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Budget Speech

For the

Fiscal Year 2006/2007

(1st July – 30th June)

by

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Minister for Finance



SPEECH DELIVERED TO THE NATIONAL ASSEMBLY ON 15TH
JUNE, 2006, BY HON. AMOS MUHINGA KIMUNYA, EGH, M.P.,
MINISTER FOR FINANCE, REPUBLIC OF KENYA, WHEN
PRESENTING THE BUDGET FOR FISCAL YEAR 2006/2007

1ST JULY, 2006 TO 30TH JUNE, 2007

Mr. Speaker Sir,

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

INTRODUCTION

1. **Mr. Speaker**, I feel greatly honoured to present my first budget since becoming the Minister for Finance. It is with the utmost humility that I present the budget proposals for Fy 2006/07 to this esteemed august House and to the people of Kenya, in the distinguished presence of His Excellency the President and several of my predecessors at the Treasury. Having experienced what they have all gone through during their time at the Treasury, allow me, **Mr. Speaker**, to pay my compliments to each one of them for their contribution to this economy.

2. **Mr. Speaker**, I would also like to record my appreciation for the support I received from a very dedicated budget team assembled through the Treasury over the last 3 months, as we analysed and put this budget together. I also wish to thank the many Kenyans who sent us proposals, and even took time to discuss the same with us. This budget is a collective product of all these people.

3. As Hon. Members are aware, our economy has steadily registered commendable growth rates over the past three years. This is a clear indication that our economy has now recovered. Indeed, in 2005, national income recorded a robust broad-based growth of 5.8 percent, and about 460,000 new jobs were created.

4. **Mr. Speaker**, for the first time in two decades we have been able to increase our per capita income over three successive years. This performance is not an accident. It reflects the policies that this Government has implemented since it came to power and it is a demonstration of our commitment to pursue the right economic policies to achieve rapid and sustainable economic growth. This is critical for ensuring increased employment for our youth, a sustainable reduction in poverty, and generating the resources that can be used to reduce income, regional as well as gender inequalities.

5. Despite this good economic performance, **Mr. Speaker**, we recognise that more needs to be done to reduce poverty and that the gap between the rich and the poor members of our society remains unacceptably wide. This is why we need to dedicate ourselves to strive even harder to reach growth targets that will ensure we win the war against poverty.

6. In this context, therefore, the Government is committed to continue addressing poverty and unemployment challenges by implementing the reforms described in the medium-term Budget Strategy Paper, 2006, which has been circulated to Hon. Members. In particular, we will continue to focus on implementing (i) sound macro-economic policies, which are a key element in creating an enabling environment for private sector-led growth; (ii) far reaching structural and sectoral reforms aimed at enhancing efficiency of resource utilization; and (iii) additional measures to strengthen governance and reduce waste and losses due to corruption.

7. **Mr. Speaker**, the Government's vision for the future is to **build a strong, cohesive, and prosperous democratic country** for our youth and for generations yet to come. This will require our continued hard work, patriotism and above all, a shared development vision. In this regard, **Mr. Speaker**, allow me to commend all Kenyans for their contribution to the significant progress we have made towards larger political freedom and democracy since 2002. In the journey so far, we have made our mistakes and have had our fair share of scandals, but more importantly, we have learnt vital lessons on the way forward.

8. **Mr. Speaker**, this year's budget aims at consolidating the gains we have painfully achieved while taking into account lessons learnt over the last three years. It also aims at investing in programmes to achieve a prosperous new future.

- A new future with more wealth for our people.
- A new future with increased employment opportunities for our youth.
- A new future with more equitable distribution of the national resources; and
- A new future with reduced poverty.

9. **Mr. Speaker**, having spent the last three years implementing key measures in our Economic Recovery Strategy, our economy has now reached a turning point. After years of stagnation, the economy is now poised for sustained economic growth and development. We must, therefore, develop and put in place frameworks in each of our priority areas that will take us to the prosperous future we all yearn for. The budget for 2006/07, is the first of those frameworks that seek to secure solutions to our future challenges, today.

For this reason, the theme for this year's budget is "Frameworks for the future, laying the building blocks."

RECENT ECONOMIC DEVELOPMENTS

The World Economy

10. **Mr. Speaker**, before I go into the main substance of my budget proposals for 2006/07, allow me to say a few words both on the recent international and domestic economic developments. On the international front, the growth of the world economy in 2004-05 demonstrated continued momentum and resilience, despite higher international oil prices and natural disasters. World output expanded by 5.3 percent and 4.8 percent in 2004 and 2005, respectively. In 2006, overall global economic growth is projected

to remain strong at 4.9 percent, aided by continued benign financial market conditions and the pursuit of appropriate macroeconomic policies across the world.

11. Mr. Speaker, the African region has also experienced strong growth, with real GDP expanding by 5.2 percent in 2005. It is projected to grow further by 5.7 percent in 2006.

The Domestic Economy

12. Mr. Speaker, I will be very brief on my comments on recent developments in the domestic economy. I, however, encourage Hon. Members to read the Economic Survey of 2006 for more detailed information.

13. Mr. Speaker, it is heartening to note that the bold measures we have painstakingly implemented over the last three years, have begun to pay dividends. As I noted earlier, our economy is now enjoying a broad-based expansion that we have not witnessed in decades. The improved performance has been driven by strong growth in key sectors of the economy such as agriculture, manufacturing, tourism, building and construction, and transport and communication. As a result of this economic growth, 1.4 million new jobs have been created over the past three years.

14. Mr. Speaker, with regard to inflation, the combination of sound monetary and fiscal policies, better weather conditions starting in April this year, as well as a firm shilling exchange rate have helped ease overall inflationary pressures. We have in consequence managed to bring down the annual inflation to about 13 percent in May 2006.

15. Mr. Speaker, interest rates on Treasury bills were stable throughout the first-half of 2005/06 with the 91-day Treasury bill rate remaining within the range of 8-8.5 percent. However, reflecting continued fiscal discipline and the confidence by market participants that Government would contain its borrowing requirements, the 91-day Treasury bill rate declined gradually in the second half of 2005/06 to around 6.7 percent by mid-June 2006. Lending and deposit rates have stabilized at around 13% and 4%, respectively. This means that the interest spread,

although it has narrowed, remains unacceptably high by international standards. We are considering putting in place corrective measures which will increase effective competition and there by improve efficiency in financial intermediation.

16. Mr. Speaker, on the external front, our trade deficit widened during 2005 as strong growth in imports outstripped the increase in exports. The strong growth in imports is attributable to higher oil prices and purchases of three aircrafts by the Kenya Airways. However, on account of large inflows of remittances, and sizable financial inflows, our overall balance of payments remains comfortable. The result of this has been an appreciation of the Kenya shilling exchange rate and a significant build-up of official foreign exchange reserves with the Central Bank to over US\$ 2 billion compared with US\$1 Billion in December 2002.

17. Mr. Speaker, we have noted the concerns raised by exporters regarding the strong shilling. We are, in this context, closely monitoring developments in this area to ensure that our goods and services remain competitive in the region and internationally.

MEDIUM TERM PRIORITIES AND FISCAL STRATEGY

Medium Term Priorities

18. Mr. Speaker, as I have already indicated, despite the strong growth performance in the last three years, poverty and unemployment challenges still remain. To substantially reduce poverty, further narrow income and regional inequalities, and move decisively toward achieving the Millennium Development Goals, our economy must expand on a sustained basis by around 7 percent per year. This is our medium term objective, which, we believe is achievable.

19. Mr. Speaker, we believe that the strategy that we have adopted of sound macro economic and structural policies, the shifting resources toward the social and economic sectors, and fighting corruption, will contribute towards achieving these objectives.

20. Mr. Speaker, although rapid economic growth is central to reducing poverty and inequality, it must be accompanied by

specific government interventions to ensure that the poor also benefit.

21. Accordingly, **Mr. Speaker**, to ensure that the expected growth will be shared, the combined share of resources I am allocating to health, education, agriculture and rural development; and to infrastructure will rise from 60.7 percent in 2005/06 to 62.7 percent in 2006/07, and will rise further to 66.5 percent by 2008/09. This is a continuation of our policy to put our fiscal house in order by restructuring our expenditures toward priority areas that was spelled out in last year's budget statement.

22. In addition, **Mr. Speaker**, the Government will continue to implement core poverty programmes countrywide. In this regard, the non-wage component of core poverty programmes will be maintained at 4% percent of GDP. Expenditures on these programmes will, therefore, rise from Ksh.78 billion in 2005/06 to Ksh.86 billion in 2006/07, representing a 10.6 percent increase.

23. **Mr. Speaker**, a stable macro-economic environment must be supported by structural reforms in order to more efficiently allocate our scarce resources. Therefore, to ensure effective public service delivery, including budget implementation, the Government will deepen priority structural reforms in the areas of governance, public expenditure and financial management, revenue administration, public enterprises, financial intermediation, and private sector competitiveness. **Mr. Speaker**, these reforms will improve the business environment, facilitate private sector growth, and create employment for our youth.

24. **Mr. Speaker**, while the projected economic growth will provide us with the resources to advance our development objectives, sound fiscal policy management remains central in ensuring that we will continue to be able to do so into the future. We will, in this regard, continue to pursue fiscal policy management aimed at: (i) maintaining a strong revenue effort; (ii) restraining the growth of total expenditures while ensuring a shift in its composition from non-productive recurrent expenditures to operations and maintenance and capital expenditures; and (iii) containing growth of domestic debt to a sustainable level.

25. Mr. Speaker, last year, my predecessor wisely excluded bilateral budgetary support from the 2005/06 budget. By so doing, we have managed to introduce predictability into our budget process and line ministries can now plan on the basis of more certain, albeit smaller, resources.

26. Mr. Speaker, this year we are going a step further by also excluding all multilateral budgetary support. Therefore, the budget that I am presenting to you today, does not contain any external budgetary support. However, we have factored in external financing which is tied to specific projects. Should budgetary funding become available, I intend to use it to scale up expenditures on education, health, agriculture and infrastructure, and, if need be, reduce our domestic debt.

27. Mr. Speaker, even in the area of project financing, we are examining ways of deepening our bond market with a view to mobilizing resources for our infrastructure. In this Budget, I will be making proposals to enhance the bond market so as to provide long-term funding for infrastructural projects. With the strengthening of the bond market, the Government and large infrastructural corporations, will increasingly rely on the domestic but predictable sources of funding to achieve our medium-term development objectives. In the coming months, Government will encourage parastatals with financing needs backed by good cash flows to issue bonds, as a further step to develop our bond market.

28. Mr. Speaker, consistent with our intention to maintain fiscal discipline, the budget limits domestic borrowing to only Kshs. 29.5 billion. At this borrowing level, we expect interest rates to remain at affordable levels which should serve as a catalyst for banks to increase credit to the private sector.

29. Mr. Speaker, allow me at this point to say a big thank you to the Kenyan tax payers for their great contribution to the realization of our economic freedom.

30. Nonetheless, after we are through with the PRGF programme, we intend to continue our engagement with the World Bank and the IMF under the Policy Support Initiative so as to ensure our home-grown programmes meet internationally acceptable standards. In tandem, we are also expecting a country-

rating mission from the world renowned rating company, Standard and Poor's, before the end of June 2006. Such a rating, **Mr. Speaker**, will not only have a beneficial effect on foreign direct investments, it will also impact positively on the capacity of our private sector to access affordable financing from international markets.

THE 2006/07 BUDGET FRAMEWORK

31. Mr. Speaker, the 2006/07 budget framework is set against the background of the medium-term macroeconomic framework I have already outlined. It aims to accelerate economic growth through continued sound fiscal and monetary policies, a strengthening of structural reforms and governance, and enhanced investments in physical and human capital.

Macroeconomic Outlook

32. Mr. Speaker, let me start by providing a brief summary of the macroeconomic assumption underlying the proposed budget. We anticipate that real GDP in 2006/07 will increase by about 5.8 percent provided the weather conditions remain normal, and will be underpinned by continued strong growth in agriculture, manufacturing, construction, tourism, horticulture, transport and communication, financial and export sectors.

33. The 12-month inflation rate is expected to decline to about 5 percent by end 2006/07, from 13 percent in May 2006, mainly on account of benign weather conditions and continued implementation of a prudent monetary policy. Gross international reserves of the Central Bank are targeted to remain at well above 3 months of import cover to adequately cushion the country against any external shocks.

34. Our proposed monetary framework targets an increase in money supply of about 10 percent through June 2007, and provides enough space for a significant non-inflationary expansion of credit to the private sector to support the projected economic growth.

The Fiscal Framework

35. Mr. Speaker, fiscal policy for 2006/07 will continue to aim at containing the growth of non-core expenditures, so as to create fiscal space to facilitate increased resources toward growth and poverty-reducing programmes.

Revenue

36. Mr. Speaker, as we aspire to become more self-sufficient in our development efforts, we will need to re-double our efforts in revenue collection. We are, therefore, targeting to collect revenues amounting to Kshs.375.4 billion, which is equivalent to 21.4 percent of GDP. This will be supported largely by the on-going improvements in tax and customs administration.

37. Mr. Speaker, with increased independence comes increased responsibilities. It is therefore imperative that each one of us contributes in this effort of making Kenya less dependent on foreign resources. We expect the Kenya Revenue Authority to ensure that the set revenue targets are met, while tax payers will be expected to willingly pay their dues. On our part as a Government, we will make sure that the scarce resources are used effectively and in the most efficient manner.

Expenditure

38. Overall expenditures in 2006/07 will amount to Ksh.461.2 billion. In relation to GDP, expenditures will remain relatively unchanged from the previous year at around 26.4 percent of GDP, as a planned reduction in the recurrent expenditures is offset by increase in development expenditures. This is in line with our strategy of increasing the ratio of resources going to development programmes.

39. Recurrent expenditures are estimated to rise by 7.6 percent to Ksh.338.3 billion. However, in terms of GDP, these expenditures are expected to fall from 20.1 percent of GDP, in 2005/06 to 19.3 percent of GDP in 2006/07, on account of moderately lower spending on foreign interest payments, pensions and other expenditures. The government's wage bill is expected to

remain unchanged at about 7.4 percent of GDP (Kshs. 129.3 billion), this figure takes into account wage awards for civil servants of Kshs. 2.1 billion and Kshs. 4.9 billion for teachers. It is important to emphasize, however, that about two-thirds of the wage bill amounting to Kshs. 81.6 billion (equivalent to 4.6 percent of GDP) goes to the education and the health sectors, leaving only Ksh. 47.7 billion (2.7 percent of GDP) for the rest of the civil service.

40. Mr. Speaker, a core requirement of our Economic Recovery Strategy (ERS) is that development expenditures should rise as a proportion of both the budget and GDP. Development expenditures are expected to rise from Ksh. 86.9 billion (5.6 percent of GDP) in 2005/06 to Kshs. 120 billion (6.8 percent of GDP) in 2006/07. This represents an increase of 38 percent from the previous year and compares favourably with a growth of 11 percent for overall expenditures. Expenditures are therefore forecast to be more development oriented, and with a special focus on improving the road network, access to water, reliable and affordable energy, and efficient telecommunications system.

Expenditure Measures

41. Mr. Speaker, creating fiscal space for priority social and development programmes requires sacrifices. Therefore, as part of austerity measures to be implemented by the Government starting July 1, 2006, a new transport policy in the public service, aimed at reducing transport costs, will, on pilot basis, be put in place. The reorganisation of transport and disposal of government vehicles should be completed by 30th September, 2006.

42. Mr Speaker as from July 1, I expect the number of government vehicles on the road to be reduced significantly and only a few will be retained for use by essential government service providers and Constitutional offices such as the Police Department, Health, Judiciary, Electoral Commission and the Auditor General.

43. Ministers, Assistant Ministers, and Permanent Secretaries will be allowed only one official car each. **Mr. Speaker**, to ensure equity, I have factored the savings arising from this measure into my Budget with a view to providing transport allowance to all civil servants.

44. Mr Speaker, before July 1, the Government will issue further guidelines on the implementation of this policy. Therefore, the estimates I am laying before this august House has no provision for purchase of motor vehicles for most ministries. In the case of essential service providers and Constitutional offices, I am directing that approval shall be sought from Treasury before any purchase is effected. This measure will apply to all public bodies. Therefore, from July 1, no public officials will be expected to use official vehicles to and from duty.

Structural Reforms

45. Mr. Speaker, accelerating structural reforms is critical to maintaining our external competitiveness. In order to use public resources more efficiently, we intend to accelerate the on-going public expenditure and financial management reforms with a view to strengthening transparency and accountability. The intention is to seal loopholes in our expenditure management system that have been exploited by corrupt individuals.

46. Mr. Speaker, following enactment of the Public Procurement and Disposal Law, we shall establish shortly an independent procurement authority. We will also, in consultation with stakeholders, develop indicators for monitoring efficiency and transparency of procurements of the central government, including those related to security. The new procurement manual will also simplify procurement procedures.

47. Mr. Speaker, under the financial sector, important initiatives are underway to further strengthen the financial system. These include a comprehensive review of the Banking Act; revisions to the Internal Loans Act to bring it up to date with recent developments in the financial area; and developing of a comprehensive strategy for Development Finance Institutions aimed at addressing issues of mobilizing long term financing for investment and access of credit by challenged sectors such as agriculture.

48. Mr. Speaker, it is the Government's duty to ensure Kenyans are not discriminated against in the provision of financial services. However, it has come to my attention that our Muslim colleagues cannot participate in the conventional banking system without

violating deeply held principles of their faith. I, therefore, welcome the recent interest shown by some of our banks to fill this vacuum.

49. Mr. Speaker, in that spirit and in order to deepen the financial system by bringing in those Kenyans who have been locked out, I will be proposing to amend the Banking Act to allow for a more differentiated and broader array of banking products and services. The resulting increased competition for funds in the financial sector will, no doubt, lower lending rates and, therefore, provide a further boost to our growth prospects.

50. Mr. Speaker, other measures to strengthen the efficiency of the financial sector and expand access to financial services by the poor will include: strengthening the supervisory capacity of various financial sector regulators, including setting up an independent Insurance Authority; and introducing legal and regulatory framework for micro-finance institutions.

51. Mr. Speaker, an acceleration of privatization and restructuring of public enterprises is vital, for efficient service delivery and strengthening of economic growth. In this regard, we intend to build on the recent highly successful partial divestiture of KenGEN, which has created unprecedented interest in the capital markets and provided an impetus for further divestitures. Specific actions slated for 2006/07 include: the restructuring and subsequent privatization of Telkom and National Bank of Kenya (NBK), the sale of part of government shares in Mumias Sugar Company and Kenya Re, among others; the sale of a second fixed-line license for domestic telecom operations; additional licenses for international telecoms gateways; and enhanced private sector participation in port operations, including for the container port operations in Mombasa.

Governance

52. Mr. Speaker, with respect to the "Framework for governance", while we have made progress in the fight against corruption, the challenge still remains. The Government is committed to upscaling the fight against this vice. In particular, the capacity of institutions like the Office of the Attorney General, the Judiciary and the Kenya Anti-Corruption Commission, which are in

the front-line of the war against corruption will be further strengthened through a number of measures, including, (i) hiring of lawyers and special prosecutors from the private sector; (ii) reviewing terms and working conditions of legal staff in the Attorney General's Chamber; (iii) increasing the number of judges and anti-corruption courts; and (iv) implementing various governance and anti-corruption strategies.

53. In this context, the National Anti-Corruption Plan, which has been developed through a process involving a wide cross section of Kenyans, will be launched early next month. Based on this comprehensive Plan, we are finalizing our second-year Anti-corruption Action Plan, that will have measurable indicators to facilitate monitoring of progress.

54. Mr. Speaker, the Government will also accelerate the investigation and prosecution of cases arising from the Goldenberg Commission, the Ndungu Land Commission, and the Anglo-Leasing scam. Linked to this, the subject of security loan contracts have been of major public interest during the last two years. The contracts have been audited and investigated, and the reports prepared by the Controller and Auditor General as well as the Public Accounts Committee have been tabled in this House. The security loan contracts are also under investigation by the Kenya Anti-Corruption Commission.

55. As Honorable Members are aware, the C&AG and PAC reports have raised serious concerns of financial management weaknesses that require to be addressed. The Government has, in this context, given its commitment to addressing the issues. **Mr. Speaker,** we are going to put in place a framework that will close the loopholes that have been exploited in the past to pilfer public funds, and I wish to assure Honorable Members that in the course of the next financial year, I will table a Debt Management Bill that will address the concerns that have been raised by the public and by this House.

Creating a Competitive Business Environment

56. Mr. Speaker, an efficient and competitive private sector is essential for jobs creation. Therefore, to facilitate trade and expand investment opportunities in our country, I am directing, Kenya Ports Authority, the Kenya Revenue Authority, the Kenya Bureau Standards, the Kenya Police and other stakeholders to ensure that services at our ports are provided around the clock, 24 hours a day.

57. Mr. Speaker, I have received complaints about the multiplicity of charges at the port and wish to assure all stakeholders that the charges by the Kenya Ports Authority, the Kenya Revenue Authority and the Kenya Bureau of Standards will be rationalized to reduce costs to importers.

58. Mr. Speaker, I am also aware that the business community has been adversely affected by delays in VAT refunds, and this has added to their cost of doing business. To address this issue, the 2006/07 budget has provided for the elimination of any outstanding refunds and has increased the monthly refund allocations by 46 percent to Kshs. 900 million. This amount should cater for all legitimate refunds. We nevertheless intend to come up with a more permanent solution in the course of the financial year so that the problem is resolved once-and-for-all. Priority in processing refunds will be given to input claims that are ETR compliant. May I also take this opportunity to warn those with wayward attitudes, that we are also taking action in this Budget to curb fake claims by introducing severe penalties for fraudulent claims.

59. Mr. Speaker, the "Framework for sustaining our competitiveness" requires that we reduce barriers to business investment and growth. As promised in last year's budget, the Government has reviewed over 1,300 licences that directly affect trade and investments in Kenya. Hon Members will recall that at the beginning of this financial year, we proposed to eliminate 37 licences and promised to eliminate a further more in the near future. Accordingly, I propose to eliminate an additional 118 licences, which are unnecessary, burdensome and hence no longer serve a useful purpose. Seven other licences will be simplified. An additional 700 licences will be simplified in the

course of the financial year through harmonization, and reduction of fees and charges.

60. Mr. Speaker, with regard to Local Authorities, several licences, permits, and other charges have been identified as requiring elimination, simplification, and retention. In order to facilitate this process, the Local Authorities are required to re-submit, by 30th September, 2006, to the Minister for Local Government for approval by the 31st of December 2006 all their licences, fees, permits and other charges that they wish to retain. We intend to put a halt to the mushrooming of licences and permits after the elimination process is completed.

61. Mr. Speaker, accordingly, I shall create a Business Regulatory Reform Unit in the Ministry of Finance to liaise with the Regulators to ensure that all future regulations with respect to licensing conform to international best practises. This Unit will develop and implement a medium-term regulatory reform strategy, including monitoring the quality of new licenses. To facilitate private sector players, the government will establish an Electronic Consolidated Regulatory Registry for all valid business licences. **Mr. Speaker,** as part of these reforms, I will, in the coming months, be introducing in Parliament a Bill on Business Regulation Reform.

62. Mr. Speaker, the streamlined business environment will reduce opportunities for rent seeking, lower the cost of doing business, and encourage existing investments to expand. In addition, it will lead to initiation of new investment, and new employment opportunities. These reforms are intended to transform Kenya into an ideal and competitive investment destination.

Sectoral and Development Priorities

Education Sector

63. Mr. Speaker, let me now turn to specific sectoral "Frameworks for our development strategy". As you are aware, the Government has continued to improve the quality of universal access to primary education, by among other things, improving financial management and accountability in schools, rationalizing deployment of teachers, targeting bursary to the poor and orphaned children, expanding and improving educational facilities

countrywide, and providing adequate teaching and learning materials in all schools.

64. Government efforts in this area have resulted in a significant achievement in the net enrolment rate; transition rates from primary to secondary schools; and in increased enrolment in both public and private universities. However, some weaknesses in the sector remain, including misappropriation of funds by some head teachers.

65. Mr. Speaker, strict monitoring and evaluation of the funds will henceforth be implemented for all schools to ensure that all resources earmarked for various aspects in support of the Free Primary Education policy are not misused, and, in cases where abuses are detected, the Government will take stern corrective actions, including dismissal and taking those involved to court.

66. Mr. Speaker, on post primary reforms, the Government will continue to provide incentives for the private sector to invest in the expansion of educational facilities. Towards this end, **Mr. Speaker,** I will be shortly announcing some tax measures. On the university education, efforts will be made to harmonize regular and parallel programmes, including rationalisation of tuition fee.

67. Mr. Speaker, to demonstrate the importance we attach to education, we have allocated to the sector the bulk of our resources amounting to Kshs. 99 billion (27 percent of total expenditure) of which Ksh.71 billion is for teachers salaries. . We have continued to allocate much of the budgetary resources to this sector on the conviction that education is the most ideal instrument to empowering our youth.

Health Sector

68. Mr. Speaker, in the health sector, the Government remains committed to providing low cost and accessible health care to all Kenyans. The Government will continue reorienting policy towards preventive healthcare provision, including expanding immunization coverage, while ensuring efficient and effective healthcare service delivery countrywide.

69. To achieve this objective, key reforms will be implemented in 2006/07, which include improving healthcare procurement procedures and accountability systems, as well as strengthening supervision capacity of medical supplies in rural health facilities. We expect these to result in improved access to drugs and medical supplies by our district and divisional health centres.

70. In order to reach out to disadvantaged groups, the Government in collaboration with non-state actors, will set up mobile medical programmes targeting vulnerable groups such as those with disabilities and people living a nomadic life.

71. Mr. Speaker, in line with the Government's commitment to achieve the Millennium Development Goals, the share of total resources going to the health sector will increase from Kshs.30 billion (8.6 percent of total expenditure) in 2005/06 to Kshs.43 billion (9.4 percent of total spending) in 2008/09. These resources will be used to fund HIV/AIDS interventions, healthcare infrastructure, affordable drugs, and to train the medical staff as part of the initial implementation phase of the National Social Health Insurance Scheme.

Reforms under Agriculture and Rural Development

72. Mr. Speaker, the agricultural sector is a major contributor to our development goals through creation of employment opportunities in rural areas, where the majority of our people live. Therefore, over the last three years, the Government has implemented a number of structural reforms aimed at improving efficiency and productivity in the coffee, pyrethrum, sugar, and the co-operative sub-sectors. I encourage Hon. Members to refer to the Budget Strategy Paper for more details on the reforms we are taking in this important sector.

73. Reflecting the need to address low agriculture productivity, and to reduce poverty and unemployment in rural areas, the share of resources allocated to the agriculture sector is projected to increase sharply from Kshs.18.6 billion (5.3 percent of total resources) in 2005/06 to Kshs.33.5 billion (7.3 percent of total resources) in 2008/09. To enhance support to the sector, we will continue with our efforts to strengthen land management and tenure system, support fisheries, forestry and mining; and protect

the environment and natural resources. We are also going to provide additional incentives for the sector, which I will announce later.

Infrastructure Development

74. Mr. Speaker, as Hon. Members are aware, the development and maintenance of physical infrastructure is a prerequisite for rapid and sustained economic growth and poverty reduction. Rehabilitating and maintaining our infrastructure is a necessary condition for reducing the cost of doing business and improving competitiveness of our products in the regional and international markets.

75. To this end, Mr. Speaker, our "Framework for improving infrastructure" call for a dramatic increase in domestically financed capital expenditure by about 42 percent in 2006/07, or from Kshs.41 billion to Kshs.58.5 billion. Over the medium-term, the share of resources going to physical infrastructure will rise from Kshs.81.7 billion (19.2 percent of total expenditure) in 2005/06 to about Ksh.126 billion (21.6 percent of total resources) by 2008/09. We will continue to give priority to expanding and improving maintenance of the road network, providing easy access to water resources, and accessing affordable energy.

76. Mr. Speaker, there are notable structural bottlenecks in the implementation of road projects and these delays continue to hold back our economy from achieving its potential. **Mr. Speaker,** our people would like to see actual roads and water projects on the ground and not figures in our books.

77. To this end, Mr. Speaker, and to improve accountability in budget implementation, the **Budget Monitoring Unit (BMU)** will be revamped and be charged with the responsibility of coordinating development of sector specific benchmarks and monitoring budget implementation, initially paying particular attention to roads and water programmes. This Unit will be required to prepare a comprehensive quarterly reports on budget implementation for dissemination to the public.

78. The Economic Management Committee of Cabinet will also enhance its monitoring of the implementation of the infrastructural programme.

Road Transport

79. **Mr. Speaker**, on the road sub-sector, the Government fully recognizes that an efficient road network facilitates development by allowing easier movement of goods, services and people and by creating linkages between products and markets to promote economic efficiency. To reduce road transport costs, we shall accelerate road repairs and construction by addressing all structural constraints, including governance related challenges holding the sector backwards. To achieve this, I have set aside Kshs. 15 billion for road programmes.

80. In addition, **Mr. Speaker**, private sector participation, including maintenance of specific urban roads, will be encouraged beginning 2006/07. To this end, I will propose measures under the income tax to allow private sector players to contribute towards infrastructure improvement in our country. We are also planning to set a Highway Roads Authority, Rural Roads Authority and Urban Roads Authority.

81. **Mr. Speaker**, it is common knowledge that road contractors take too long to complete new roads and that many of our roads are in a state of disrepair, mainly due to poor workmanship. This practice is unacceptable. From now on, strict rules and benchmarks will be developed to ensure that contractors deliver their services within stipulated time and standards, and those who fail will be blacklisted and will not be allowed to participate in government procurement.

82. **Mr. Speaker**, while contractors have failed us in delivery of quality roads, we know this has been done in connivance with our engineers. We have ample evidence through review of the pending bills. Let our engineers who are not ready to reform know that the Government is ready to dispense with them and, if need be, hire expatriate engineers. We cannot continue to tax Kenyans without giving them value for money.

Other Transport Sector Reforms

83. Mr. Speaker, under the transport sub-sector, we expect the concessioning of Kenya Railway services to improve railway transport and facilitate faster movement of cargo through the port of Mombasa. Similarly, we will continue with our efforts to modernize the Mombasa Port, including introducing private sector participation in the port container terminal operations. Furthermore, to improve the competitiveness of our port, we will initiate work on dredging the channel in order to accommodate large vessels. We welcome development partners who want to partner with us on this initiative.

84. Plans to setup a Freeport in Mombasa will be hastened with arrangements to offer tax incentives to facilitate its establishment. On air transport, current efforts to modernize Jomo Kenyatta International Airport will continue and further upgrading and modernization of most airstrips in the country will be undertaken to improve air safety.

Information, Communication and Technology (ICT) Advancement

85. Mr. Speaker, our country needs to do a lot more to reap the full benefits of ICT. These benefits include reduced costs, increased productivity and increased employment for our people. In this regard, our "Framework for improving ICT" involves continuing to create an enabling environment for private sector participation, including through further liberalization of the sector and by investing heavily in e-government initiative, mainly to boost the current strong growth in the sector.

86. Mr. Speaker, the Government will in particular facilitate training, ICT research and development, and promote value addition services including incubators, telecenters, among others. To encourage rapid growth, and create employment opportunity for our youth through sourcing back office jobs abroad, I will be proposing further tax incentives targeted at strengthening Kenya's position as the regional leader in information and communication technology.

Vulnerable, Marginalized Groups and ASAL

87. Mr. Speaker, the recent drought has highlighted the need for a stronger response to the vulnerability of our people who live in marginal areas. The Government is now taking steps to reduce such vulnerabilities on a sustained basis. Although we have a credible early drought warning system, its linkage to an early rapid response has been impaired by lack of funds. Accordingly, the Government, in collaboration with our development partners, has established a National Drought Contingency Fund to facilitate flexible, appropriate and quick responses to drought emergencies. The Government has allocated half a billion Kenya Shillings to this Fund.

88. In addition to on-going drought mitigation initiatives and development programmes, the Government will adopt a comprehensive policy for the sustainable development of the Arid and Semi-Arid Lands. Towards this end, I am allocating a further Kshs. 1.5 billion for water programmes in the Arid and Semi-Arid Lands Livestock (ASAL) districts.

89. Mr. Speaker, a large number of Kenyans have been rendered landless by tribal clashes and relocation from water catchment areas. To alleviate their suffering, I am allocating Ksh.400 million which, in addition to the resources in the settlement Fund, will be used to purchase land for resettling these people.

90. Mr. Speaker, the livestock sub-sector is estimated to account for 7 percent of GDP in addition to contributing to food security. Within the Arid and Semi-Arid areas, it accounts for nearly 90 percent of family incomes. This sector was severely affected by the recent drought. In order to promote the growth of this sector, the Government will continue with aggressive marketing, particularly in the external markets.

91. In addition, as Hon. Members are aware, the receivership of the Kenya Meat Commission (KMC) has been lifted and rehabilitation of the facility is almost complete. I have, therefore, allocated KSh.200 million to make KMC operational. This will create a market for livestock from arid and semi-arid areas, which

besides creating jobs, will begin to address the issue of regional inequality.

Support for Women Related Activities

92. Mr. Speaker, the Kenya Government is also conscious of the important role our women play in the development of our country. We commit to take further efforts to provide an enabling environment to ensure more effective participation of our women in national development. In this regard, and recognizing that women are more likely to be unemployed than men, special attention will be paid to those measures that increase opportunity for employment or access to productive resources for women, including access to credit, health care, safe water and education.

93. Priority will be given to provision of portable and clean water within reasonable walking distance in order to reduce water related illnesses, and time spent by women and girls fetching for water. In addition, we expect the proposed increase in expenditure on health and education, to also help increase the opportunities for employment among our women folk.

94. Mr. Speaker, let me also mention that, as part of our efforts to enable women to improve themselves and take advantage of opportunities in the job market, various skills and entrepreneur training programmes will be developed and implemented. Given majority of our women live in the rural areas and are mainly involved in agriculture, the Agricultural Entrepreneurship Development Programme will be developed and be implemented in Fy 2006/07.

Youth Empowerment

95. Mr. Speaker, the youth constitute a large percentage of the Kenyan population, yet they are generally marginalized. Today, young Kenyans are confronted with daunting challenges, including unemployment, lack of skills and training, crime and drugs, and health problems such as HIV/AIDS. Our "Framework for Youth Empowerment" begins with a commitment in the Fy 2006/07

budget, of substantial resources to youth related programmes and activities in order to provide the youth with meaningful economic opportunities.

96. It is evident that the youth lack skills and access to capital for investment in various productive activities available in the country.

Therefore, the Government will establish a Youth Enterprise Fund to enable young people to access credit to start or scale up small and medium scale enterprises and to develop their entrepreneurial skills and create job opportunities. To make this Fund operational, I have allocated KSh.1.0 billion in the 2006/07 budget, and I wish to encourage Kenyans to assist us in building a brighter future for our youth by making contribution to this Fund.

97. Mr. Speaker, key priority areas of our immediate attention include: rehabilitation and development of youth polytechnics; skill development, including through expanded admissions by the National Youth Service and Vocation Training Centres; and youth empowerment and participation especially through career fairs, and leadership training, among others. To this end, I will allocate KSh.105 million towards the rehabilitation and operations of at least one youth polytechnic per constituency, which will also; provide a start-up kit, including working tools, which will be accessible to all youth graduating from those village polytechnics. In addition, I have allocated a further Kshs.50 million for various innovative youth projects across the country.

98. In this regard, **Mr. Speaker,** I wish to urge our young people living around these institutions to take advantage of this opportunity and acquire the necessary skills for securing a lifetime source of livelihood.

99. I wish also to urge the management of these village polytechnics and vocational training centres to consider organizing in groups the youth under their training, and where possible, tender for some of the construction works being implemented under the CDF. This will create employment opportunities for the youth in the rural areas, reduce rural urban migration and reduce the level of crime in urban centres.

100. Mr. Speaker, as part of Government commitment to democracy and freedom, I have allocated KSh.100 million towards the establishment of the proposed Kenya Youth Council which will create a forum for youth countrywide to discuss matters that affect their social, economic and political welfare. I have also allocated KSh.250 million towards the operations of the National Youth Service and a further KSh.100 million for food rations to cater for expected increased admission for youth training and skill development.

101. Mr. Speaker, special measures will be taken in promoting the growth of music and theatre industry alongside expansion of technical and vocational centres. I will later refer to some fiscal incentives I am putting in place to encourage music, drama and such entertainment services, which are dominated by the youth.

102. Mr. Speaker, in line with the Government's commitment to mainstream gender in development, the Government will endeavour to earmark 50 percent of the proposed funds under the Youth Enterprise Fund to support entrepreneurial initiatives by young women. In addition, the Government is currently working on modalities to develop special credit products and incentives to be extended to financial institutions that set-aside funds specifically to support enterprising women.

Improving Management of Devolved Funds

103. Mr. Speaker, this Government is fully committed to improving the delivery of services at the local level as a way of alleviating poverty, providing increased employment opportunities and reducing regional imbalances. The government has continued to increase the level of devolved funds for poverty alleviation and local development, mainly through the Constituency Development Fund (CDF), Local Authority Transfer Fund (LATF), and Road Maintenance Fund (RMF), among other funds.

104. In 2006/07, the amounts earmarked for the CDF will increase by about 40 percent from KSh.7.2 billion to KSh.10.0 billion, which is equivalent to increasing the statutory requirement of 2.5 percent of ordinary revenues to about 3 percent. Resources for the LATF will increase from KSh.5.6 billion to KSh.7.5 billion which includes

KSh.1 billion from accumulated deposits, while those for the overall Road Maintenance Levy will increase from KSh.9.0 billion to KSh.14.0 billion.

105. Mr. Speaker, as Hon. Members can see from the printed estimates, the resources earmarked for each constituency in form of CDF will increase by about 43 percent in 2006/07 from KSh.35 million in 2005/06 to KSh.50 million. Of the KSh.14.0 billion earmarked for road maintenance, KSh.4.2 billion will be allocated for district and constituency roads, with each constituency directly receiving KSh.11 million for road works. **Mr. Speaker**, I expect that the Hon. Members will ensure efficient and effective deployment of these funds in order to significantly improve the economic conditions of our people in the rural areas.

106. Further, **Mr. Speaker**, to avoid duplication and waste of scarce resources, the provision of the bursary funds and construction of police posts and health clinics have been shifted from their respective ministries to the Constituency Development Fund (CDF). I am confident that the Hon. Members, in close collaboration with the line ministries and the local CDF Committees, will be able to disburse these funds equitably and transparently to fund priority programmes at the local level.

107. In addition, **Mr. Speaker**, given the sharp increase in the road maintenance levy, I have proposed, under miscellaneous amendments, to reduce the statutory allocation to Kenya Roads Board from 3 percent to 2 percent and allocate the savings to road improvement and maintenance within the city of Nairobi from where we collect about 80 percent of our taxes. This proposal will not reduce the absolute resources to the Kenya Road Board.

108. Mr. Speaker, while these funds have improved the lives of our people in some constituencies, in others, their managements have come under sharp scrutiny by the public, including some allegations of abuse, misallocation, and corruption. As part of efforts to ensure efficiency, transparency and accountability in the use of these funds, the Government, in collaboration with the Hon. Members, will develop and enforce stringent auditable systems and cases of abuse will be dealt with promptly. In the meantime, I need not remind Hon. Members that we will all be going back to the

electorate next year and our management of these resources will be a major criterion by which we will be judged.

FINANCIAL OUTTURN FOR 2005/06

Revenues

109. Mr. Speaker, allow me to briefly update Hon. Members on the budget outturn for 2005/06. Total revenues (including LATF) were originally estimated at Ksh.326.2 billion comprising Ksh296.3 billion in ordinary revenue and Ksh.29.9 billion in appropriations-in-aid. Due to administrative challenges relating to the new customs automation management system and the strengthening of the Kenya shilling against major hard currencies, total revenues are now estimated at KSh.325.6 billion, of which KSh.291.1 billion is ordinary revenue and KSh.34.5 billion is appropriations-in aid.

Recurrent Expenditures

110. Mr. Speaker, Hon. Members will recall that the Supplementary Estimates for fiscal year 2005/06 recently approved by this House had gross recurrent expenditures of Ksh.400.4 billion. This included Ksh.30.5 billion financed through appropriations-in-aid and payments financed directly from the Consolidated Fund Services amounting to Ksh.132.5 billion, leaving Ksh.237.5 billion for discretionary expenditures.

111. Mr. Speaker, the Consolidated Fund Services for the financial year comprised of KSh.28.6 billion for domestic interest; Ksh.4.7 billion for foreign interest; Ksh.23.3 billion for pensions, gratuities and other. The Supplementary Estimates indicated that Ksh.11.5 billion would finance external redemptions while domestic redemptions totalled Ksh.64.3 billion.

Development Expenditures

112. Mr. Speaker, the Supplementary Estimates for fiscal year 2005/06 also had gross development expenditures of Kshs.92.1 billion, including Ksh.29.9 billion to be financed through appropriations-in-aid. Therefore, Ksh.62.2 billion was to be financed from the Exchequer.

FINANCIAL PROJECTIONS FOR 2006/07

113. Mr. Speaker, let me now turn to the 2006/07 budget.

Revenue

114. Mr. Speaker, the total revenue target for fiscal year 2006/07 is KSh.375.4 billion (21.4% of GDP) comprising of KSh.336.4 billion of ordinary revenue and KSh.38.9 billion of appropriations-in-aid. The targeted revenue is predicated on the on-going reforms in tax and customs administration. We have overcome the teething problems associated with the implementation of the customs modernization reforms and the difficulties with the new Simba2005. In addition, efforts are also underway to improve the efficiency of the Large Taxpayer Office.

Recurrent Expenditure

115. Mr. Speaker, as Honourable Members have noted from their copies of the Printed Estimates gross recurrent expenditures for 2006/2007 are estimated at Ksh.412.5 billion. This includes Ksh.31.1 billion to be financed through appropriations-in-aid, and payments financed directly from the Consolidated Fund Services, amounting to Ksh.129.1 billion, leaving Ksh.252.3 billion for discretionary expenditures. The Consolidated Fund Services comprise KSh.32.3 billion for domestic interest; Ksh.5.3 billion for foreign interest; Ksh.22.0 billion for pensions, gratuities and other; Ksh.133 million for subscriptions to international organizations. In addition, I expect to finance external redemptions amounting to Ksh.16.5 billion while domestic redemptions will amount to Kshs.52.9 billion.

Development Expenditure

116. Mr. Speaker, gross development expenditures for 2006/2007 are estimated at Ksh.137.6 billion. Out of this amount, KSh.46.1 billion will be financed through appropriations-in-aid, composed of direct project financing of KSh.19.8 billion in loans, KSh.18.7 billion in grants and Ksh.7.5 billion in local appropriations-in-aid. Consequently, I expect to finance net development expenditures of Ksh.91.5 billion from the Exchequer, comprising Ksh.9.7 billion in

grants, Kshs.10.4 billion in loans and Kshs.71.4 billion from Government of Kenya.

External Grants

117. Mr. Speaker, on external grants, I have received commitments amounting to Kshs. 28.4 billion to finance projects. Details of the donors and projects financed are included in the Development Estimates. I wish to thank, sincerely those donors.

Deficit

118. Mr. Speaker, the overall fiscal deficit, after grants, will amount to Ksh.57 billion. After taking into account expected net foreign financing of projects, amounting to Ksh.9.7 billion, and projected privatization receipts amounting to Ksh.18.2 billion, this would leave a financing requirement of Ksh.29.5 billion to be financed through domestic borrowing. **Mr. Speaker,** this means that the fiscal framework for 2006/07 is fully financed and there are no financing gaps.

TAXATION PROPOSALS

Overview of the Tax Policy measures

119. Mr. Speaker, the rest of my speech outlines tax measures I intend to take to further remove administrative and legal barriers in order to create an enabling environment for private sector growth. The proposed measures are also intended to address inequality, while creating opportunities for the youth to actively participate in economic development. These measures will result in additional revenue of about Ksh. 1 billion. I therefore, request that the remainder of my speech be regarded as a Notice of a Motion to be moved before the Committee of Ways and Means.

120. Mr. Speaker, my presentation of tax proposals today groups together the various proposals based on their intended objective, rather than grouping them by type of tax.

Reducing Poverty and Addressing Inequality in Our Society

121. The broad objective of the following set of tax proposals is to reduce poverty and address inequality.

122. First, Mr. Speaker, Hon Members will recall that last year, the Government zero rated basic commodities such as maize flour, milk, LPG and kerosene making them affordable to Kenyans. However, wheat flour was left out. I now propose to also zero-rate wheat flour. **Mr. Speaker,** I expect the wheat millers to reduce prices of wheat flour and make it affordable to the consumers.

123. Second, Mr. Speaker, young parents incur a significant proportion of their income on childcare and upbringing expenses. To ease the family burden of raising children, I propose to zero rate baby's diapers, napkins, and feeding bottles. I expect the traders to translate this relief into reduced prices and enable many mothers to access these products for childcare.

124. Third, Mr. Speaker, in order to allow for input tax deduction, reduce the cost of treatment and supply of natural water, and encourage supply of clean water to every home in Kenya, I am proposing to zero-rate the supply and treatment of natural water by all local authorities and public water suppliers. Bottled water will, however, remain taxable.

125. Fourth, Mr. Speaker, increasingly, bicycles are becoming a major mode of transport among our people both in rural and urban areas. In order to create incentives for the assembly and to make bicycles affordable, I propose to remove duty on Kits for bicycles imported by approved local assemblers.

126. Fifth, Mr. Speaker, duty on unassembled kits for motorcycles imported by approved local assemblers will be reduced from 25% to 10%.

127. Sixth, Mr. Speaker, electrical energy costs have continued to adversely affect household's budgets. In order to reduce energy costs on consumers and to help conserve energy, duty on energy saving bulbs will be removed.

128. Seventh, Mr. Speaker, to create employment through promotion of youth talents in sports, music, and drama, I propose to exempt from VAT, entertainment services supplied by local Kenyan artistes.

129. Eighth, Mr. Speaker, while the property sector has grown tremendously in the recent past, its share of income tax contribution has not grown as much. To ensure equity in our tax system and to make those who derive their incomes from capital gains contribute towards financing our development programmes, I propose to lift the suspension and re-introduce the taxation of capital gains on transfer of property other than road vehicles and marketable securities.

130. Ninth, Mr. Speaker, as we reduce our dependency on donor support, it will be important for all Kenyans to contribute to development of this country. In this regard, **Mr. Speaker,** I am proposing that in addition to taxing the salaries of Constitutional office holders, the house and entertainment allowances payable to these office holders be taxed like is currently the case for all Kenyans.

131. And Lastly, Mr. Speaker, I recognize that Hon. Members take pride in contributing towards the development of our country. I wish therefore to humbly appeal to the Hon. Members to appoint an Independent Committee to repeal the current legal barriers under the National Assembly Remuneration Act, which denies them the opportunity to make their due contribution through payment of taxes on their house and entertainment allowances. This will allow the Hon. Members to proudly participate in the development of their country.

Promoting Agricultural Productivity and Reducing Poverty

132. Mr. Speaker, let me now move to the next set of incentives which are intended to promote productivity in the agricultural sector and thereby reduce poverty.

133. First, Mr. Speaker, I propose to zero-rate tractor tyres, agricultural tractors and semi-trailers for agricultural tractors. These

measures should reduce costs to commercial farmers and boost productivity, for the welfare of our farmers.

134. Second, Mr. Speaker, the cost of transporting unprocessed agricultural produce has been a major concern to farmers, agro-based industry players and exporters. I am therefore, proposing to zero-rate the transportation of unprocessed agricultural and agro-forest produce.

135. Third, Mr. Speaker, In addition to the above measures under the VAT , I am proposing several measures under the income tax to support growth of our agricultural sector as follows:

- (i) Increase the farm works allowance from 33.3% to 50%.
- (ii) To make our horticultural products more competitive, I propose to exempt commissions payable to non-resident agents, for purposes of auctioning horticultural produce abroad, from withholding tax; and
- (iii) To encourage growing of avocados and mangoes, I propose to declare them permanent and semi-permanent crops so as to enjoy tax advantages available to declared crops.

Promoting Housing and Shelter Ownership

136. Mr. Speaker, I propose to offer incentives to encourage many Kenyans to build and own permanent houses through mobilisation of personal savings. Currently, the deposits made into a Home Ownership Savings Plan (HOSP) by an individual are tax exempt up to a maximum of KSh.4,000 per month or KSh.48,000 per annum, for a maximum period of ten years. I propose to exempt from income tax the interest earned on deposits of up to a maximum of KShs 3.0 million by a depositor who uses the plan for the first time for purposes of owning a permanent house.

Promoting Education

137. First, Mr. Speaker, to encourage expansion of learning facilities, and improve transition rate from primary to secondary

schools, I propose to exempt from stamp duty land purchased for expansion and development of schools.

138. Second, Mr. Speaker, to encourage construction of hostels, especially for our college going girls to ensure their safety, and to encourage construction of school buildings, I propose to give industrial building allowance to both hostels and buildings used for educational purposes at an enhanced rate of 10%.

Encouraging Philanthropy and Social Development

139. Mr. Speaker the recent overwhelming response by Kenyans to help those who were affected by drought shows just how charitable we are as a nation. There is need to encourage philanthropy and to offer incentives for private-public participation in social development.

140. First, Mr. Speaker, in furtherance of private-public sector partnership, I propose to make the cost of construction of a public school, hospital, road or any similar kind of social infrastructure, to be income tax deductible, when such expenditure is incurred with the prior approval of the Minister for Finance.

141. Second, Mr. Speaker, to encourage and deepen philanthropy, I propose to make cash donation made to charitable organizations whose income is exempt from income tax or to projects that are approved by the Minister for Finance, income tax deductible.

142. Last, Mr. Speaker, while our country now enjoys political freedom we must make deliberate effort to strengthen party politics by encouraging democratic participation in our political parties. To facilitate wider participation in registered parties, and promote transparency in funding political parties, I propose to make income tax deductible any contribution by an individual or enterprise up to KShs.1.0 million per annum, provided that these contributions are made through guaranteed cheques drawn in the name of the political party.

Encouraging Infrastructure Development and Deepening Capital Market Growth

143. Mr. Speaker, there is need to deepen our bond market so as to mobilize private sector resources to improve our infrastructure.

144. First, Mr. Speaker, in order to encourage private sector participation in the rehabilitation and maintenance of our infrastructure, I propose to exempt from income tax interest income earned by investors who buy listed bonds as asset backed securities for purposes of developing the infrastructure.

145. Second, Mr. Speaker, on the development of capital market, Hon. Members may recall that in 1995, the Government made the legal costs and other incidental costs relating to the initial public offer of shares, income tax deductible. I am proposing to extend this incentive to companies, which list on the securities exchange without raising additional capital, in order to deepen the growth of stock market.

146. Third, Mr. Speaker, to help deepen the bond market and provide an avenue to mobilize resources for development of our infrastructure, I propose to exempt from income tax interest income accruing from all listed bonds used to raise funds for infrastructure and social services, provided that the bonds shall have a maturity of at least three years.

147. Fourth, Mr. Speaker, ownership of enterprise or business jointly between employer and employee not only improves corporate governance but also creates incentives for productivity among employees. In order therefore to encourage employers to establish employee share ownership plans (ESOPS), I propose to introduce legal provisions to determine how the benefit accruing to employees by exercising the option to own shares shall be brought to charge.

148. Lastly, Mr. Speaker, our motorists spend a lot of money and time complying with requirements for road licence under the Traffic Act. On average, a motorist spends about Kshs 300 daily or

approximately 4 litres of motor spirits, which excludes cost of wear and tear arising from poor conditions of our roads. In a year, **Mr. Speaker**, this translates to about KShs 100,000 or 1,500 litres of motor spirits. In addition, motorists spend about Kshs 3,000 on road licence on average annually and more on compliance cost, including waiting and queuing time at the Kenya Revenue Authority, and other costs associated with traffic police enforcements.

149. To reduce compliance cost incurred by motorists under the Traffic Act, I propose to remove requirements for road licence, and transfer this charge to Road Maintenance Levy at additional rate of Kshs.3.20 per litre, with effect from midnight tonight.

150. Mr. Speaker, while this may appear to increase the cost of transport, when coupled with other measures in insurance, elimination of road licence, and improved roads, the net result is a gain for motorists. I therefore do not expect public transport operators to raise fares on account of this. This measure will raise additional Kshs. 5.0 billion in revenue, of which Kshs 3.0 billion will be earmarked for road maintenance (total allocation increasing from Kshs 9.0 billion to Kshs 12.0 billion) and the remaining Kshs 2.0 billion will be used for rehabilitation and construction of new roads. Improvement in the road network should ultimately reduce costs to our private sector, and lead to happy motoring for all of us.

Encouraging Industrial Growth and Making Imported Commodities Affordable

151. First, Mr. Speaker, to facilitate faster growth of the information and communication technology, create employment opportunities for our youth, and make our country a regional leader on ICT, I propose to remove VAT on computer equipment, computer parts and accessories.

152. Second, Mr. Speaker, in consultations with the Ministers for Finance for Uganda and Tanzania, we agreed on a number of measures designed to improve the welfare of our people, reduce cost of production, and offer some protection to our infant industries. Some of these include removal of import duties on:

- (i) Solar equipment and accessories, including deep cycle and sealed batteries specifically for solar power in order to promote alternative sources of energy
- (ii) Filter paper, an essential input used in the production of oil, fuel and air filters, which are used in the motor vehicle industry; and
- (iii) Wire of stainless steel and nickel bars, rods, profiles and wire, which are essential inputs for the manufacture of arc welding electrodes used widely in the metal fabrication.

153. Thirdly, Mr. Speaker, we also agreed to reduce import duties on unprinted aluminium foil from 25% to 10% to give an incentive to local manufacturers;

154. Lastly, Mr. Speaker, we agreed to increase import duty on floor coverings and mats from 10% to 25%, and on matches from 35% to 50% to protect the local producers

Ensuring Equity under Excise Taxation

155. Mr. Speaker, the measures I am proposing under excise duty are intended to address equity concerns and to improve excise tax administration.

156. First, Mr. Speaker, the current excise tax payable to the Exchequer, is only KShs 42.00 per litre or KShs 21.00 per 500 ml bottle of malt beer. I propose to increase the excise tax on malt beer from KShs 42.00 per litre to KShs 48.00 per litre. This modest increase of Sh.3 per bottle will allow those loyal malt beer drinkers to contribute more towards financing our development priorities, as they enjoy their drink

157. Second, Mr. Speaker, many Kenyans continue to drink illicit and dangerous alcohol, thereby becoming unproductive while at the same time imposing higher costs on our health care facilities. Therefore, to make some beer products affordable to the poor, so they avoid the dangerous drinks, I propose to remove the excise tax on non-malt beer sold in keg. I expect the industry to reduce the price of these beers by at least KShs 5.00 per 300 ml. I also expect them to expand their production and distribution network so that more Kenyans can have access to good quality beer at the same prices as sodas.

158. Third, Mr. Speaker, to simplify and enhance compliance with taxation of wine products, I propose to increase the excise tax on wines from 45% to a hybrid rate of KShs 54.00 per litre or 65 percent, whichever is higher. This measure will harmonize all wine products, including fortified wines.

159. Fourth, Mr. Speaker, similarly, to improve compliance with excise tax laws under the spirit industry and to ensure equity in our tax system, I propose to increase excise tax on portable spirits from the current rate of KShs 100.00 per proof litre or 65 percent to KShs 120 per proof litre or 65 percent, whichever is higher. This measure is expected to create a level playing ground for the alcoholic beverage industry.

160. Fifth, Mr. Speaker, to improve compliance with tax laws, I propose to introduce excise stamps on wines and spirits, whether locally produced or imported.

161. Sixth, Mr. Speaker, in order to address inequity among cigarette smokers and to raise more resources, I propose to increase excise tax on category "B" and "D" by 10 percent to KSh.780 per mille and KSh.1,690 per mille, respectively.

Mr. Speaker, these excise measures are effective from Midnight, today.

Encouraging Growth of The Financial Sector

162. Mr. Speaker, a strong, vibrant and efficient financial sector is essential for economic development and needs to be encouraged.

163. First, Mr. Speaker, in the insurance sector, the income received by the Policy Holder's Compensation Fund, is not exempt from income tax. I propose to exempt the Fund from paying Income Tax so as to be in line with Investor Compensation Fund and the Deposit Protection Fund, which have similar objectives.

164. Second, Mr. Speaker, the current unlimited level of compensation for Third Party body injuries claims by the Insurance Companies has made insuring motor vehicles costly to motorists and unviable to insurers.. To encourage the growth of this sector

and create employment opportunities for our young persons, I propose to limit up to Kshs.3.0 million any compensation payable by the Insurance Companies on third party injury claims arising out of any claim by one person. **Mr. Speaker**, I consider this as a stop-gap measure, while we await for the enactment of a Structured Accident Compensation Bill or a long term solution for the existing problem.

165. Third, Mr. Speaker, as I have pointed above, the motor vehicle insurers have been experiencing a lot of difficulties, some emanating from insurance brokers holding premium collected on their behalf for sixty days, or more in some cases, while the insurer assume the risk immediately the premium is paid to the brokers. To address this and reduce cost to the insurance industry, I propose, under the Insurance Act, to provide that in respect of motor vehicles and fire insurance business, the broker should remit the premium the same day he/she receives it. This “cash and carry” measure will improve the liquidity of the Insurers as well as minimize the risks of the money not being remitted by the brokers.

166. Fourth, Mr. Speaker, the current law restricts insurance agents to act for a maximum of three insurers. This reduces the choice of insurers as to who they can appoint as their agents. This has also prompted the agents to use different names in order to look for more businesses in the insurance industry. To encourage talented school and college leavers to find jobs in the insurance industry, I propose to amend the Insurance Act to remove the restrictions. This will enable the agents to work for as many insurers as can appoint them, consistent with a liberalised economy.

167. Finally, Mr. Speaker, there is a need to broaden the financial sector to allow for more differentiated banking products and services. I am therefore proposing to amend Section 53(1) of the Banking Act to allow for the introduction of new banking products subject to approval by the Minister.

Improving Tax Administration and Reducing Compliance Costs

168. First, Mr. Speaker, to further simplify value added tax under the Hotels and Restaurants, I am proposing to harmonize the VAT

rate applicable on all taxable services provided by hotels and restaurant owners at a general rate of 16 percent.

169. Second, Mr. Speaker, currently taxpayers are allowed to recover the cost of the Electronic Tax Register from the tax payable but there is no time limit on this. I propose to provide for taxpayers to recover the cost of the Electronic Tax Register from the tax payable by the 31st December 2006. Taxpayers who purchase and install Electronic Tax Registers after the 31st December, 2006 will not be allowed to recover the cost of ETR from the VAT payable. They will have to pay out of their own resources.

170. Third, Mr. Speaker, to penalize taxpayers who lodge refund claims that are not genuine, I propose that any registered person who submits a fraudulent refund claim be liable to a penalty equivalent to twice the fraudulent claim lodged. Such a person will also be prosecuted and imprisoned for a term not exceeding three years or both.

171. Fourth, Mr. Speaker, non-resident withholding tax rate of service providers in the telecommunications sector has been left to the discretion of the tax Authority. To remove this uncertainty, I propose to impose a withholding tax at the rate of 5% on the gross receipts by a non-resident service provider whose income accrues or is derived from Kenya.

172. Fifth, Mr. Speaker, during the last budget, the employers' contribution to the retirement scheme was locked in until the employees retirement age. This has created some difficulties to some people especially those who are leaving the country permanently. In view of this, I propose to allow those individuals leaving Kenya permanently to access all their benefits.

173. Sixth, Mr. Speaker, business deals between foreign entities and related resident persons within a multinational group should be carried out as if they were two independent entities. Determination of arms length price has not been clear in the law. In order to bring certainty in the determination of "arms length" price, I propose to publish the Income Tax (Transfer pricing) Rules, together with the Finance Bill.

174. Seventh, Mr. Speaker, since the introduction of Income Tax (Leasing) Rules in 2002, asset financing of equipment and machinery through leasing has increased. The potential for lease financing of saloon motor vehicle is high in Kenya. I, therefore, propose to remove the current restriction that limits tax advantage to asset financing for commercial vehicles. However, in order to safeguard revenue, I further propose that lease rentals will be subject to withholding tax at a rate of 15 percent of gross sum payable.

175. Lastly, Mr. Speaker, up to 75 percent of registered VAT taxpayers file nil returns or do not file any return at all annually, while the 40,000 VAT registrants who have turnover of below KShs 5.0 million pay a total of less than KShs 300 million annually. We appreciate both the considerable costs borne by those taxpayers in complying with VAT regulations and the disproportionate costs incurred by the Kenya Revenue authority in trying to enforce compliance. **Mr. Speaker,** to reduce the burden to taxpayers, improve compliance and ensure taxation of small taxpayers conforms to best international practices, I propose to introduce a turnover tax, effective 1st January 2007, under the Income Tax Act at a rate of KShs.150,000 per annum or 3 percent of turnover, to cater for this category of taxpayers, which shall be a final tax. Consequently, the VAT threshold will be raised to KShs.5.0 million per annum.

Improving Governance

176. First, Mr. Speaker, currently the law provide for the Governor and Deputy Governor to be the Chairman and Deputy Chairman of the Board of Directors of Central Bank, respectively. This arrangement leads to conflict of interest. To enhance corporate governance in the management of the Central Bank of Kenya, I propose to amend the Central Bank Act, to provide for the Chairman to be an independent person. In this regard, the Governor becomes the Chief Executive of the Bank and will be responsible for carrying out functions imposed on him by the CBK Act. The Governor will be answerable to the Board of Directors.

177. Second, Mr. Speaker, for a long time, the sugar development levy has been levied as a sugar tax on consumers

contrary to the understanding of user charge. As a user charge, Sugar Development Levy should correctly be levied on those who use or directly benefit from the Fund. **Mr. Speaker**, in order to correct this situation and to improve governance by ensuring that those who contribute this levy hold the Kenya Sugar Board accountable, I am proposing to amend the Sugar Levy Order to shift the base from the final consumers to the cane growers, where it should have been in the first place. This measure will reduce the price of sugar for our consumers, while making sugar farmers vigilant on the utilization of these funds.

178. Lastly, Mr. Speaker, a number of companies hold huge amounts of unclaimed dividends attributed to various reasons, including change of addresses of the beneficiaries, and closure of bank accounts, among others. To ensure that the beneficiaries do not lose their benefits according to the limitation of Actions Act after seven years, I propose to amend the Capital Market Act to approve that the dividends that remain unclaimed for more than seven years, be paid to the Capital Markets Investors Compensation Fund where the beneficiary will be able to access or claim if he/she resurfaces.

CONCLUSION:

179. In conclusion, Mr. Speaker, as I noted earlier, the 2006/07 Budget I have just presented contains the main frameworks for building a prosperous future for our country. These include:

- (i) Shifting resources to key priority areas such as infrastructure, agriculture, health, education, youth and development of marginalized groups;
- (ii) Deepening structural and governance reforms to reduce administrative and legal barriers to create a favourable environment for private sector investments;
- (iii) Reducing poverty and addressing income and regional inequality through targeted interventions, including through increased spending in rural development and reducing taxes which fall disproportionately on the poor; and
- (iv) Empowering all Kenyans, and in particular, our youth through skill development and by creating economic

opportunities and business environment both in rural and urban areas.

180. Mr. Speaker, the budget proposals I have outlined this afternoon are intended to lock-in the gains in development we have achieved over the last three years. But more importantly, these proposals are aimed at laying a firm foundation for accelerated growth as a means of wealth creation, poverty reduction and equitable social development.

181. Mr. Speaker, achieving our shared development vision for a prosperous and democratic Kenya with equitable social development, will not be easy. It will require our continued commitment to excellence, persistence, hard work, and above all a strong sense of patriotism. It will also require renewed faith in ourselves, and passionate conviction, that with Gods' help, we can achieve our best dreams. In my humble opinion, **Mr. Speaker,** we all need to engage less in politics and more in production, with our eyes fixed on the Goal. As His Excellency, the President has time and time again reminded us, we should strive to ensure that indeed Kenya becomes a "Working Nation". We should focus on creating opportunities and defining avenues for our people and our companies to assist in accelerating the pace of national development.

182. Finally, Mr. Speaker, this Great Nation belongs to us all. It has a great future. Let us walk together, to achieve the Kenyan dream. Differences should not obscure our collective vision as a Nation, which is to strive to improve the well being of all Kenyans. I therefore, urge each and every Kenyan to play their part in helping to build a truly prosperous Kenya. A Kenya that we all will be proud to call Home.

183. Mr. Speaker, I beg to move.

BUDGET POLICY STATEMENT

I. INTRODUCTION

1. This is the first Budget Policy Statement (BPS) to be tabled in Parliament in accordance with the requirements of Fiscal Management Act, 2009, section 7 sub-sections (1), (2) and (3). It presents broad strategic macroeconomic, fiscal policy and structural reform measures underpinning the Budget for FY 2010/11 and the medium-term. Specifically, the 2010 BPS presents the recent economic developments; the medium-term macroeconomic and fiscal framework underlying the MTEF budget; an outline of the expenditure programme priorities and allocation of resources as well as a summary of sector achievements and medium-term priorities.

2. The overriding policy thrust of this BPS is to consolidate the economic recovery gains made so far and put the economy back onto a firm foundation of high and sustainable growth path. To achieve the envisaged performance, the Government will step-up investment in the key priority social and economic sectors. Equally important is the planned up-scaling of investment in critical physical infrastructure such as roads, rail, power generation as well as power transmission and distribution systems, and port modernization and expansion.

3. To complement the investment in the socio-economic sectors and physical infrastructure, the Government aims at deepening structural reforms in the area of governance, public financial management; public service, business regulation, and the financial sector. These reform measures are aimed at reducing the cost of doing business with a view to enhancing Kenya's competitiveness and investment.

4. The 2010 BPS also underlines the importance of continued maintenance of macroeconomic stability to the achievement of high and sustainable economic growth, employment creation and poverty reduction objectives. On the fiscal front, this BPS takes cognisance of the reality that available resources are scarce and that there is need to focus on national priority programmes that have high impact on our stated national objectives, but within a framework of a stable macroeconomic environment.

II. RECENT ECONOMIC DEVELOPMENTS

Growth

5. After experiencing a sharp decline in growth from 7.1 percent in 2007 to 1.7 percent in 2008, Kenya's economy is beginning to emerge from the challenges of the last quarter of 2007 and the first quarter of 2008 following return of peace in the country. Provisional estimates put the growth in real GDP at about 2.2 percent, which, though weak an improvement, is encouraging. Indeed, economic recovery is now underway; thanks to the good rains that started falling in November 2009, and the global economic recovery that is gaining momentum.

6. Adherence to sound macroeconomic policies, a credibility achieved over the last seven years, has played a crucial role to stabilize the economy and allow counter-cyclical adjustments. Cautious policies that reduced substantially domestic and external debt levels (from about 60 percent to 40 percent) during the last decade has enabled the Government to maintain monetary and fiscal policy stance supportive of increased economic activities, without compromising its macroeconomic stability objective.

Inflation and Interest Rates

7. The 12-month overall rate of inflation fell from 14.6% in February 2009 to 4.7 percent in January 2010. Over the same period the annual average rate of inflation dropped from 16.8% to 8.5%. The decline reflected in part the change in the computation methodology and more importantly reduced prices of food items that were driving inflationary pressures in 2009. However, the underlying rate of inflation (excluding food and energy), which had eased to 4.9% in November 2009 from 8.4% in February 2009, stood at 5.7 percent in January 2010.

8. Interest rates have remained generally stable during the period under review, with the average 91-day Treasury bill rate rising modestly from 7.7 percent in September 2008 to 8.5 percent in January 2009 before easing to 6.6 percent in January 2010. The 182-day Treasury bill rate also increased to about 9.1 percent in December 2008 from 8.1 percent in September 2008, but it declined to 7.0 percent by end-January 2010. Interest rates for longer term (3 to 20-year) government bonds ranged between 9 percent and 12.5 percent.

Balance of Payments and Exchange Rates

9. During the year ending-December 2009, the external current account worsened recording a deficit of US\$ 2.1 billion (7.3 percent of GDP) compared with a deficit of US\$ 2.2 billion (7.2 percent of GDP) in 2008. The weaker current account position in 2009 reflected the deterioration in the trade balance from a deficit of US\$ 5.6 billion to US\$ 5.7 billion. The weakening of the trade balance was driven by 11.4 percent contraction in exports earnings, which more than offset the 4.5 percent drop in imports. The fall in export earnings largely reflected reduced volume of exports of horticulture, tea and re-exports that outpaced the improvement in commodity prices during the review period.

10. The capital and financial accounts, on the other hand, recorded a larger surplus amounting to USD 2.5 billion (8.9 percent of GDP) and thereby offset the deficit in the current account. In consequence, the overall balance of payments registered a surplus of US\$ 464 million, a sharp turnaround from a deficit of US\$ 513 million in 2008.

11. The improvement in the overall balance of payments was mirrored in the country's foreign exchange holdings. Official foreign exchange reserves rose to reach

US\$ 3.8 billion at end-December 2009 (equivalent to 3.3 months of imports cover¹) from US\$ 3.1 billion at end-December 2008 (equivalent to 2.9 months of imports cover). The improved reserve position was bolstered by disbursements from the IMF's Exogenous Shock Facility and the enhancement in the SDR allocations by the Fund, as well as CBK's efforts to increase its foreign exchange holdings through purchases in the inter-bank foreign exchange market.

12. After depreciating to Ksh. 80.3 per US dollar by March 2009, the Kenya shilling stabilised during the second half of 2009, exchanging at Ksh. 74-76 per US dollar. By February 2010, the shilling exchange rate strengthened to trade at Ksh. 76.7 per US dollar compared to Ksh 79.5 per US dollar in February 2009. Against the other major currencies, the Kenya shilling depreciated by 25.8 percent to the South African Rand, 4.9 percent to the Sterling Pound and 3.3 percent against the Euro but appreciated by 1.3 percent against the Yen in February 2010.

Monetary Developments

13. Broad money, M3, increased by 19.2 percent in the twelve months to January 2010, compared to 11.8 percent in a similar period in 2009. The stronger expansion in money supply reflected growth in both net foreign assets (NFA) and net domestic assets (NDA) of the banking system. The NFA of the banking system grew by 5.9 percent compared with a contraction of 6.1 percent a year earlier.

14. Over the same period, the NDA of the banking system, mainly driven by government borrowing, rose by 24.7 percent compared to 21.1 percent in 2009. Credit to the private sector in the 12-month to January 2010 slowed to 15.2 percent compared to 23.4 percent over a similar period in 2009. Most of the credit extension to the private sector supported agriculture and construction sectors as well as consumer spending.

15. After dipping to 2,475 points in February 2009, from a peak of 5,774 points in January 2007, the NSE Index rose to 3,247 points in December 2009. By January 2010, the index had risen further to 3,565 points. Similarly, market capitalization increased to Ksh. 910 billion in January 2010, from Ksh. 611 billion in February 2009. The strengthening of the stock market indicators reflects improved profitability of key companies listed at the NSE and improvement in investor confidence, in part due to the bold reform measures taken by the Government to improve transparency and accountability in the operations of the NSE as well as steps to strengthen the supervisory capacity of the Capital Markets Authority (CMA).

¹ This refers to next year's import cover

Fiscal Performance, July 2009 – February 2010

16. Total revenue for the period July 2009- February 2010 amounted to Ksh. 340.7 billion, following an increase of Ksh. 31.5 billion or 10.2 percent over a similar period ending February 2009. Ordinary revenue stood at Ksh 313.4 billion at the end of February 2010, representing an increase of Ksh. 27.6 billion or 9.7 percent over a similar period in the previous financial year. However, against the budget target of Ksh. 363.7 billion, total revenue was Ksh. 23 billion lower than expected. Ordinary revenue was Ksh. 20.6 billion below the expected receipts of Ksh. 334.0 billion over the period under review. Indeed, the underperformance in ordinary revenue accounted for nearly 90 percent of the shortfall in total revenue for the 8-month period ending February 2010. The under-performance in ordinary revenue was largely due to slower recovery of the economy than envisaged. On the other hand, Appropriations-in-Aid (A-I-A), which stood at Ksh. 27.3 billion by the end of February 2010, also underperformed and accounted for Ksh. 2.4 billion or about 10 percent of the overall shortfall in total revenue. (see Table 1 below). The lower than targeted A-I-A is mainly attributed to reporting lags in projects supported by the development partners who funding does not pass through the National Exchequer.

17. During July 2009 - February 2010, total expenditure amounted to Ksh. 440.0 billion against a target of Ksh. 503.6 billion, reflecting an under-spending of Ksh. 63.5 billion. Recurrent expenditure amounted to Ksh. 331.2 billion against the budget target of Ksh. 332.3 billion, recording a slight under-expenditure of about Ksh. 1.0 billion. Development expenditure, on the other hand, amounted to Ksh. 108.3 billion against a target of Ksh. 170.3 billion, representing an under-spending of Ksh. 62 billion (see Table 1 below).

18. Domestically financed development expenditure amounted to Ksh. 85.0 billion, Ksh. 23.1 billion below the budget target. This under-performance was mainly due to the slow take off in the implementation of Economic Stimulus Programme (ESP), occasioned by the need for consulting widely with all relevant stakeholders in order to establish a credible framework for implementing and monitoring the progress in the implementation of the ESP projects.

19. Foreign financed development spending continues to face a number of implementation problems at the project level and thus affecting the extent of uptake of external resources. Indeed, for the period under review, foreign-funded development expenditure amounted to Ksh. 23.3 billion against a target of Ksh. 62.3 billion (see Table 1 below). Some of the factors behind this underperformance include: lengthy and at times unnecessary disbursement steps and procedures, cumbersome procurement procedures, and delays in obtaining no objection approvals required by the donors. These challenges are compounded by insufficient understanding of donor policies by project personnel.

20. Taking into account the developments in revenue and expenditure during July 2009 and February 2010, the overall fiscal balance registered a deficit (after

grants) amounting to Ksh. 88.1 billion compared to the budget target of Ksh. 118.1 billion. After taking account of net foreign financing, the actual net domestic financing amounted to Ksh. 87.3 billion against a target of Ksh.81.8 billion (see Table 1).

21. It is, however, worth noting that whereas domestic borrowing fared well and financed almost the entire fiscal deficit in the period under review, over reliance on domestic borrowing poses a potential risk of crowding out the private sector, which, over the years has been recognised as the engine for economic growth, employment creation and poverty reduction. Consistent with Vision 2030 and Medium-term Plan, the Government will contain growth in total expenditures to levels consistent with sustainable debt and gradually reduce domestic debt to create fiscal space through reduced interest payments. To facilitate reduction in domestic debt, the Government aims to increase access to external concessional funds and use part of the proceeds to repay the domestic debt already acquired. The savings likely to arise from this debt management strategy will be used to finance critical and strategic priority development programmes.

Table 1: Fiscal Developments, July 2009 – February 2010

	2008/09	2009/10	2009/10		Deviation
	Feb-09 Prov.	Budget	Feb-10 Prog.	Prov.	
TOTAL REVENUE	309.2	568.9	363.7	340.7	(23.0)
Ordinary Revenue (excl. LATF)	285.8	522.8	334.0	313.4	(20.6)
Ministerial and Departmental fees (AiA)	23.5	46.1	29.7	27.3	(2.4)
EXPENDITURE AND NET LENDING	359.0	772.4	503.6	440.0	(63.5)
Recurrent expenditure	277.8	509.1	332.3	331.2	(1.0)
Development and Net lending	80.5	261.3	170.3	108.3	(62.0)
Domestically financed	56.8	157.5	108.0	85.0	(23.1)
Of which Net Lending	1.1	2.4	1.1	1.3	0.2
Foreign financed	23.7	103.8	62.3	23.3	(38.9)
CCF	1.0	2.0	1.0	0.5	(0.5)
GRANTS	9.6	35.3	21.8	10.0	(11.8)
BALANCE INCL. OF GRANTS (CASH BASIS)	(43.3)	(168.2)	(118.1)	(88.1)	30.0
FINANCING	40.1	168.2	113.6	87.9	(25.7)
Net foreign financing	2.9	50.2	27.7	0.6	(27.1)
Disbursements	14.1	68.5	40.5	15.4	(27.1)
Repayments	(11.1)	(18.3)	(12.8)	(12.8)	-
Domestic financing	37.2	118.0	85.8	87.3	1.5
Privatization proceeds & Others	-	8.5	4.0	-	(4.0)
Net domestic borrowing	37.2	109.5	81.8	87.3	5.5
Financing Gap/Statistical discrepancy	(3.18)	0.00	(4.50)	(0.17)	4.3

Source: Ministry of Finance

Emerging Challenges

22. Since the commencement of this financial year in July 2009, a number of challenges, which are likely to affect the original assumptions that formed the basis of the FY 2009/10 Budget, have emerged. These challenges include:

- (a) **Revenue underperformance:** On the resources front, as already indicated, ordinary revenues experienced a cumulative shortfall of Ksh. 20.6 billion by end of February 2010. Therefore, revenue targets for FY 2009/10 may not be fully realized.
- (b) **Privatization:** The FY 2009/10 budget framework envisaged receipts amounting to Ksh. 6.0 billion from sale of government shares in SONY Sugar Company and the National Bank of Kenya. It is now evident that the privatization process will not be complete before the close of the financial year, thus reducing the expected resource envelope by Ksh. 6.0 billion.
- (c) **On the expenditure side:** In August 2009, the Government rolled out a Ksh. 24.6 billion programme to mitigate the adverse effects of the prolonged drought experienced in most parts of the country. Of this amount, Ksh. 13.1 billion was financed through realignment of the concerned spending ministries' budget; Ksh 6 billion from the Civil Contingency Fund and borrowing from the Strategic Grain Reserve (SGR); and the balance of Ksh. 5.5 billion from expenditure cuts across all ministries.
- (d) **Additional Funding:** Treasury has since July 2009, received requests for additional funding by spending ministries amounting to slightly over Ksh. 123 billion. Among these expenditures include the Ksh. 9.9 billion required to put into operation the IIECK in readiness for the Constitutional Referendum. An additional Ksh. 2.9 billion is also now required to rehabilitate infrastructure damaged by the floods from the mini-El Nino rains, which rocked the country in late 2009 and continued in early 2010.

23. In view of the financial constraints and the need to ensure sustainable domestic borrowing and maintain macroeconomic stability, the requests for additional funding have been rationalized and limited only to key interventions that cannot be postponed.

III. MEDIUM-TERM MACROECONOMIC FRAMEWORK, 2010/11-2012/13

24. The broad national objectives remain as outlined in the National Vision 2030, which aims at raising growth to 10 percent by 2013/14 and sustaining it at that level in the medium-term; reducing poverty and addressing socio-economic regional