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A BLUEPRINT FOR FISCAL REFORM IN THE GCC

With the recent drop in oil prices, it is imperative that GCC nations remove subsidies and diversify revenues.

THE PRECIPITOUS FALL IN OIL prices since June 2014 is projected to result in a $287bn loss in oil exports for the GCC, a massive shock of about 21 per cent of combined GDP. Given the high dependence of GCC governments on oil revenue, the impact on budgets is large: deficits of $113bn or about 8.5 per cent of GDP. The GCC countries can draw on accumulated financial buffers and substantial international reserves to offset the negative effects on economic growth. But this is a short-term palliative and cannot be sustained given the unfavourable prospects for oil prices.

While the fiscal buffers from past oil revenues are providing GCC nations with short-term relief, policy reform is needed. Budget consolidation is required to ensure fiscal sustainability and preserve resources for future generations, along with the introduction of new policy tools for economic management. This can take the form of expenditure reduction, new sources of revenues or a combination. Specifically, the sharp fall in oil prices provides a unique and timely opportunity to remove fossil fuel subsidies in the GCC and to adjust the prices of public utilities (electricity, water, transport) to reflect underlying full costs.

Fiscal reform has now become a buzz-word of sorts in the GCC with ministers of finance no longer refraining from the use of phrases like reducing subsidies, revenue diversification or introducing taxes. From the raising of electricity tariffs in Abu Dhabi and gas prices in Oman to the adoption of a draft agreement on value added tax at the recently concluded meeting in Doha of the GCC's Financial and Economic Cooperation Committee, the GCC is gradually making peace with the scenario of higher tariff rates for public goods and services.

What would a blueprint for medium-term fiscal reform look like? There should be three building blocks: (a) eliminate subsidies and rationalise the prices of public utilities; (b) improve energy efficiency and (c) diversify revenue by introducing taxation.

ELIMINATION OF FUEL SUBSIDIES

Subsidies cause overconsumption of petroleum products and natural gas, and this in turn aggravates global warming and worsens local pollution. In addition to imposing large fiscal costs, energy subsidies also distort consumption and production patterns, encourage energy-intensive activities. This defeats government economic diversification policies and creates disincentives in relation to investments in energy efficiency, renewables and energy infrastructure. Meanwhile, it increases the vulnerability of countries to volatile international energy prices. The MENA and Pakistan region accounts for about 47 per cent of total global pre-tax subsidies and could potentially gain close to 9 per cent of regional GDP from removing subsidies, according to the IMF. Fossil fuel subsidies account for about 10 per cent of the GCC's combined GDP – a major drain on government budgets. The gap between international and domestic subsidised prices is now at its lowest in a decade. There would be a minimal burden on consumers (the majority of whom are non-tax-paying expats) when removing subsidies and their accompanying distortions.

Eliminating energy subsidies in phases would also generate substantial environmental and health benefits by reducing carbon footprints.

The subsidisation of electricity and water in the UAE is so acute that, according to the UAE's Federal Water and Electricity Authority, a UAE resident uses an average of 550 litres of water and 20-30 kilowatt hours of electricity a day against the international average of 170 to 300 litres and 15KWh per day respectively. It is, therefore, little surprise that prices were raised in Abu Dhabi

late last year. In Qatar, up until recently, every citizen enjoyed an allowance of free water and of electricity up to a certain volume of consumption.

Eliminating energy subsidies, in phases, would also generate substantial environmental and health benefits by reducing carbon footprints. Currently, Qatar, the UAE, Kuwait and Bahrain have some of the highest per capita CO2 emission rates in the world. Qatar's economy, for example, emits approximately 42 tonnes of CO2 per capita per year, more than 10 times above the world average of 4.6 tonnes.

IMPROVE ENERGY EFFICIENCY

Fossil fuel subsidies have led to enormous energy waste in the GCC. Contrast Germany and Saudi in terms of energy efficiency, GDP per unit of energy used is 11.2 in Germany; it is 7.3 in Saudi Arabia. Germany is some 53 per cent more energy efficient than Saudi and much of the energy used goes to production in Germany as opposed to consumption in Saudi. It is imperative to increase energy efficiency by at least 2-3 per cent per annum in the GCC in all aspects of human life. Raising energy prices will provide a major incentive to improve energy efficiency. But more should be done by imposing energy efficiency standards and guidelines for the energy-intensive areas of transportation, industry and buildings. GCC governments should provide leadership by improving energy efficiency in public transport by investing in electric transportation ecosystems and in the state-owned enterprises that dominate public utilities and industry.

Improving energy efficiency should also be accompanied by engineering a shift in the energy mix towards renewables and clean energy. As of 2013, all 21 MENA nations have renewable energy targets (19 have specified targets by technology), up from just five in 2007. If realised, the targets would result in 107GW of installed capacity by 2030. While a sign of reform, these targets are modest and are not a substitute for a strategy and effective policies that would result in a public-private partnership in renewable and clean energy.

RENEWABLE ENERGY TARGETS IN THE GCC STATES

Bahrain: 5 per cent by 2020	**Kuwait:** 1 per cent of electricity generation by 2015; 10 per cent by 2020; 15 per cent by 2030
Oman: 10 per cent of electricity generation by 2020	**Qatar:** At least 2 per cent of electricity generation from solar energy sources by 2020
Saudi Arabia: 50 per cent of electricity from non-hydrocarbon resources by 2032: 54GW from renewables (of which: 41GW from PV and CSP, 9GW wind, 3GW waste-to energy, 1GW geothermal), 17.6GW from nuclear	**UAE- Dubai:** 5 per cent of electricity by 2030; **Abu Dhabi:** 7 per cent of electricity generation capacity by 2020

Source: REN21/ISEP: Global Renewable Futures Report 2013.

REVENUE DIVERSIFICATION & TAXATION

The GCC needs to introduce broad-based taxation to compensate for the loss of oil revenue and for revenue diversification. Plans for the introduction of a harmonised VAT at GCC level were well advanced but were shelved with the onset of the financial crisis and later with the onset of the Arab firestorm. Policy discussions have recently been initiated again to introduce VAT and potentially other taxes, as evidenced by statements following the March 2015 Doha meeting of GCC Under-Secretaries of the Ministries of Economy and Finance. There, a draft VAT framework agreement was adopted. While no time frame for the introduction of VAT or its rate was specified, it was stated that each jurisdiction would implement its own VAT law. VAT is generally viewed as the most stable revenue source, which has the least detrimental effects on investments. A broad-based consumption tax such as VAT would raise revenue proceeds at a low efficiency cost. At the same time, its equity implications would be relatively insignificant and tax administration would receive a significant and positive boost. A VAT rate of about 5 per cent with few exemptions could generate revenue of some 3.5 per cent of GDP and is likely to be considered by the GCC.

The GCC also needs more specific instruments for its policy toolbox. Excise taxes are levies on particular goods and services, which generally apply in addition to VAT. In general, many MENA countries have excise taxes on commodities ranging from tobacco, alcoholic and non-alcoholic drinks to petroleum products, cars, and mobile telephony. There are no excise taxes in the GCC. Introducing excise taxes on items like tobacco, cars, fuel and alcoholic drinks could mobilise revenue as well as address environmental and health concerns and objectives.

FISCAL REFORM IS IMPERATIVE FOR THE GCC

For the GCC, the time is right to develop a blueprint for fiscal reform, starting with the phasing out of fuel subsidies and more rational pricing of public utilities. Removing fuel subsidies would remove distortions, help improve energy efficiency and encourage investment in renewable and clean sources of energy. Measures are also required to diversify revenues. Introducing VAT at 5 per cent in addition to excise taxes on products like tobacco, cars, fuel and alcohol would provide much needed revenue sources while providing new economic policy tools. Removing fuel subsidies and introducing VAT would largely offset the loss in government from lower oil prices and would provide a more stable revenue base. The proposed blueprint for fiscal reform is eminently practical, feasible and most timely. It should be part of a new model of economic development for the GCC.