A Blueprint for Fiscal Reform in the GCC: Opinion piece in Gulf Business, Jun 2015

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The precipitous fall in oil prices since June 2014 is projected to result in an US$287 billion loss in oil exports for the GCC, a massive shock of about 21% of combined GDP. Given the high dependence of GCC governments on oil revenue the impact on budgets is large: deficits of US$113 billion or about 8.5% 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 required. 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 (VAT) 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, the need to reduce or eliminate "generalized energy subsidies" (as called for by the IMF[1]) to discourage the inefficient use of energy, and, in the near future, taxation.

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

(a) **Elimination of fuel subsidies & raising prices of public utilities**

Subsidies cause overconsumption of petroleum products and natural gas, and this over-consumption 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 which defeat government economic diversification policies and create disincentives to needed investments in energy efficiency, renewables, and energy infrastructure, while increasing the vulnerability of countries to volatile international energy prices. The MENA + Pakistan region accounts for about 47% of total global pre-tax subsidies currently and could potentially gain close to 9% of regional GDP from removing subsidies[2]. Fossil fuel subsidies account for about 10% of the GCC's combined GDP – a major drain on government budgets. The gap between international and domestic subsidized 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) of removing subsidies and their accompanying distortions.

The subsidization 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 550 litres of water and 20-30 kilowatt hours (KWh) 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, UAE, Kuwait and Bahrain have some of the highest per capita CO_2 emission rates in the world. Qatar's economy, for example, emits approximately 42 tons of CO_2 per capita per year, more than 10 times above the world average of 4.6 tons.

(b) **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 fifty three percent 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% p.a. 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 high energy use 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 (such as electricity production & distribution) 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 5 in 2007. If realized, 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.

Table 1: Renewable Energy Targets in the GCC States

Bahrain: 5% by 2020	Kuwait: 1% of electricity generation by 2015; 10% by 2020; 15% by 2030
Oman: 10% of electricity generation by 2020	Qatar: At least 2% of electricity generation from solar energy sources by 2020
Saudi Arabia: 50% 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% of electricity by 2030; Abu Dhabi: 7% of electricity generation capacity by 2020

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

(c) **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 harmonized Value Added Tax (VAT) at GCC level were well advanced but were shelved with the onset of the Great Financial Crisis and later with the onset of the Arab firestorm. Policy discussions have recently been re-initiated 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, where 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% with few exemptions could generate up revenue of some 3.5% of GDP in revenue and is likely to be considered by the GCC.

The GCC also need more specific instruments for its policy tool box. Excise taxes are levies on particular goods and services, which generally apply in addition to a VAT. In general, many MENA countries have excise taxes on commodities ranging from cigarettes/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 a VAT of 5% 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.

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[1] IMF Regional Economic Outlook for the Middle East and North Africa, Afghanistan and Pakistan, May 2015.

[2] Source: “How Large Are Global Energy Subsidies?”, IMF Working Paper, May 2015