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THE NEED FOR REFORM

Why tax and subsidies reform is imperative in the Gulf

THE GCC REGION AND WIDER MENA region is enormously wealthy in energy and other natural resources, with 48.5 per cent 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.

KEY POLICY CHALLENGES

Gulf economic policy makers face a number of daunting challenges: (a) steering 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 and financial risks from oil price volatility; (c) over-dependence on energy subsidies; (d) arresting growing environmental deterioration and fresh water shortages and (e) ensuring security of food supplies in a region that imports some 90 per cent 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 percent age of non-oil GDP): the average for the GCC has been in excess of 40 per cent of non-oil GDP since 2008, with Kuwait, Oman and Saudi running the highest deficits.

> **"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."**

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. The fossil fuel consumption subsidy rate as a percentage of the full cost of supply varies from a high of 80 per cent in Venezuela, 79 per cent in Saudi, 77 per cent in Libya and 70 per cent in the UAE, to 54 per cent and 50 per cent in Egypt and Algeria respectively.

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 aluminium 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 AND 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 per cent 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 per cent of GDP for energy infrastructure investment by 2030 compared to just 1 per cent 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.

INVEST IN EDUCATION, HEALTH, INFRASTRUCTURE & SOCIAL CAPITAL

Given MENA country demographics, growing urbanisation and historical under-investment in physical and social infrastructure, spending should be reoriented toward more inclusive and growth-enhancing capital expenditures, towards economic and social development and reconstruction. Education and health spending should be a priority given the need to build human capital endowed with market skills. Switching from subsidies to investing in education, science and 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.

Fuel subsidies have led to alarmingly high energy consumption in the GCC.

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 per cent 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 per cent, well below the world average (43.1 per cent) 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, making 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.

> **"Generalised fuel subsidies should be gradually phased out and spending re-oriented to education, health, productivity increasing infrastructure and social capital."**

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 and 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.