

Interview on taxation in Thomson Reuters report "Taxation in the GCC", June 2016

The interview (below) is published in Thomson Reuters new report titled "Taxation in the GCC", published in June 2016; the full report can be downloaded on the Thomson Reuters website:

<http://onesource.tax.thomsonreuters.com/Taxation-in-the-GCC-Report>.

Economic challenges: the oil price has declined steeply on numerous occasions in the past. Oil prices aside, what other critical factors necessitate fiscal reform, and how would you rank them? What concerns would you still have if the prices suddenly jumped back up?

Oil prices tend to be volatile and we have seen several price cycles over the past 30 years. However, this time we are living a 'New Oil Normal' where both demand and supply factors point to lower prices for an extended period if not permanently. On the demand side, the trend to greater energy efficiency, a shift away from energy intensive activities, new technologies such as e-cars as well as concern with climate change and Paris COP21 commitments imply a downward shift in demand. On the supply side, technological innovation has opened up substantial supplies of shale oil & gas which are widely available (e.g. the vaca muerta deposits in Argentina), while the cost of renewable, clean energy such as solar, wind and hydro has rapidly declined and with rapidly falling cost of storage, are competitive with fossil fuels. In addition, countries such as Iran, Iraq and eventually Libya are coming back into world markets. These supply factors are increasing available energy from a variety of sources, implying downward

pressure on prices. Oil producers highly reliant on oil revenue will need to diversify both their economies and the sources of government revenue. Diversification has been the talisman of economic strategy on the agenda of GCC

Diversification has been the talisman of economic strategy on the agenda of GCC policy makers. Prior to the 2014- 2016 oil price tsunami, some countries were more successful in diversifying and implementing structural reforms (e.g. reducing barriers to FDI through the establishment of Free Zones, policies to promote greater private sector participation, export diversification) than others. However, GCC governments' continuing high reliance on oil revenues to finance budgets has limited reform efforts and made them very vulnerable to oil price volatility. Across the GCC countries oil revenues accounted for between 70 and 95% of total government revenues during 2011–14, with the more than 60% decline in oil prices resulting in large budget deficits during 2015 and continuing into 2016. While the fiscal buffers from past oil revenues are providing GCC nations with short-term relief in this period of low oil prices, policy reform is required. Oil & gas are non-renewable natural resources and the GCC countries have young and fast growing populations. There are two policy implications: One is that the sale of oil & gas should not be considered "revenue" or "income": it is
Oil & gas are non-renewable natural resources and the GCC countries have young and fast growing populations. There are two policy implications: One is that the sale of oil & gas should not be considered "revenue" or "income": it is transformation of natural resource wealth into financial wealth. Sound economic and public finance policy dictates that only a fraction of the return on the wealth should be counted as income and consumed. Two, given their young demographics, inter-generational equity requires that the GCC countries should be saving a substantial portion of their income for future generations through investment. A high proportion of natural resource 'revenue' should go to savings (including through SWFs) and productive domestic investment to generate

economic diversification and sustained development gains. All of this means that the GCC countries need to put in place a fiscal sustainability framework, including fiscal reform and the institution of tax regimes that generate broad based, domestic sources of government not dependent on the oil sector. These reforms are required even if oil prices recover given the imperatives of inter-generational equity and the efficient management of non-renewable natural resources.

To what extent are these problems already being addressed? Which countries do you think have already made significant progress in the GCC in economic and fiscal diversification and can perhaps serve as a role model for other member states?

The short answer is that the GCC countries have yet to address the challenges of the 'new oil normal' and the high economic and government dependence on "oil revenues". The private sector including the non-oil sector, has been overly reliant on government spending and its rentier state largesse. There is a long road ahead for the GCC countries to address the fundamental requirements of non-oil dependent medium and long term fiscal sustainability. The UAE, particularly Dubai (and Bahrain) have become more economically diversified by diversifying into manufacturing, industry and services. Dubai stands out and has been able to minimize its dependence on oil through building infrastructure and logistics, creating free zones, adopting pro-business legislation, focusing on the cost of doing business, openness and allowing freedom of entry & establishment, enabling it to become an international, trade, tourism and financial hub. It is not clear that this 'Dubai model' can be adopted and adapted in other GCC countries.

However, all the GCC countries need to establish and implement a revenue diversification strategy. The GCC countries need to establish fiscal institutions, build tax capacity, develop and implement fiscal rules that smooth revenue volatility and provide the basis for long-term fiscal sustainability. The 'new oil normal' has led to intense, on-going discussions and negotiations to establish a new tax regime for the GCC countries. The new tax regime would include broad based

taxation, such as a value-added consumption tax, a corporate income tax that would apply to all companies and not only to foreign companies, property taxation, in addition to selective taxation in the form of excise taxation on items including tobacco, cars, fuel, alcoholic and other drinks and other. Eventually this will mean a new social contract and a new basis for economic governance.

How would you rank and quantify each type of tax in terms of tax revenue potential (as a percentage of GDP)? In particular, do you think there could be more than one type of excise tax – going beyond tobacco, including tackling obesity, such as taxing high sugar products?

GCC non-oil tax revenues averaged ~1.6% of GDP (~3% of non-oil GDP) in 2012–14, most of which are customs duties and trade taxes, which will have to be phased out due to bilateral and WTO commitments. The GCC economies are maturing and require fiscal policy tools for economic management. Going forward, there should be a mix of taxes including a broad-based consumption tax, with selected excises, tax on business profits as well as recurrent property taxes. While these taxes should start at low rates, it is also important that these be implemented in conjunction with a reduction in existing tariffs and the large number of distortionary fees and charges that increase the cost of doing business, while raising limited amounts of revenue. Apart from VAT, excise taxes are likely to be the major revenue earners: these could apply to commodities such as cigarettes/ tobacco, alcoholic and nonalcoholic drinks, to petroleum products, cars, and mobile telephony. For example, for Saudi, a corrective tax of 52 cents per liter on gasoline and 54 cents on diesel consumption to address the negative externalities of fossil fuels (pollution, environmental and climate change, congestion, health costs, and other), would mean a tripling of the current price, but could raise some \$56 bn in revenue, covering more than half of the 2015 budget deficit of \$98 billion! As for VAT, the IMF estimates that the potential revenue from a 5% VAT ranges from about 0.7–2.1% of GDP depending on the country

and the share of consumption in GDP.

Real estate transaction fees can also provide a stable source of revenue. It is preferable to keep registration fees low to counter tax evasion. Real estate transaction fees could be raised substantially for properties re-sold within a short time of purchase (as was done in Hong Kong and Singapore) to tax speculation and 'flipping', and left unchanged for all other transactions.

Which taxes do you think could be introduced more quickly, and which would take longer to implement?

Excise taxes would be relatively simpler to introduce and implement; VAT would take some 2 years to implement after an agreement has been reached across the GCC. VAT is generally viewed as the most stable revenue source and which has the least detrimental effects on investment. A broad-based consumption tax such as VAT would raise revenue proceeds at a low efficiency cost without introducing distortions in the economy.

Case studies: There are numerous examples of resource-rich countries diversifying their economy and fiscal revenues. Which examples do you think could serve as a strong analogy for GCC countries?

International experience shows that diversifying away from oil is very difficult. Success or failure appears to depend on the implementation of structural reforms and appropriate policies well ahead of the decline in oil revenues. Malaysia, Indonesia, and Mexico perhaps offer the best examples of countries that have been able to diversify away from oil, while Chile has had some success in diversification away from copper. In addition to creating a favorable economic and business environment, these countries focused on trade openness and export diversification and quality upgrading by encouraging firms to develop export markets and by supporting workers in acquiring the relevant skills and education to boost productivity. However, those diversifications happened in a different pre-globalisation environment. Diversification must be viewed in a dynamic framework. For the GCC the focus

needs to be on education and skills for participation in global value chains, digital and knowledge based economies. International openness and supporting the development of SMEs is part of a framework to diversify and encourage job creation and innovation.

China's example is not the most ideal one to follow for the GCC: it is preferable to implement a single VAT with limited exemptions across the GCC than follow China's multiple VAT rates across different sectors. The message should be: keep it low and simple.

What other notable fiscal diversification methods would you recommend as a very strong analogy and why?

Taxation is of course one of the most common ways of revenue diversification. However, the other major source of revenue can be the sound and efficient management of non-financial state owned assets which include land, buildings, infrastructure, networks (electricity, water, and telecommunications), transport, and state owned enterprises (SOEs) as well as holdings in private or listed companies. For example, Dubai's Emirates Airlines is a highly profitable and successful government owned company contributing to diversify revenues. The actual value of assets owned (apart from natural resources) by GCC governments is not known but is likely to be substantial. The imposition of user fees and tolls and the appropriate pricing of public utilities and other services provided by governments and SOEs could provide a steady, resilient source of revenue. For the taxes you think are most promising, what are your cautions to implementing taxes. In particular, what do you think are the major political risks? Which taxes do you think will be more challenging to introduce? First, a good communications strategy is necessary to gain political support. Instituting a new tax regime is a change to the current, long-standing, social contract. The motivation,

For the taxes you think are most promising, what are your cautions to implementing taxes. In particular, what do you think are the major political risks? Which taxes do you think

will be more challenging to introduce?

First, a good communications strategy is necessary to gain political support. Instituting a new tax regime is a change to the current, long-standing, social contract. The motivation, objectives and incidence of taxes needs to be explained and appropriately communicated. It is also necessary that new tax regimes be harmonized across GCC, introduced in a synchronized manner, to prevent market fragmentation, avoid arbitrage and tax avoidance/ evasion. Implementing revenue diversification by introducing new taxes such as VAT or excises should follow a multi-year plan to allow the build-up of tax capacity and administration and for the private sector to adjust and make necessary investments to comply. Effective enforcement is required. Governments should implement track and trace systems for excisable goods, develop specialized resources and tools, with officials skilled in audit, ability to use IT tools, analyze and assess tax declarations and underlying financial statements and documents.