

Why Tax & Subsidies Reform is Imperative in the Gulf – Opinion piece in Gulf Business, Apr 2014

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The GCC region and wider MENA region is enormously wealthy in energy and other natural resources, with 48.5% of the world's proven energy resources. Much of that wealth is being wasted without generating long-term sustainable growth prospects and economic development. Governments are the main beneficiaries of oil receipts, and their fiscal policy decisions -often made in an environment of volatile and uncertain oil revenues – have a dominant effect on macroeconomic stability, development of the non-oil economy, and intergenerational equity. Moreover, given the region's largely US dollar pegged exchange rate regimes resulting in lack of monetary policy independence and inability to run active monetary policy, fiscal policy is dominant and is the main instrument of economic management. In the absence of strong fiscal management frameworks and inadequate tools for maintaining a counter-cyclical fiscal policy, government spending is typically pro-cyclical (higher spending when oil prices are higher and vice versa) and therefore aggravating the boom-bust cycle resulting from oil price fluctuations.

Key Policy Challenges

Gulf economic policy makers face a number of daunting challenges: (a) steering their economies towards greater

economic diversification – away from oil to non-oil growth. This essentially means creating opportunities for greater participation by the private sector, family businesses and SMEs in order to create jobs for the ‘youth bulge’ generation; (b) managing the macroeconomic & financial risks from oil price volatility; (c) over-dependence on energy subsidies; (d) arresting growing environmental deterioration and fresh water shortage and (e) ensuring security of food supplies to a region that imports some 90% of the food it consumes.

High oil prices & the Arab firestorm led to government profligacy

Over the past five years, with oil prices on the rise, the region witnessed a jump in government spending in the oil exporting countries, leading to higher fiscal breakeven oil prices and threatening fiscal sustainability. To take an example, the IMF has warned Kuwait that at current rates and as soon as 2017 government expenditure will exhaust all oil revenues. The fiscal breakeven oil price for Kuwait – i.e. the average price at which budget of the oil-exporting country is balanced (no deficit or surplus) – has increased from \$28 per barrel in 2009 to an estimated \$52.3 this year. For Saudi Arabia growing government spending has resulted in a jump in the fiscal break-even price from \$37.6 in 2008 to about \$84 per barrel in 2014. A measure of the fiscal vulnerability of the GCC countries is the non-oil fiscal deficit (budget deficits excluding oil revenues as a percentage of non-oil GDP): the average for the GCC has been in excess of 40% of non-oil GDP since 2008, with Kuwait, Oman and Saudi running the highest deficits. Profligate government spending in reaction to the pressures of the Arab firestorm and energy subsidies are major sources of the deficits.

Burning Fuel is Not Sound Economic Development Policy

Nations with plentiful natural resources tend to undervalue them. Availability is considered synonymous with cheap.

Governments typically underprice or subsidise the provision of natural resource based products and services such as electricity and fossil fuels. In the Middle East and oil exporters this is notorious. The fossil fuel consumption subsidy rate as a percentage of the full cost of supply varies from a high of 80% in Venezuela, 79% in Saudi, 77% in Libya, 70% in the UAE, to 54% and 50% in Egypt and Algeria respectively. Not surprisingly, the result is waste and abuse of this 'cheap energy'. In MENA fuel subsidies eat up 22% of government revenues and represent 8.5% of regional GDP and at \$240 billion are half of global subsidies! Spending more on subsidies means you have less to spend on other items. As a result and despite their young and growing populations the GCC and other MENA countries spend more on fuel subsidies and on the military than they do on education! The burden of fuel subsidies is greater for the poorer oil importing nations: the subsidies burn a hole in their current accounts and the benefits are not equitably distributed. In Egypt, 90% of subsidies benefit the richest 20% of the population and not the intended target of the poor!

Cheap energy also encourages wasteful use. Energy usage (amount of energy used per unit of GDP) in the GCC and the wider MENA region is twice as high as in the OECD countries. For example, Saudi Arabia uses as much oil as Germany though it has a quarter of the population and produces one-tenth of the output. Cheap subsidised energy is distorting consumption and production towards high energy intensity technology choices and activities, such as aluminum production. The problem is that such activities would not be internationally competitive in the absence of cheap energy and do not lead to long-term sustainable economic development.

Policy priorities and reforms

There are three clear policy priorities. One, governments should gradually remove fuel price subsidies, target subsidies to the under-privileged and poor and establish social safety

nets. Two, governments should radically reform expenditure patterns. Three, governments need to diversify their sources of revenue and lower their dependence on oil revenues.

Phase out fuel subsidies & focus on energy efficiency

Gradually removing energy subsidies and raising prices to international levels would lead to greater energy efficiency.

According to the World Bank, energy intensity in MENA has increased by 14% since the beginning of the 21st century, outstripping GDP growth. Indeed, energy intensity has been declining in all regions except MENA. The GCC countries have a per capita annual electricity consumption of 9.650 terawatt-hours (TWh) compared to a global average of 2.782 TWh. This consumption is alarmingly high and unsustainable. If the region continues on this high energy abuse path, it will require more than 3% of GDP for energy infrastructure investment by 2030 compared to just 1% for the rest of the world. The obvious but yet overlooked fact is that untapped energy efficiency is the least expensive and most effective form of energy available today. Targeted energy efficiency measures are MENA policymakers' best bet for reversing high energy intensity while curbing greenhouse gas emissions in the region. Indeed, improving energy efficiency and investing in renewables is a policy imperative for the countries of the region. A feasible target would be to improve energy efficiency by 2-3% per annum. Policy measures should include energy efficiency legislation, rationalising energy pricing policy by gradually reducing subsidies, designing and enforcing energy performance building standards, energy efficient transport and spatial planning, household and business energy efficiency obligations, labeling standards, providing financial incentives for investment in energy efficient technologies and activities, and raising public awareness. Around 60% of the global savings in energy use are from the buildings sector.

Invest in education, health, infrastructure & social capital

Removing subsidies and implementing energy efficiency measures would liberate resources for productivity raising investments, while previously domestically consumed resources would be available for export, improving the balance of payments and building net foreign assets.

Given MENA country demographics, growing urbanisation & historical under-investment in physical and social infrastructure, spending should be reoriented toward more inclusive & growth-enhancing capital expenditures, towards economic & social development and reconstruction. Education and health spending should be given priority given the need to build human capital endowed with market skills. Switching from subsidies to investing in education, science & technology, health and social capital would raise overall and labour productivity growth, increase international competitiveness and result in an economic revolution in the Arab world. We would regain potentially lost generations.

Revenue diversification is a necessity

MENA governments are highly dependent on non-tax and revenues from natural resource exports. Oil exporters have an extremely narrow tax base with high dependence on oil revenues, which represent more than 80% of total revenue. These revenues are vulnerable to the volatility of international oil prices and market demand & supply conditions, which are largely outside the control of any individual oil exporting country. The Average Total Tax Rate for the MENA region stands at 23.7% well below the world average (43.1%) and the lowest of any region. Given the low total tax rate it is not surprising that it takes the typical company only 159 hours for tax compliance and makes 17.6 payments, substantially lower than global averages of 268 hours and 26.7 payments. While this implies a lower overall cost of doing business and low tax burden, the obverse is that governments do not have the tax instruments for economic or social policy or overall economic management.

The main non-oil revenue base includes customs duties, payroll & employment taxes along with a large number of license fees and charges, which lack buoyancy, are unresponsive to the state of the economy and are inefficient in raising revenue, given the relatively high costs of collection. Additionally, these distortionary charges are impediments to trade, with cascading effects due to the taxation of inputs. There has also been significant loss in customs revenues due to free trade agreements with major trading blocs. Reform is necessary for fiscal sustainability.

The GCC should introduce a broad based VAT

The modern MENA economies need revenue mobilization & diversification via a broadening of tax bases & establishing progressivity for social equity. In particular, GCC governments require stable, broad-based sources of revenue to finance government spending, investment & economic development. Introducing a Value Added Tax (VAT) would be appropriate. The argument in favour of introducing VAT as a potential revenue earner has increased in the past years as fiscal stimulus packages have pushed break-even oil prices higher and given the presence of a large expatriate population (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. Previous plans to introduce VAT were shelved in part due to inflationary pressures in 2008 and to the political pressures of the Arab firestorm. To ease the potential burden of introducing VAT, custom duties and tariffs can be removed along with a consolidation of the small, fragmented collection of fees and charges. A VAT at a rate of 5% could generate revenue of up to 2.5% of GDP, improve the international competitiveness of the GCC and remove existing distortionary fees and charges.

In addition to the domestic fiscal and social equity pressures for fiscal reform, there is also substantial pressure to

comply with external standards, including the Global Forum on Transparency and Exchange of Information for Tax Purposes, the US Foreign Account Tax Compliance Act (FATCA) and FATF which has expanded the scope of AML/CFT predicate offenses to include tax crimes and stepped-up requirements related to the transparency of companies and trusts. All these external laws and standards require effective exchange of information for tax purposes, higher standards of disclosure & transparency and legal and regulatory changes. The GCC countries that have lived in benign neglect of tax matters will have to invest in building revenue/tax administration and collection capacity as well as create standardised reporting and accounting.

Concluding remarks

The GCC countries, despite their wealth, were not immune to the tsunami of the Global Financial crisis and the resulting Great Contraction. As their economies mature they need to develop new tools for economic policy management and change expenditure patterns. Fiscal consolidation and reforms are imperative for sustained long-term growth in the region. Generalised fuel subsidies should be gradually phased out and spending re-oriented to education, health, productivity increasing infrastructure and social capital. Fiscal sustainability requires revenue diversification and lowering the dependence on oil & gas revenues. A broad based VAT would generate needed revenues and replace custom duties and tariffs and the plethora of distortionary fees and charges. The region also needs to develop public debt markets and management to allow governments to smooth volatile energy revenues, enable conduct of counter-cyclical policies, including deficit financing as well as the efficient finance of infrastructure and public works. These reforms are imperative and will challenge policy makers and governments in the coming decade.