Cytonn INVESTMENTS

The Draft 2025 Budget Policy Statement Note

The National Treasury released the Draft 2025 Budget Policy Statement, in line with section 25 of the Public Finance Management (PFM) Act, 2012 which mandates the Treasury to incorporate the views of stakeholders, including the public, during the preparation of the Budget Policy Statement (BPS). Following this consultative process, the Budget Policy Statement (BPS) is submitted to the Cabinet for approval and subsequently presented to Parliament for discussion and adoption. The statement expresses the priority economic policies, structural reforms and the sectoral expenditure programs to be implemented under the Medium-Term Expenditure Framework for FY 2024/25– 27/28.

As such, we will be reviewing the statement and discuss the following:

i. A comparison of the FY'2024/25 Supplementary Budget I and the projected FY'2025/26 budget as per the Draft 2025 BPS,
ii. Our analysis and view of key aspects of the budget,
iii. Recovery Strategy, and,
iv. Conclusion and key areas of improvement,

Section I: A comparison of the FY'2024/25 Supplementary Budget II and the projected FY'2025/26 Budget as per the Draft 2025 BPS

Below is a summary of the major changes as per the BPS 2025 from the expected FY'2025/2026 budget performance:

Comparison of 2024/25 and 2025/26 Fiscal Year Budgets as per The 2025 Budget Policy Statement				
	FY'2023/2024 Budget Outturn (Kshs bn)	FY'2024/2025 Revised Estimates (Kshs bn)	FY'2025/2026 BPS (Kshs bn)	% change 2024/25 to 2025/26
Total revenue	2,702.7	3,060.0	3,516.6	14.9%
External grants	22.0	52.3	53.2	1.7%
Total revenue & external grants	**2,724.7**	**3,112.3**	**3,569.8**	**14.7%**
Recurrent expenditure	2,678.4	2,826.2	3,076.9	8.9%
Development expenditure & Net Lending	546.4	599.5	804.7	34.2%
County governments + contingencies	380.4	455.1	447.7	(1.6%)
Total expenditure	3,605.2	3,880.8	4,329.3	11.6%
Fiscal deficit including grants	**880.5**	**768.5**	**759.5**	**(1.2%)**
Deficit as % of GDP (Including grants)	5.6%	4.4%	3.9%	(0.5%)
Net foreign borrowing	222.7	355.5	213.7	(39.9%)
Net domestic borrowing	595.6	413.1	545.8	32.1%
Total borrowing	818.3	768.6	759.5	(1.2%)
GDP Estimate	15,826.4	17,434.5	19,272.8	10.5%

Key take-outs from the table include:

i. Total revenue inclusive of Ministerial Appropriation in Aid is projected to increase by 14.9% to Kshs 3.5 tn from Kshs 3.1 tn as per FY'2024/25 revised budget estimates, with proposals such as expanding the tax base and improving tax compliance already in place to work towards increasing the amount of revenue collected in the next fiscal year,

ii. The 2025 BPS points to a 11.6% increase of the total expenditure, to Kshs 4.3 tn from Kshs 3.9 tn in the FY’ 2024/25 revised budget estimates,
iii. Development expenditure is set to increase at a higher rate than recurrent expenditure; with development expenditure increasing by 34.2% to Kshs 804.7 bn from Kshs 599.5 bn as per the supplementary budget II, while recurrent expenditure is projected to increase by 8.9% to Kshs 3.1 tn from Kshs 2.8 tn as per the FY’2024/25 supplementary budget II. However, the recurrent expenditure will still constitute the largest allocation of 71.1% while development will be allocated 18.6%
iv. The budget deficit is projected to decline by 1.2% to Kshs 759.5 bn (3.9% of GDP) in FY’2025/2026, from the projected Kshs 768.5 bn (4.4% of GDP) in the FY’2024/25 revised budget; the decline is in line with the International Monetary Fund’s (IMF’s) recommendation for fiscal consolidation, as the country seeks to reduce Kenya’s public debt requirements,
v. The total borrowing requirement is expected to decline by 1.2% to Kshs 759.5 bn from Kshs 768.5 bn as per the FY’2024/25 revised budget, in a bid to reduce Kenya’s public debt burden which is estimated at 65.5% of GDP as of June 2024, 15.5% points above the East African Community (EAC) Monetary Union Protocol, the World Bank Country Policy and Institutional Assessment Index, as well as, the IMF threshold of 50.0%, and,
vi. Debt financing for the 2025/26 budget is estimated to consist of 28.1% foreign debt and 71.9% domestic debt, a change from the 46.3% foreign debt and 53.7% domestic debt as projected in the revised FY’2024/25 budget, pointing towards increased domestic borrowing.

Section II: Analysis and house-view on key aspects of the BPS:

Below we give our analysis and view on various aspects of the Budget Policy Statement:

1. **Revenue**

In FY’2025/26, revenue collection including Appropriation-in-Aid (A.i.A) is projected to increase by 14.9% to Kshs 3.5 tn, up from the estimated Kshs 3.1 tn as per the FY’2024/25 Supplementary Budget II, mainly underpinned by the ongoing tax policy reforms and revenue collection measures geared towards increasing the tax base and improving tax compliance. Ordinary revenues are expected to increase by 14.7% to amount to Kshs 3.0 tn in FY’2025/26 up from the estimated Kshs 2.6 tn in FY’2024/25 Supplementary Budget II.

Revenue collection inclusive of grants recorded a slower growth of 7.6% for the period to November 2024 to Kshs 1,088.1 bn, compared to a growth of 13.2% over a similar period in 2023, and similarly performed below the target by Kshs 77.3 bn. The performance was mainly on the back of below target tax collections amounting to Kshs 937.4 bn, against a target of Kshs 1,009.0 bn, translating to an underperformance rate of 92.9%. This was majorly attributable to the withdrawal of the Finance Bill 2024, and protests that led to a slowdown in economic activities, coupled with the rising cost of living, which has impacted the business environment negatively, leading to lower tax remittances, despite an increase in tax rates.

To address revenue shortfalls, the Kenyan government has implemented several tax amendments through the Tax Laws (Amendment) Bill 2024, aiming to enhance tax collections and tax compliance. Notable reforms include:

i. **Digital Marketplace Taxation:** Imposing withholding taxes on income from digital platforms, with rates of 5.0% for residents and 20.0% for non-residents, targeting the expanding digital economy.

ii. **Revised VAT Input Tax Deductions:** Limiting businesses making 90.0% zero-rated supplies to claim VAT input proportionate to taxable sales, reducing VAT refunds and retaining more funds in government coffers.
iii. **Excise Duty on Imported Sugar Confectionery:** Introducing a Kshs 40.0 per kilogram excise duty on imported sugar confectionery to protect local manufacturers and generate additional revenue.
iv. **Expanded Definition of Royalties:** Broadening the definition of royalties to include payments for software use and related services, bringing previously untaxed transactions into the tax net.
v. **New Excise Duty on Financial Services:** Defining "other fees" to include charges and commissions by financial institutions, excluding interest, insurance premiums, and Islamic finance premiums, to expand excise duty collections.
vi. **Increased Taxation on Aid-Funded Projects:** Restricting VAT input claims for manufacturers supplying to aid-funded projects, resulting in higher VAT revenues.
vii. **Higher Employment Benefits Tax Thresholds:** Adjusting non-taxable limits for employment benefits such as gratuity, meals, and retirement fund contributions, to align with inflation and potentially capture more taxable income over time.
viii. **Excise Tax Amendments from the Finance Act, 2023:** Raising excise duties on specific goods and services, such as alcoholic beverages, tobacco, and luxury items, to boost excise tax collections.

We are of the view that the higher targeted revenue collection for FY'2025/2026 was expected given the current administration's focus on expanding the tax base to include the informal sector, increasing the excise duty tax, VAT, and the roll-out of the e-TIMS system to improve VAT collection margins. However, the upward revision of taxes comes at a time when the cost of living remains elevated and as such we expect this to weigh down on the projected revenue performance. We however expect that revenue performance will be partly supported by the stability of the Kenyan Shilling against the Dollar and other strong currencies and the easing inflationary pressures.

2. Expenditure

As per the 2025 BPS, total expenditure is set to increase by 11.6% to Kshs 4.3 tn from Kshs 3.9 tn in FY 2024/25 as per the Supplementary Budget II. Development expenditure is set to increase at a higher rate than recurrent expenditure; with the development expenditure increasing by 34.2% to Kshs 804.7 bn from Kshs 599.5 bn in FY'2024/25 as per the revised estimates, while recurrent expenditure is projected to increase by 8.9% to Kshs 3.1 tn from Kshs 2.8 tn in FY'2024/25. One of the key concerns lies in the proportion of recurrent expenditure compared to development spending over the years, which as per the BPS is expected to come in at 71.1% against 10.3%, respectively in FY'2025/26.

In line with the Government's consolidation strategy, total expenditure and net lending for the eleven months to November 2024 came in at Kshs 1,442.9 bn, which was Kshs 66.6 bn below the prorated amount of Kshs 1,509.5 bn, translating to 95.6% underperformance rate. Recurrent spending amounted to Kshs 1,091.8 bn while development expenditures and transfer to County Governments were Kshs 193.1 bn and Kshs 158.0 bn, respectively, against prorated targets of Kshs 175.0 bn and Kshs 184.0 bn respectively.

Development expenditures exceeded the target by Kshs 18.1 bn mainly attributable to over absorption of foreign financed development projects by Kshs 14.8 bn and domestically financed projects by Kshs 5.2 bn. Recurrent expenditure falling below target by Kshs 57.6 bn was mainly attributable to lower than targeted expenditure on pensions, operations and maintenance and other CFC domestic and external interest. Due to the higher shortfall in expected revenue of Kshs 77.3 bn compared to the shortfall in expected expenditure, of Kshs 66.6 bn during the eleven months to November 2024 an overall deficit of Kshs 350.9 bn was recorded,

which was above the projected deficit of Kshs 339.7 bn for the period. This deficit was financed through net domestic financing of Kshs 401.7 bn and net foreign borrowing of Kshs 1.7 bn.

The government plans to strengthen expenditure control and enhance public spending efficiency through several measures:

i. **Austerity and Transparency**: Implement austerity measures to reduce recurrent expenditure, roll out an end-to-end e-procurement system for transparency, and scale up Public-Private Partnerships (PPPs) for viable projects. Governance reforms targeting state corporations will also be expedited.
ii. **Treasury Single Account (TSA)**: Over three years, the TSA will consolidate government cash resources, starting with national government entities in FY'2024/25, followed by county governments in FY'2025/26, and other entities by FY'2026/27.
iii. **Accrual Accounting**: Transitioning from cash-based to accrual accounting will enhance resource management and fiscal reporting, with assets and liabilities recognized over a three-year period.
iv. **Zero-Based Budgeting**: The government will entrench Zero-Based Budgeting in FY 2025/26, using a new budgeting tool for streamlined costing and prioritization.
v. **Public Investment Management (PIM)**: Reforms will prioritize completing ongoing projects, assess environmental risks, and integrate PPP projects. PIM systems will be expanded across all government levels.
vi. **Assets and Liabilities Management**: The government will standardize and digitize asset management, develop an asset valuation framework, and introduce an asset tagging system to enhance visibility and utilization.
vii. **Leasing Framework**: A standardized leasing framework will address inconsistencies in leasing practices across public entities.
viii. **Pension Reforms**: Governance of the Public Service Superannuation Scheme (PSSS) will be delinked from non-contributory schemes. Digitization and re-engineering of pension systems will improve accuracy and timely payments, supported by actuarial evaluations for sustainability.

Key to note, the projected recurrent expenditure is still high despite the significant increase in the development expenditure. As such, the quality of fiscal consolidation remains a concern and this could potentially compromise the growth potential of the economy. To reduce government expenditure, and in turn what needs to be plugged in through borrowing, we suggest the following:

i. **Enhancing Public-Private Partnerships (PPPs)** – The government should involve the private sector in development as this will increase efficiency while reducing pressure on the government. This should be done by removing bottlenecks to PPPs and joint ventures to attract more private investors to attract more development projects especially the infrastructure ones,
ii. **Reduction of The Public Wage Bill** – This should be done through rationalization of the public office roles we currently have by getting rid of redundancies in the representation of counties and constituencies, and, etc. and relooking at the salaries, allowances and benefits earned,
iii. **Privatization of Parastatals** - The government should revive economic performance of parastatals or privatize poorly performing ones to release capital, lower debt and also to prevent the widening of debt from losses and inefficiencies. Fortunately, the government has identified this as a suitable approach and has started the process of privatizing at least 35 state owned firms through the Privatization Commission,
iv. **Enhancing Efforts to Fight Corruption** – The government should ensure efficiency and advance efforts to fight corruption, as funds lost to corruption are estimated at roughly a third of the national budget

(Estimates from the Ethics and Anti-Corruption Commission). Kenya has been engaged in the fight against corruption since the 1960's, without successfully being able to get rid of recurrent scandals involving huge sums of public funds that are inflating the expenditure but not impacting the lives of the common Kenyan, and,

v. **Prioritizing Impactful Development Projects** – To ensure fiscal consolidation and manage expenditure, the government should give priority to completing ongoing development projects after thorough auditing. Further, it is essential for the government to also concentrate on ensuring that Development budget is more concentrated on projects that have high social benefits and high economic return. Going forward, development budget absorption needs to improve as most fiscal years end in an under-absorbed development budget and an over-spent recurrent budget. Development projects need to be prioritized and better planning incorporated to match fund availability to project execution, and measures taken to improve the public procurement process; while also being prudent in recurrent spending.

3. Public Debt

From the Draft Policy Statement, the total new public debt requirement for the FY 2025/26 is set to decline by 1.2% to Kshs 759.5 bn from the projected Kshs 768.6 bn, in FY'2024/25. The public debt requirement mix is projected to comprise of 28.1% foreign debt and 71.9% domestic debt, compared to the 46.3% foreign debt and 53.7% domestic debt as per the Supplementary Budget II FY'2024/2025. The government plans to continue to address borrowing needs by leveraging both domestic and external resources. External funding will primarily come from multilateral, bilateral, and commercial lenders, with a strong focus on concessional loans. Non-concessional and commercial borrowing will be strictly limited to projects that align with the national development agenda and lack concessional financing options.

In response to global challenges such as supply chain disruptions and rising external financing costs, the government will closely monitor macroeconomic conditions before accessing international capital markets through sovereign bonds or liability management operations. Additionally, it will explore innovative financing options, including green and climate-related financing, and expand into new markets with instruments like Panda and Samurai bonds to diversify funding sources.

Domestically, the government recognizes the critical role of local borrowing, which has historically accounted for more than half of its funding needs, and is focused on lengthening the public debt maturity profile through issuance of medium to long-term bonds. To enhance this market, reforms will focus on improving efficiency, diversifying the investor base, and ensuring stability. The M-Akiba bond platform will be revamped to make government securities more accessible to retail investors, fostering financial inclusion and a culture of saving.

Despite the decrease in the public debt-to-GDP ratio to 65.5% in June 2024 from 72.0% in June 2023, debt sustainability remains a significant concern for the country. The International Monetary Fund's (IMF) debt sustainability analysis classifies Kenya's public debt as sustainable, with the country being rated a medium performer in terms of Debt Carrying Capacity (DCC). As of November 2024, Kenya's debt service to revenue ratio stood at 56.8%, which is 26.8% points above the recommended IMF's threshold of 30.0%. The sustained level of debt service to revenue ratio above the recommended threshold is a worrying sign, elevating the refinancing risk following shocks arising from global supply disruptions. To manage debt sustainably, the government will prioritize fiscal consolidation efforts aimed at moderating debt accumulation and reducing debt servicing costs.

Below are some actionable steps the government can take towards debt sustainability;

i. **Restructuring of Debt Mix**- The government should prioritize concessional borrowing to reduce the amounts paid in debt service and reduce its dependence on commercial borrowings which are usually expensive and has been increasing debt servicing cost. Further, commercial borrowing should be limited to development projects with high financial and economic returns, to ensure that more expensive debt is invested in projects that yield more than the market rate charged,
ii. **Improving Capital Markets** - The government should channel efforts towards strengthening the Capital Markets structure to ease the pooling of funds by investors to undertake development projects instead of the government heavily undertaking capital projects on their own. Key to note, our capital markets remain dormant with banking markets having mobilized Kshs 5.7 tn in deposits compared to Collective Investment Schemes at only Kshs 0.3 tn, hence the need to increase support to the sector,
iii. **Fiscal Consolidation** – The main attribute to higher fiscal deficit is higher expenditure compared to lower revenue collections consequently leading to increased borrowing to finance the deficit. However, the government can bridge the deficit gap by implementing robust fiscal consolidation through expenditure reduction by introducing austerity measures and reducing amounts extended to recurrent expenditure and capital-intensive projects but mainly focus on projects with high social impact or a higher economic return. The government can also focus on completing pending projects whose economic benefits will be transmitted into the economy and support overall economic growth instead of starting new ones,
iv. **Improving the Country's Export**- The government can focus on developing certain sectors to build an export-driven economy by formulating export and manufacturing policies. Encouraging growth in the manufacturing sector will help increase the value of our exports leading to an improved current account, and,
v. **Improve the Efficiency of Public Debt Management Office** –The directorate was established to minimize the cost of public debt management, promote development of market for government debt securities and ensure sharing of benefits and costs of the debt between different generations. However, the authority should also have a mandate of solving Kenya's debt problems which have been more of a lack of fiscal discipline coupled with the inadequate political will to fight corruption so as to avoid pilferage. The authority should also be given the mandate to monitor expenditure and funds allocation to specific projects.

Section III: Conclusion

The 2025 Budget Policy Statement is the third to be prepared under the new administration with the main aim of realizing the administration's main objective of achieving the Bottom-Up economic model. The BPS comes at a time when the country, is facing a deceleration in economic activity, reflected in the slower GDP growth in the first three quarters of 2024, and projected at 4.6% for FY'2024 from the 5.6% growth in FY'2023. As such, the formulation of the BPS is hinged on ascertain economic recovery projected at 5.3% GDP in 2025. In the event of an economic downturn, the measures would be negative discouraging entrepreneurship, growth of SME and depress earnings growth in the private sector. From the statement, the implementation of the budget will rely more on increased revenue collection with the treasury putting on proposals to achieve the revenue target of Kshs 3.6 tn. The statement has also indicated a reduction in government debt to ensure fiscal consolidation to ease on the debt burden of the country. In line with its manifesto, the Kenya Kwanza regime has also proposed a marginal increase in recurrent expenditure by 8.9%, but significantly increased the development expenditure by 34.2% to help push the key development agendas. The proposed budget is also set to have a deficit that will be met through a mix of domestic and foreign borrowing which is projected at Kshs 759.5 bn compared to Kshs 768.6 mn in the FY'2024/25 revised budget.