A means to an end: Article on GCC VAT in the Banker Middle East, Dec 2016

The article titled "A means to an end", on GCC's VAT and wider excise taxation plans, was first published on Banker Middle East's December 2016 issue. The article is on Page 42 of the magazine, which can be directly accessed here.

The precipitous decline in oil prices from 2014 peaks has led to sharp falls in government revenues, fiscal buffers and current accounts for oil producers. Though the UAE is one of the more diversified economies of the GCC, it is expected to post a fiscal deficit of 9.8 per cent of GDP and a current account deficit of 3.7 per cent of GDP this year. The UAE needs to introduce broad-based taxation to compensate for the massive loss of oil revenue, to diversify revenue and ensure fiscal sustainability over the medium and long-term.

A necessity?

Currently, tax revenues are negligible in the UAE, with the share of non-oil tax revenue to GDP averaging 2.5 per cent of GDP during the 2012-14 period, mostly from customs duties, fees and charges—which yield little revenue and are distortionary impediments to trade. Trade taxes have to be phased out given World Trade Organisation and bilateral free trade agreement commitments. Trade taxes should be replaced by domestic excise taxes. Several reasons underlie the use of excise taxes—they can produce significant government revenues and can be tailored to impose tax burdens on those who benefit from government services. Gasoline taxes are often justified as user fees for government provided roads.

Excise is also used for the control of externalities, for example on polluting substances. In addition, excise taxes may discourage consumption of potentially harmful substances (such as alcohol and tobacco) that individuals might over-consume in the absence of taxation.

The UAE is expected to introduce value-added tax (VAT) by the beginning of 2018. Once the GCC VAT Framework Agreement is approved, the UAE will issue a VAT law and implement rules and regulations. In this regard, a Federal Tax Authority is currently being established. For the UAE, the IMF projects that a VAT rate of five per cent would raise revenue of around two per cent of GDP (assuming a tax base of 90 per cent of private consumption). Realised revenue will depend on unknown details of the law—coverage (registration threshold), exemptions (basic foodstuffs, health, and education), zero-rating of exports, the inclusion of free zones and financial services among others.

The improvement in government finances will boost the sovereign credit rating of the UAE, resulting in better access to international credit markets and better terms for the various Emirates' governments as well as for corporates. Given the low VAT rate, we should not expect a major impact on consumption spending and, as a result, on economic growth and employment.

However, it will be important to ensure that visitors to the UAE can obtain refunds on their purchases, to avoid a negative impact on tourism, a major industry for Dubai and the UAE. There will be a temporary increase in inflation, during the first year, but no continuing effect on inflation. Ideally, the introduction of VAT and excise taxes should be used as an opportunity to replace the existing large number of fees, charges and stamp duties that raise cost of doing business.

Application

GCC finance ministers have, in principle, approved an Excise Tax Treaty, which will form the basis of national excise tax legislation, with implementation in 2017. Excises would apply to tobacco (a 100 per cent excise), soft drinks (50 per cent) and energy drinks (100 per cent). Other items such as cars and fuel could potentially also be subject to excise. The choice between ad valorem (on the value) or specific (on the quantity) depends on the nature of the product, the ease and efficiency of collection and market structure.

Taking tobacco as an example, specific excise taxes provide more reliable revenues and are easier to administer than ad valorem. Given that tax administration is nascent in the UAE, implementing a specific excise tax on tobacco is recommended, since it is much easier to determine the quantity (cigarette packs) than the value, which is subject to marketing and pricing decisions by businesses and can be manipulated. Specific taxes are also preferred from a health perspective, since the negative health effects of cigarette or shisha smoking are proportional to the quantity consumed not to the value. Given the large increase in tax (100 per cent in addition to customs of 100 per cent) it will be important to introduce measures such as digital stamps as well as track and trace systems to fight smuggling and illicit activities.

Substantial investment will be required by the private sector ahead of the VAT implementation. The introduction of VAT is likely to result in increased administrative and compliance burdens as well as additional costs as accounting and other IT systems will have to be radically overhauled to address the requirements of new tax laws and regulations. VAT refunds need to be issued promptly for the system to maintain credibility, and timeliness of refunds will be a key issue businesses look at in evaluating the effect of VAT. There will be great demands placed on finance and tax departments. Contracts will require thorough legal review to ensure that the introduction of taxes is provided for. Cross-border issues will also need to be sorted out.

The bottom line is education and investment in tax accounting, reporting and compliance is essential ahead of the potential 2018 VAT implementation timeline.

Impact

The tax reforms imply revenue diversification and less volatility of government revenues, improved fiscal sustainability and eventually allow the UAE to implement counter-cyclical fiscal policy, resulting in improved macroeconomic stability. In turn this means a more stable financial system with improved credit ratings.

This is a new tax regime for the UAE and it will be a steep learning curve both at the government level as well as the business level. A solid communication strategy is critical to ease awareness and gain public buy-in. The taxes to be imposed affect consumption and the VAT rate is low compared to other emerging and advanced nations and will not affect the international competitiveness of the UAE. Profitability in some businesses, such as luxury goods, automobiles, tobacco, soft/energy drinks and real-estate sectors is likely to be the most affected.

Taxes are only one of the adjustments required in the backdrop of the new oil normal. A new economic model, through macroeconomic and structural reforms, including phasing out and targeting fossil fuel and other subsidies (underway across the GCC), efficient pricing of public utilities services (e.g. Abu Dhabi’s recent move to raise electricity and water tariffs) and increasing the efficiency of government spending. Economic diversification for job creation will require greater private sector participation through a programme of privatisation and UAE-wide public-private partnership, reform of the sponsorship system (Wakalah) to reform the labour market and attract foreign direct investment.