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LOWER OIL PRICES SHOULD LEAD TO GCC FISCAL REFORM

Fiscal reform including taxes is the solution to the region's oil price dilemma.

DESPITE GEOPOLITICAL TURMOIL in Iraq, Libya and the region, rising worries of a global slowdown and growing supplies have pushed oil prices down in the past few weeks. Oil prices are down about 25 per cent since June, falling by $4 on October 14 alone, while futures market prices are in the range of $79 to $81. Saudi Arabia, meanwhile, increased its production by 100,000 bpd last month despite the fall in prices (signaling its interest in maintaining market share) and increasing the pressure on other major oil producers such as Russia. Fundamentals are weighing heavily on oil prices: a slowing global economy (in particular, from emerging market economies and China), greater energy efficiency and a changing energy mix from lower prices and access to renewable energy are reducing demand. The other side of the scissors, disruptive new technologies (horizontal drilling) and tight oil expansion (shale oil and gas in the US) with continued supply from OPEC implies greater supply. Importantly, the forces at work are more likely to be permanent rather than temporary and cyclical, suggesting low and/or a downward trend for oil and gas prices.

CONSUMPTION VS SUSTAINABILITY

Given the state ownership structure, governments in the GCC are the main beneficiaries of oil export receipts, but with the near-absence of taxation, governments are highly dependent on revenues from hydrocarbon exports, which represent more than 80 per cent of total revenue. This dependence comes with high risk and unreliability. Oil and gas revenues are vulnerable to the volatility of international oil and gas prices and to market demand and supply conditions and production interruptions, which are largely outside the control of any individual oil exporting country. This uncertainty about current and future revenues means that countries face the dilemma of how much to consume, how much to invest and to save. In addition countries must consider future generations: oil and gas stocks are an exhaustible natural resource wealth. Extracting and consuming more today means less is left for future generations who are not represented when choices are made. Higher consumption today means we bequeath less to future generations, reducing their future income prospects.

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LOWER OIL PRICES THREATEN GCC FISCAL STABILITY

The likelihood of lower oil and gas prices means that the GCC countries face lower current account and balance of payments surpluses, implying lower accumulation of net foreign assets and greater vulnerability to external shocks. On the domestic front, lower oil prices means lower oil revenues which – absent of other sources of revenue – threatens fiscal stability and sustainability. This threat is aggravated by the large increase in government spending since 2011 in reaction to the Arab firestorm, in addition to massive infrastructure and investment spending programmes. The absence of fiscal policy instruments only adds to the burden of adjustment to the large oil price shock. All GCC governments have reacted to the Arab firestorm tsunami with a surge in spending (mostly on wages, salaries, pensions, subsidies and other current spending) that has raised break-even oil prices. Political economy calculus suggests that the ratchet effect will not be scaled back. Add to this the lack of

revenue diversification, and there is a high probability that countries like Saudi Arabia, the UAE and Kuwait will be running budget deficits in the coming years, in addition to Bahrain and Oman.

THE IMPERATIVE OF FISCAL REFORM

Currently, the main non-oil revenue base includes customs duties, payroll and employment taxes along with a large number of distortionary license fees and charges. However, such fees and charges lack elasticity and buoyancy being unresponsive to the state of the economy, do not grow with GDP, are an inefficient source of revenue, and suffer from relatively high costs of collection. Additionally, the fees and charges directly add to the cost of doing business for the private sector and act as impediments to trade. The GCC is also facing increasing erosion of customs revenues due to WTO commitments and bilateral free trade agreements notably with the US (Bahrain and Oman). Fiscal reform is necessary to address the growing risk of fiscal unsustainability of public finances.

INTRODUCE VAT AND EXCISE TAXES ON GASOLINE AND TOBACCO

The GCC states need to adjust to the negative oil price shock by diversifying their sources of government revenue and reducing their dependence on oil revenues. This can most efficiently be done by both introducing broad-based sources of taxation (Value Added Tax) and indirect taxes (excise taxes) on specific goods and products like gasoline, diesel and tobacco.

The argument in favour of introducing a broad-based source of revenue such as a value-added-tax on consumption (VAT) has strengthened in the past years as fiscal stimulus packages have pushed break-even oil prices higher, and given the growing presence of large expatriate populations (the majority in the UAE) that do not pay income or other taxes but benefit from the quality infrastructure, public utilities and social amenities provided by host governments.

A common low rate of VAT of 5 per cent could raise net revenue of about 2 per cent of GDP, while allowing for the removal of customs duties to improve the international competitiveness of the GCC and the abolition of existing distortionary fees and charge and their costly administration and collection. This would lead to a big simplification of the revenue system. The earlier VAT is introduced the better. Implementing VAT will take time since it requires (a) agreement between the GCC countries given the existing Customs Union and (b) building tax capacity in the form of tax revenue authorities required to implement new tax regimes, monitor and collect revenue.

Additionally, the GCC could easily introduce excise taxes on items like gasoline and oil products and tobacco. Gasoline and diesel prices are highly subsidised imposing a large burden on government budgets while the benefits largely accrue to the rich and high-income earners. They should be gradually removed so that prices converge with international prices. Similarly, customs duties on cigarettes and other tobacco products, like the widely-used *Shisha*, should be removed and replaced with specific excise taxes. Excise taxes are taxes on consumption and generate more predictable revenues. To avoid introducing distortions, the excise duty should apply equally to imports and domestic production, including that originating in Free Zones. Such a policy reform would simultaneously reduce consumption – a desirable health objective – help raise prices towards international levels and raise substantial revenues for governments.

The negative oil price shock threatens GCC fiscal stability and sustainability. Adjustment to the loss of oil and gas revenue should be fiscal reform for revenue diversification: introduction of a VAT on consumption and excise taxes on items like gasoline, cigarettes and *Shisha*.