Stubbing out a habit by way of new taxes: Gulf News Op-ed, 14 Aug 2015

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Government spending in the Gulf countries has been rising rapidly since the onset of the Arab Spring. On the revenue side, oil and gas revenues account for more than 85 per cent of government revenue.

This high dependence makes the Gulf countries highly vulnerable to oil price fluctuations, with the recent decline bringing fiscal sustainability concerns to the forefront. The IMF estimates that the GCC fiscal balance is expected to turn into deficit of $113 billion (8 per cent of GDP) in 2015 from a surplus of $76 billion (4.5 per cent of GDP) a year ago.

To address their revenue vulnerability and fiscal sustainability, Gulf countries should prioritise fiscal reform and put in place policies to diversify the sources of government revenue. Revenue diversification policies should be directed not only at mobilising non-oil revenue in the short run, but also at improving the buoyancy of tax revenue.

Reforms are recommended with the most efficient plan being to introduce both broad-based sources of taxation (a value added tax) and indirect taxes (excise taxes) on specific goods and products like gasoline, diesel, alcohol and tobacco.

'The Global Tobacco Epidemic 2015' report states that 6 million people a year die from tobacco-related diseases, with that number estimated to increase to 8 million people by 2030. According to the World Health Organisation (WHO) and Tobacco Free Initiative (TFI), a 10 per cent price increase on a pack of cigarettes would be expected to reduce demand for cigarettes by about 4 per cent in high-income countries and by about 5 per cent in low- and middle-income countries, where lower incomes tend to make people more sensitive to price changes.

This price increase is interlinked with price and tax measures, as Article 6 of the WHO Framework Convention on Tobacco Control states: ‘Price and tax measures are an effective and important means of reducing tobacco consumption by various segments of the population, in particular young persons.’

However, despite clear evidence that increasing taxes is an effective intervention to reducing tobacco use whilst increasing government revenues, Gulf countries remain constrained by international and bilateral trade agreements from raising the common external tariff on cigarettes and other tobacco products thereby restricting the ability of the GCC to raise prices to reduce tobacco consumption.

The Middle East and North Africa region is one of the fastest growing consumers of tobacco products, especially cigarettes. With a young, fast-growing population, where smoking is culturally acceptable and with low awareness of health implications, tobacco consumption is high. In 2010, the region accounted for a 7.1 per cent market share of global cigarettes volume, the fourth largest globally.

Significantly, the smoking of pipe tobacco in the region, popular due to the consumption of shisha, represents roughly 45.5 per cent of global demand. By country, Saudi Arabia has the highest per capita consumption of shisha pipe tobacco in the world while Egypt, which is MENA’s largest cigarettes market, consumes most in volume terms. Saudi Arabia, with the largest population among Gulf states, is the largest market for the cigarette industry, closely followed by the UAE.

The GCC countries are considering raising custom duty on tobacco, both to raise revenues and for health objectives of reducing consumption and smoking incidence (as per WHO guidelines). Earlier this month, the Gulf states endorsed a call by the WHO to raise taxes on tobacco. However, they face a number of constraints in achieving their objectives given their international obligations.

International and bilateral trade agreements constrain the Gulf countries from raising the common external tariff on cigarettes and other tobacco products. As members of the WTO they have to comply with their treaty commitments and with a maximum import duty, known as the 'bound' rate.

The current 100 per cent import duty across the GCC is set at the bound rate for both Bahrain and Kuwait. Furthermore, free trade agreements signed by Bahrain and Oman separately with the US dictate that the countries remove tariffs on cigarettes (among other products) within a 10-year time frame (due 2016 and 2019 respectively).

Last, but not the least, the GCC Customs Union agreement includes a Common External Customs Tariff (CET) for goods imported from outside the GCC, as well as common customs regulations and procedures, which further constrains tobacco tax policy options.

The uniform system of cigarette taxation places the Common External Tariff at 100 per cent of the CIF price (ad valorem) and a minimum specific duty equivalent to SR100 per 1,000 cigarettes, whichever is higher.

The minimum specific duty component of taxation is an essential component, given that it enables a secure contribution towards the government revenue base. It was first introduced by Saudi Arabia in the 1990s and was fully harmonised among Gulf Cooperation Council member-states when Kuwait adopted the current KD8 per 1000 cigarettes minimum in 2002.

In the years that followed, manufacturers have increased prices of many brands above the levels at which the minimum duty applies, thus increasingly subjecting them to the ad valorem component of the tariff. However, the minimum specific duty was not systematically adjusted for inflation and its real value and incidence has declined.

Any increase in specific duty would mean that all cigarettes must pay the minimum amount of tax regardless of their CIF price. By contrast, when the ad valorem duty rises, the price of mid and premium price cigarette brands increase by more than that of low and cheap brands given that the tax charged is a proportion of the CIF price.

This provides an incentive to consumers to substitute, trading down to cheaper and lower quality products, which could reduce government revenues under a purely ad valorem tax regime and undermine governments' health objectives.

The GCC countries should agree and introduce excise taxes on tobacco consumption as a policy tool to increase tobacco prices for health reasons and to raise revenue. Ideally, the introduction of domestic excise taxes on tobacco should be in the form of a specific nominal excise duty to be introduced in each GCC member-state consisting of a fixed amount per 1,000 cigarettes or equivalent units of other tobacco products.

The new excise duty would be introduced by the ministries of finance, with a revised mandate enabled by the requisite legal and regulatory reforms, which would set up the revenue administration. It is also feasible that the revenue administration be outsourced to customs, which then becomes 'customs and excise'.

Additionally, there should be GCC policy harmonisation, i.e., introduction of tobacco excise taxes should be applied uniformly (including on domestic production), equally and in synchronised manner in all countries to prevent arbitrage opportunities and illicit trade or smuggling. The process of implementation of the new tax structure should also be gradual.

This will enable the building of tax capacity in the form of tax revenue authorities to implement the fiscal reform, monitor and collect revenue. The set-up of an excise revenue administration has the added advantage of facilitating the introduction of other excises, notably on gasoline, diesel and other oil products – gradually leading to revenue diversification and eventually fiscal consolidation.