64 MW geothermal power plant. Power purchase agreements are expected to be signed during the early part of 1998/99 financial year. Two additional independent power producer units, 55 MW each, are expected to start operations in the second half of 1999, one in Eldoret and the other in Nakuru. The two have been selected on the basis of least cost criteria.

To improve the operating environment, the Electricity Regulatory Board which was appointed in April this year, will regulate retail tariffs and also approve power purchase contracts between the power producers and the Kenya Power and Lighting Company Limited. The Act further provides for issuance of generation licences for a minimum of 15 years. These provisions aim to promote investor confidence and attract more private investments to the energy sector.

To improve efficiency in the subsector, performance contracts have been prepared between the Government and both the Kenya Power and Lighting Co. Ltd and the Kenya Power Co. Ltd. The contracts will form the basis of commercial relations between the Government and the two public enterprises. To improve efficiency further, Kenya Power Lighting Co. Ltd has downsized its personnel establishment, and contracted out non-essential services. Opportunities for contracting out some of the core functions, such as construction of transmission lines to private sector, will continue to be explored. The ultimate objective is to ensure efficiency that translates into reduced costs to power users. Finally, the Government will proceed with partial privatization of the Kenya Pipeline Company Limited.

Tourism

Mr. Speaker, tourism is one of the growth sectors of our economy. In 1996, the sector contributed 11.2% of GDP and 18% foreign exchange earnings. However, in 1997 the sector performed very poorly, mainly due to insecurity in the country which scared away the tourists. Continued deterioration of physical infrastructure arising from the heavy floods, outbreak of epidemics, and inflammatory political statements, made 1997 one of the worst years for tourism. Indeed, this has not only been a disaster for the other sectors that benefit from tourism, but more so for the regions where tourism is concentrated and which, for now, do not have other viable economic alternatives. As a result, anything that hurts tourism leads to further marginalisation of these regions. Needless to say, tourism is essential to uplifting the levels of income together with opening up these areas.

To address this problem, the Government will take the following measures:- (i) repair the damaged road infrastructure; (ii) provide more resources for marketing and promotion; (iii) ensure peace and harmony in the affected areas; (iv) allocate more resources to security oriented services; (v) finalise arrangements with the European Union for establishment of an endowment fund for the Kenya Tourism Board, which will provide a stable source of funding for the Board; and, (vi) finally allow zero rating under the VAT for locally financed tourist hotel development and refurbishment.

Trade and Investment

Export Promotion

Mr. Speaker, export-led manufacturing is a major pillar of a sustainable development strategy. Therefore, with the declining external receipts, our balance of payments position can only be secured through increased exports which includes enhanced tourism performance. Unfortunately, in 1997, our export trade was adversely affected by a ban of fish and fish products by the European Union who also threatened to ban export of horticultural produce. It is now necessary to reverse export decline which occurred in 1997/98 fiscal year. Towards this end, the Government will take measures to bring the interest rates down; and, repair the roads in order to facilitate transportation. On its part, the private sector must exercise diligence to comply with quality and health specifications of the importing countries. Any concerns raised by our buyers must be addressed immediately and effectively.

Regional Co-operation

Mr. Speaker, during the year, Kenya continued to play a leading role in the regional organizations to which we belong. We will continue to fulfill our obligations to these regional organisations and appeal to our regional partners to do the same. The process to create a single trade and investment area in the East African region has been set in motion and an appropriate trade regime is under discussion. We have made good progress towards harmonizing economic policies with our two sister countries, Tanzania and Uganda. I note with satisfaction that today the three countries are delivering their budget statements on the same day. We have also agreed to implement the following: (i) harmonize Pre-shipment Inspection threshold at US$5,000; (ii) adopt zero tariff for intra-cooperation trade; and (iii) use a single customs declaration document. With regard to zero tariff, the necessary legal provision is already in place. A maximum surcharge of 10% on specific goods has been agreed for revenue purposes and protection of infant industries. We will gazette the zero-tariff rate for intra-cooperation trade as soon as the items for surcharge are finalised. The Investment Promotion Authorities in our three countries have been instructed to work on harmonization of investment incentive procedures. I will be meeting with my counterparts from the two countries in August for post-budget review of any measures in our budgets which may be contradictory to the spirit of co-operation. Mr. Speaker, this is a milestone in our co-operation arrangement, given that tariff barriers have been the most serious impediment to trade among the three countries.

Anti-Dumping and Anti-Subsidies Legislation

Mr. Speaker, provisions relating to anti-dumping were approved by this House last year. However, some aspects of the provisions are inconsistent with the World Trade Organization (WTO) to which Kenya is a member. We have now proposed amendments which will make these provisions consistent to WTO and also specify the procedures for appointment of an investigation committee. These proposals seek to ensure legitimate protection to local producers so that underpriced or subsidized imports do not cause damage to our industries. The measures will not over-protect local industries from competing imports which would benefit consumers. Indeed, any measures we take to protect domestic goods from unfair trading practices, must be seen to be fair to our trading partners.

Diversion of Transit Goods

Mr. Speaker, last year measures were introduced to deal with the problem of diversion of transit goods. Although, some progress has been made, the problem remains, especially with regard to sugar, tyres and petroleum products. To effectively deal with this problem will require cooperation of all law enforcement agents, industry operators, and the support of the courts. Those netted with uncustomed goods should be dealt with severely and not allowed to get away with minor fines. Today, I have proposed amendments to the Customs and Excise Act which will tighten controls on transit cargo and provide for heavier penalties. The Commissioner will have the authority to deny licences to individuals who have been involved in Customs irregularities. Finally, tighter provisions have been made with regard to customs bonds.

Education

Mr. Speaker, as indicated in KANU Election Manifesto, the philosoph of the ruling party on education is that every Kenyan has a right to educati It also emphasizes that in the process of economic transformation, peopl our greatest asset. To realize this potential, we need quality educatio promised in the KANU Election Manifesto, a Commission to rev education and manpower development strategies has already been is now up to all Kenyans to come forward and give views and Commission and help it to achieve the noble objectives which we desire.

As honourable members are no doubt aware, of l system has come under severe criticism on account of eit inappropriate skills. There is a wide spread feeling that institutions and even universities are producing skills not need. Both private and public institutions conti skills while the graduates they produced two to roaming our towns in search of jobs that are not a heavy investments in skills development are not For these reasons, we must impress on all educational services to urgently review their stakeholders, and redesign their courses to suit the needs of the economy. We need to shape our education to suit our needs.

V. FINANCIAL OUTTURN 1997/98

Mr. Speaker, the challenges that the Government faced in 1997/98 had their inevitable impact on our fiscal performance. **First**, the lapse of the ESAF programme led to a dramatic increase in interest rates on Treasury Bills from 18% to 27% and as a result interest payments increased by 45% or K£485 million compared to the budget estimates.

Second, following this suspension, the World Bank and the African Development Bank also withheld their budget support programme loans amounting to about K£300 million.

Third, substantial additional expenditures were incurred during the first half of the financial year on account of unplanned salary increases for teachers and to a lesser extent to civil servants, cost overruns on the elections, and *El-Nino* related expenditures on relief together with additional security costs.

Fourth, as economic activities slowed down, Government revenues fell short of targets. However, some of the shortfall was made good by the additional revenue measures taken in March 1998 together with strong administrative improvements which the Kenya Revenue Authority has put in lace.

urrent Expenditures

Let me now review recurrent expenditures. As the Honourable bers will recollect, the Supplementary Appropriation Bill for this year ved by this House, involved an additional recurrent expenditure of 9 million. Part of this requirement, K£389.8 million, was reallocated her areas within the recurrent budget, resulting in a net increase of million. I also expect domestic interest payments to increase by million from K£1,085.9 million in the printed Estimates for the year about K£1,571.5 million.

Development Expenditures

Mr.Speaker, net development expenditures are expected to fall by K£241.9 million comprising of an increase of K£39.4 million to finance supplementary expenditures and a reduction from the approved provisions of K£281.3 million. Therefore, the projected net development expenditure is likely to be K£752.2 million, compared to K£994.1 million in the printed Estimates.

Mr. Speaker, through further expenditure controls put in place in March 1998, this year's net recurrent expenditure is likely to be about K£5,410.7 million, and net development expenditure about K£752.2 million. The cumulative effect of these developments will be to increase the budget deficit, on commitment basis, in 1997/98 to 2.7% of GDP compared to the original target of 1.7% of the GDP.

VI. FORECAST OUTTURN FOR 1998/99

Expenditure

Mr. Speaker, the 1998/99 Budget which I am presenting to this House, reflects two principles that can be summarized in a few words - **fiscal restraint and a balanced budget.** In planning the expenditure levels for the next year, I have taken into account two very important features of our present fiscal situation. **First** is the problem of domestic debt and interest rates to which I have already alluded. **Second** is the slow down in economic activity, which will limit the growth of revenues available to finance expenditures. We have already noticed a substantial drop in corporate profits this year and th situation is expected to continue in 1998.

Mr. Speaker, to resuscitate the economy, it is important to bring int rates down. However it is equally important to improve the composit expenditures with a view to funding adequately operations and maint quality development expenditure and essential social services. It is n to tailor our investment budget and social sector expenditures to ac desired growth objectives. We must therefore remove un expenditures and duplication of activities and programmes acros sector as well as in corporations, regional development authorities and universities that are supported by the Government budget.

The budget that I am presenting today is a balanced budget, and seeks no new borrowing from the domestic sources in 1998/99 fiscal year in order to facilitate reduction of interest rates. It also reflects major improvements in the allocation of available resources. **First**, I plan to reduce the ratio of salaries and allowances to total expenditures in order to release resources for operations and maintenance in accordance with the Medium-Term Strategy for Civil Service Reform. Therefore, total expenditures on salaries and allowances to civil servants and teachers will drop marginally from K£3.10 billion this year to K£3.05 billion in 1998/99 fiscal year, and the ratio of salaries to the ordinary revenues from 38% this year to about 35% in 1998/99 fiscal year. The budget also includes an initial K£75 million for financing a new voluntary retirement scheme. With the expected rapid implementation of the medium term civil service reform starting next fiscal year, I hope to have some further savings in the wage bill, which when realized, will be utilized to finance additional allocations for the new voluntary retirement scheme. In the recurrent budget, I propose to increase allocations for operations and maintenance by 51% or K£210 million, from K£410 million this year to K£620 million in 1998/99 fiscal year.

Mr. Speaker, to achieve a balanced budget requires very strong expenditure controls, especially in the areas that will not improve delivery of services to the Wananchi. I therefore plan to take several cost saving measures.

Firstly, the Government has a large fleet of vehicles which cost a
stantial amount of money to maintain. Consequently, purchase of new
vehicles will be strictly controlled. In this connection, the Government
purchase passenger motor cars with engine capacity exceeding 2,000
security and specialized agencies will be allowed to buy vehicles in
this limit. In addition, a large number of officers use free
transport. This situation must be stopped. Therefore, with
ct, only officers of Job Group "R" and above will be allowed
t they too will be entitled to two vehicles, one of which, where
specifically for field work. All extra vehicles should be
ccounting Officer in charge of the Ministry. **Any officer**