EXCISE TAXATION FOR GCC REVENUE DIVERSIFICATION

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Tax Reform Required to Adjust to the New Oil Normal

The GCC countries are experiencing a sharp rise in budget deficits (some 13% of GDP in 2015) following the precipitous drop of oil prices since June 2014 and their high reliance on oil revenues, which accounted for between 70-95% of total government revenues during 2011–14, while non-oil tax revenues were only some 1.6% of GDP. Revenue diversification is a policy priority and requires the introduction of new taxes that do not distort economic incentives or adversely affect investment and growth.

Currently, trade taxes (custom duties) are the most significant non-oil revenue contributor- but these are declining as a result of tariff-reducing and removing commitments under WTO and bilateral free trade agreements (notably with the US). Plans are afoot to introduce VAT in 2018 to produce a stable broad based source of revenue, while discussions are ongoing on corporate and property taxes along with selective taxation in the form of excises (on commodities such as cigarettes/tobacco, alcoholic and non-alcoholic drinks, petroleum products, cars, and mobile telephony).

Excise taxes instead of trade taxes

GCC Ministers of Finance meeting in November 2015 agreed that an additional uniform 100% tax would be imposed on tobacco products[ii]. Media reported that implementation of this common decision was approved for early 2017[iii]. However, two countries - Bahrain and Saudi Arabia - have introduced additional "fees" on tobacco in the past few weeks. Bahrain introduced a special goods fee/tax on cigarettes (imposed when entering the domestic market and collected by Customs), equivalent to a 100% of the CIF value of goods (with no minimum specific component). This has resulted in an increase in cigarette prices by some 40%, with the fee being shifted to consumers.

In Saudi Arabia, the minimum specific import duty has doubled: import duties will now be assessed at either 100% of the CIF value of the goods or at a minimum specific of SAR 200/1000 ($54/1000), whichever is higher. The official statement from the Customs Authority indicates that the main reason behind the move is the losses incurred by Customs to the tune of around SAR 3bn annually due to "some importers…under-billing their purchases" by understating their CIF prices[iv].

Table 1: **GCC minimum specific duty rates on Cigarettes import duties, Mar 2016**

Country	Rate per 1000 cigarettes in local currency (in USD)
Bahrain	BHD 10 (USD 26.95)*
Kuwait	KWD 8 (USD 28.4)
Qatar	QAR 100 (USD 27.46)
Oman	OMR 10 (USD 26.05)
Saudi Arabia	SAR 200 (USD 53.2)
UAE	AED 100 (USD 27.2)
* Bahrain has introduced in addition to this, a fee equivalent to a 100% of CIF	

While raising the minimum specific rate is appropriate, including to compensate for inflation (the tax had remained unchanged since 1997), it is preferable that tax policy measures be harmonised, coordinated and synchronised across the GCC countries to avoid tax-induced market distortions in the GCC customs union and common market. As noted below, large, uncoordinated, increases in tax rates should be avoided as they provide incentives for smuggling and illicit trade and do not always lead to the desired increase in revenues.

Raising revenue from fuel & tobacco taxation in the GCC

*R*evenue generation from excise taxes depends on the tax rate (i.e. amount of tax per unit of whatever is being taxed) and the tax base (i.e. the quantity of the good being taxed). Increasing the tax rate can increase or decrease tax revenue depending upon the elasticity of supply and demand for the good as well as the size of the tax base. Given an amount of revenue to be collected, optimality can be achieved with a general set of selective excise taxes by setting excise tax rates for various products inversely to their elasticity of demand.

To illustrate the use of excise taxes, consider taxes on two widely used products, fuel and tobacco. The IMF (2011) estimates a long-run price elasticity of oil demand of -0.081 for major oil exporting economies like the GCC i.e. if oil prices go up 10%, then the long-run demand for oil declines by 0.81%, relatively inelastic demand. Given that fossil fuel consumption damages the environment through CO_2 emissions and generates other negative externalities (health costs, road congestion, deaths from traffic accidents, etc.), governments should impose a corrective carbon tax. It is estimated that for Saudi Arabia, a carbon tax of 52 cents per litre on gasoline and 54 cents on diesel should be charged[v]. With Saudi Arabia's domestic oil consumption at 142 mn tonnes in 2014, a potential $53.3bn in revenue could be raised from a gasoline excise tax, compared to a declared 2015 budget deficit of $98bn!

For tobacco products, several studies show that the price elasticity of demand lies in the range from -0.25 to -0.50, implying that a 10% increase in the price of cigarettes would reduce overall cigarette consumption by between 2.5% and 5.0%. How does this affect revenue generation?

(a) A study of excise taxes on tobacco in Europe found[vi] that a 20% increase in the *specific* excise tax would raise government revenues from cigarette consumptions by 4%-6%, but a 20% increase in the *ad valorem* excise tax would reduce government revenues from cigarette consumption by 1.5%-2%.
(b) In Greece both excise and VAT were raised multiple times through 2010-12. Initially, this resulted in higher illicit trade and a marginal increase in revenue initially. However, due to the high reliance on an ad valorem excise duty, over the 3-year period, tobacco excise revenues fell short by over EUR 1.5bn.
(c) In Turkey, the tobacco tax (highly *ad valorem*) was raised during 2010-11, resulting in increases in retail prices, the tax burden (by 80%), but also by a large increase in illicit trade from 5% to 20%.
(d) Singapore saw a sharp increase in excises from SGD 150 per 1000 cigarettes to SGD 352 over 2000-2005. This was followed by a period of no excise hikes. Excise revenue initially (2000 to 2003) rose by 54% but declined by 10% between 2003 and 2006, illustrating how multiple sharp increases in tax rates can lead to a decline in excise revenues. Part of the dip in revenue is due to the growth in smuggling and illicit trade.

Two important lessons emerge. One is that specific excises are preferable than ad valorem taxes: they are easier to administer, with a well-defined tax base (a quantity) and generate higher and more predictable tax revenue. They also make sense from a health perspective: because every cigarette is equally harmful, every cigarette should be taxed equally. On the other hand an ad valorem tax can be abused because the exact tax base (valuation) can be manipulated. Importantly this means that governments should undertake good market analysis before undertaking tax reform in order to optimize tax design and the impact on health and revenue.

The other lesson is that governments should avoid steep successive increases in tax rates as this can lead to a loss of revenue, and increase in illicit trade. The GCC countries currently have relatively low illicit penetration rates, but are wedged between the tobacco industry's established smuggling centres in MENA and Former Soviet Union countries and the burgeoning tobacco markets in the Indian subcontinent. Around 30% of the total cigarette market in the Middle East is illegal. While around 64% of this illicit trade occurs in the Levant and Yemen, the remaining 36% is in the GCC and Iran. In the UAE, the size of illicit cheap whites is as high as 32%. With deteriorating security across the region, we can expect growing illicit trade and higher penetration rates. This is likely to accelerate should there be an uncoordinated move within the GCC to sharply raise taxes. Given that tobacco smuggling returns are very high compared to minimal risks due to low penalties and weak enforcement, smuggling provides a lucrative revenue stream for financing organised crime and terrorist groups like Daesh and threatens national security[vii] A sharp tax hike would mean increased illicit trade, forcing governments to spend more on enforcement and border controls thereby reducing the potential increase in revenue.

A Proposal for Tobacco Excise Taxes in the GCC

Existing WTO and & bilateral trade agreements constrain the GCC from raising the common external tariff on cigarettes and other tobacco products. Introducing excise taxes would allow GCC member states to raise the tax burden on cigarettes, thereby reducing consumption and raising revenue, without violating their international obligations. Table 2 below shows estimates of imposing a specific excise tax on tobacco for the GCC.

Table 2: GCC revenue forecasts from import duty & specific excise tax on cigarettes

Scenario		Import duty	Excise tax	Est. revenues, USD bn
Current (except in KSA & Bahrain)	Ad valorem, % CIF	100%	-	1.9
	Min. USD/000	27	-	
Saudi Arabia's current scenario	Ad valorem, % CIF	100%	-	2.5
	Min. USD/000	54	-	
Proposed scenario (doubling min specific + excise taxes are introduced in one shot)	Ad valorem, % CIF	100%	100%	4.3
	Min. USD/000	54	54	
Scenario (doubling min specific ala KSA + staggered 3-year increase in excise tax component)	Ad valorem, % CIF	100%	-	3.5
	Min. USD/000	54	27	
	Ad valorem, % CIF	100%	-	3.9
	Min. USD/000	54	41	
	Ad valorem, % CIF	100%	-	4.4
	Min. USD/000	54	54	

Source: PMI estimates.

Our previous research recommended that a uniform specific nominal excise duty consisting of a fixed amount per 1,000 cigarettes or equivalent units of other tobacco products should be introduced across the GCC[viii]. This would fall in line with the global trend with respect to the excise tax structure, and ensure steadily growing tax revenues. Table 2 shows that if the current move of Saudi Arabia – of doubling the minimum specific import duty – were to be adopted by the rest of the GCC, revenues would increase to USD 2.5bn from the $1.9bn raised before the recent changes. Another simulation (similar to the tax proposal agreed by GCC Ministers in Dec 2015) was doubling of the existing minimum specific duty in addition to the introduction of a **specific** excise tax (at double the minimum specific tax): this would raise revenues to USD 4.3bn. By contrast, higher ad valorem taxes would encourage smokers to substitute down to less expensive cigarettes and provide sellers to downshift, i.e. pricing cigarettes in the lower tiers in order to avoid the higher rates in the upper tiers, with both reactions leading to lower tax revenues being raised. The final simulation exercise plays out a staggered 3-year increase of the specific excise tax component to $54/'000: interestingly, this scenario would assure government revenues worth USD 11.8bn over the period. Increasing the rate at one shot would encourage illicit trade, in addition to brand substitution and/or reduced smokers, thereby reducing revenue-raising capacity.

Principles & Recommendations

The GCC countries are seeking to raise revenue and address health concerns by taxing tobacco and related products. This is best done as part of a comprehensive, multi-year tax reform plan aiming at revenue diversification and allowing the build-up of tax capacity and administration. Excise taxes are a versatile tool that GCC governments can use to replace trade taxes. In particular, the GCC's proposed 100% tax increase on tobacco should take the form of a domestic specific excise tax with gradual implementation to allow authorities to assess success in implementation of the policy change.

Given recent tax changes in Saudi and Bahrain and best international practice, there are five main recommendations:

(i) **Replace customs tax with a specific excise tax structure**; ad valorem taxes should be avoided. Newly introduced fees/taxes in Bahrain and Saudi Arabia can be migrated way from customs-based to a specific excise tax ;

(ii) **New tax structures should be harmonized, coordinated and synchronized across the GCC** in line with requirements of maintaining the GCC customs union and common market and to avoid creating tax-induced market distortions and arbitrage. They should be based on market data, information and analysis.

(iii) **New tax structures require building tax capacity**, and new revenue administrations separate from customs and under the authority of Ministries of Finance.

(iv) **Implementation of taxes needs to be accompanied by revenue protection and anti-smuggling measures**, including tax stamps, unique identifiers, and law enforcement[ix] as sharp tax increases will lead to a jump in illicit trade and smuggling with proceeds financing criminal activities and terrorism given the proximity of the GCC to countries suffering from turmoil, violence, lack of security, with high illicit penetration rates[x].; and

(v) **Establish GCC-wide track and trace systems** (for tobacco products and ingredients, equipment and finished illicit tobacco products) through implementing open standards which will enable information sharing across the GCC. Tracking means monitoring and recording the route taken by tobacco products through the supply chains by means of systems and technology, while tracing is the power of identifying back the main steps of a product along the supply chain.

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[i] The viewpoints and proposals in this Policy Brief are the author’s own. Phillip Morris International (PMI) supported the research for this Policy Brief.

[ii] http://www.bna.bh/portal/en/news/695252

[iii] http://www.arabnews.com/economy/news/863486

[iv] See clarification statement issued by Saudi Customs further to the issuance of circular issued on Date: 27/05/1437 H, Ref # 444/11/m, with subject line Amendment to the minimum specific tax on tobacco products and derivatives

[v] See IMF (2015)
[vi] Chaloupka et.al. (2010)
[vii] See the US State Department report, The Global Illicit Trade in Tobacco: A Threat to national Security, http://www.state.gov/documents/organization/250513.pdf
[viii] See Nasser Saidi & Associates white paper on "GCC Fiscal Reform: Oil, Government Revenue, Excise Taxes & The Tobacco Market', published in 2014
[ix] See World Bank, op. cit.
[x] See Nasser Saidi & Associates white paper on "Taxation, Illicit Trade in Tobacco Products and Finance of Terrorism in the Middle East", published in 2015