Fiscal Sustainability & Reform: Challenges for MENA & GCC
Keynote @ 5th MENA Tax Forum
Riyadh, KSA

Dr. Nasser Saidi

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NASSER SAIDI
& ASSOCIATES

Agenda

- ✓ **Macroeconomic Developments & Oil Markets**
- ✓ **MENA Economic Policy Challenges**
- ✓ **Imperative of GCC Fiscal Policy Reform**
- ✓ **Policy Recommendation for Excise Taxation with Application to Tobacco**

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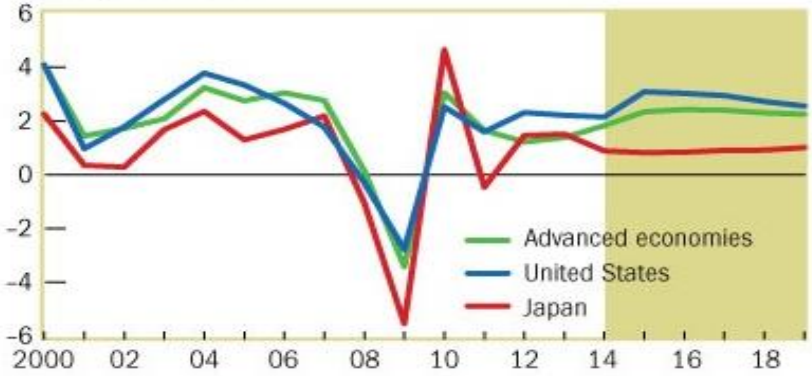
Global Recovery Fragile & Uneven; Secular Stagnation in Advanced Economies? Slowing growth in EMEs

(Real GDP, percent change)

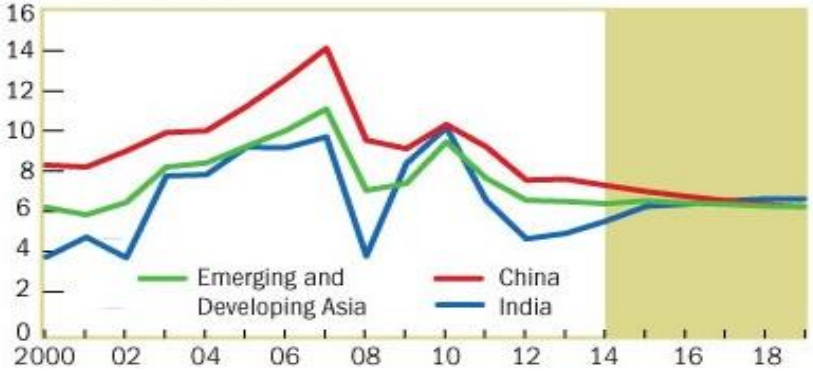
United States and Japan

Growth in the U.S. has rebounded with jobs picking up; Japan's recovery has slowed



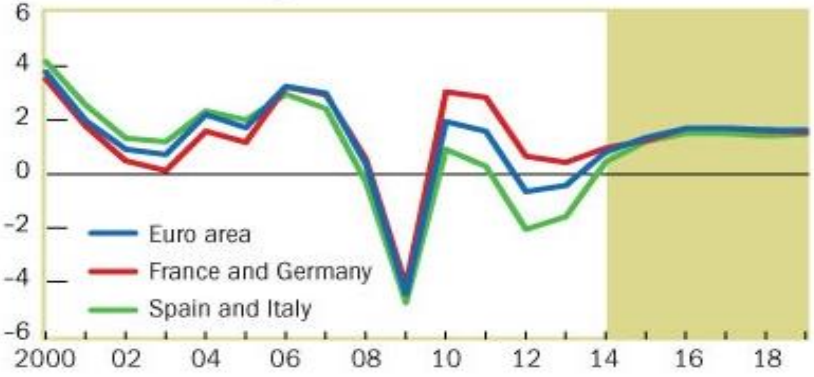
Emerging and Developing Asia

Emerging markets are adjusting to slower growth to different degrees in the region



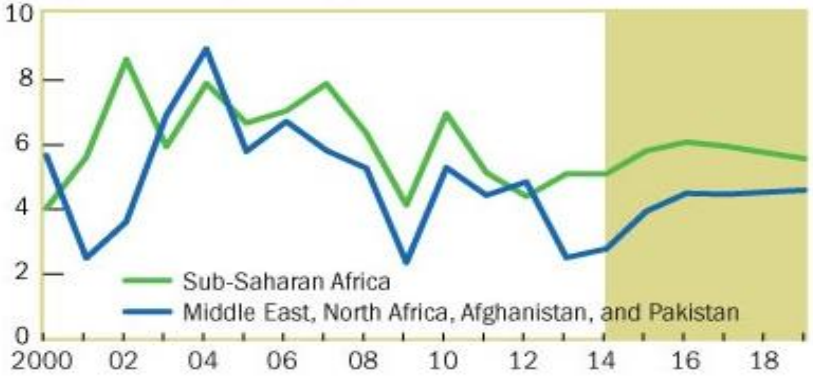
Euro Area

The euro area shows signs of a slow and fragile recovery, but still faces difficult challenges



MENAP[2] and Sub-Saharan Africa

Growth in the Middle East has been marked down; Africa is still doing well, although Ebola poses risks



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Global Economy Is Still Recovering from Great Financial Crisis & Great Contraction

Risks have increased

- ✓ Uneven fragile growth
- ✓ Potential deflation risks
- ✓ Bubbly Asset Markets
- ✓ Simmering geopolitical tensions
- ✓ Slowing Emerging Markets
- ✓ Uncertainty over Monetary Policy normalisation

However, growth potential still remains via:

- ✓ Low interest rates
- ✓ Structural labour & product market reforms
- ✓ Infrastructure investment
- ✓ Macro-prudential regulation
- ✓ Reducing private debt

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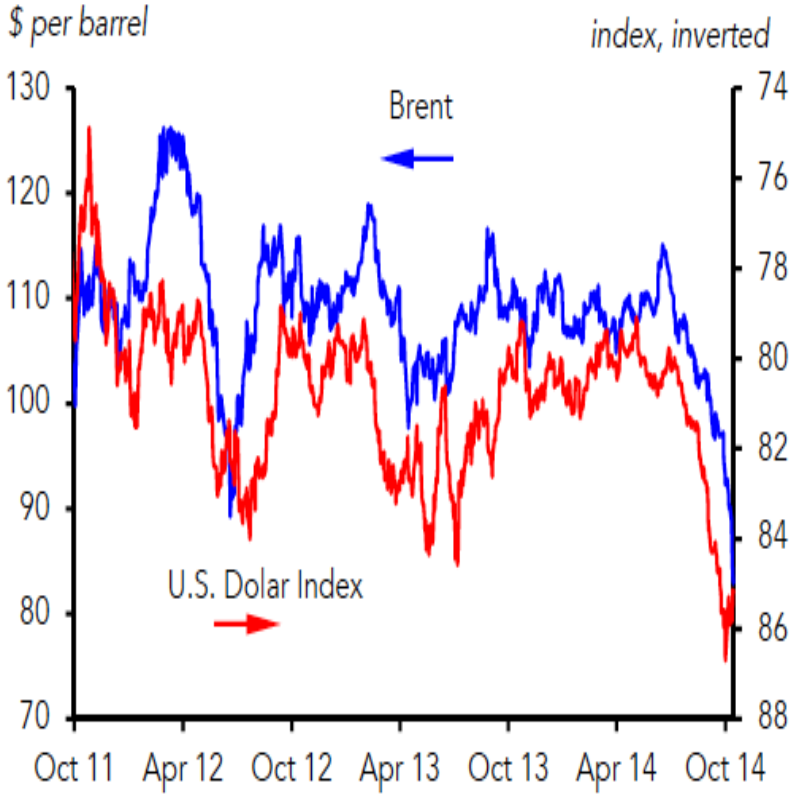
Soft Outlook for Oil Prices

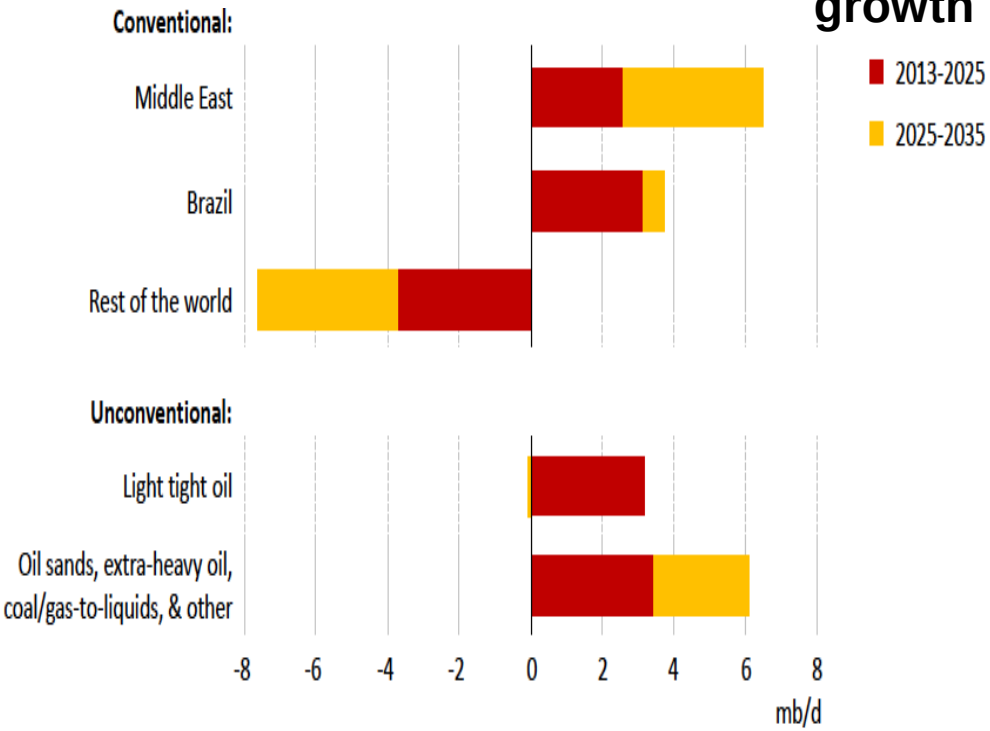
Excess supplies, weak demand, and stronger dollar shaved more than 25% off oil prices from recent highs. Prices are likely to remain under pressure with technology opening new resources

Brent Prices & the Dollar



Source: "Oil: A Perfect Storm Hits Prices", Oct 2014, IIF

Contributions to global oil production growth



Source: World Energy Outlook, IEA, Nov 2013

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MENA Macro: Growth, Inflation & Oil Market Uncertainty for Oil Exporters; Stressed economies in Oil Importers/Transition countries

	Real GDP			Consumer Prices[1]			Current Account Balance[2]			Unemployment[3]		
		Projections			Projections			Projections			Projections	
	2013	2014	2015	2013	2014	2015	2013	2014	2015	2013	2014	2015
Middle East and North Africa	**2.3**	**2.6**	**3.8**	**9.2**	**7.5**	**8.0**	**10.9**	**8.6**	**6.8**	. . .	. . .	. . .
Oil Exporters[4]	**2.2**	**2.5**	**3.9**	**9.5**	**6.8**	**7.3**	**14.8**	**11.6**	**9.8**	. . .	. . .	. . .
Saudi Arabia	4.0	4.6	4.5	3.5	2.9	3.2	17.7	15.1	12.4	5.5	. . .	. . .
Iran	–1.9	1.5	2.2	34.7	19.8	20.0	7.5	4.2	1.7	10.4	11.6	12.2
United Arab Emirates	5.2	4.3	4.5	1.1	2.2	2.5	16.1	11.1	11.8	. . .	. . .	. . .
Algeria	2.8	3.8	4.0	3.3	3.2	4.0	0.4	–3.0	–2.9	9.8	10.8	11.3
Iraq	4.2	–2.7	1.5	1.9	4.7	6.2	–0.8	3.0	2.4	. . .	. . .	. . .
Qatar	6.5	6.5	7.7	3.1	3.4	3.5	30.9	27.1	23.2	. . .	. . .	. . .
Kuwait	–0.4	1.4	1.8	2.7	3.0	3.5	40.5	40.8	38.6	2.1	2.1	2.1
Oil Importers[5]	**2.6**	**2.6**	**3.7**	**8.3**	**10.0**	**10.6**	**–6.2**	**–4.7**	**–5.9**	. . .	. . .	. . .
Egypt	2.1	2.2	3.5	6.9	10.1	13.5	–2.7	–0.4	–4.0	13.0	13.4	13.9
Morocco	4.4	3.5	4.7	1.9	1.1	2.0	–7.6	–6.8	–5.8	9.2	9.1	9.0
Sudan	3.3	3.0	3.7	36.5	38.0	20.6	–8.6	–6.3	–6.3	14.8	13.6	13.3
Tunisia	2.3	2.8	3.7	6.1	5.7	5.0	–8.4	–7.7	–6.6	15.3	15.3	15.0
Jordan	2.9	3.5	4.0	5.6	3.0	2.6	–9.8	–10.0	–6.9	12.2	12.2	12.2
Lebanon	1.5	1.8	2.5	3.2	3.5	4.0	–12.9	–12.7	–12.3	. . .	. . .	. . .
Memorandum												
Middle East, North Africa, Afghanistan, and Pakistan	2.5	2.7	3.9	9.0	7.6	8.0	10.0	7.8	6.2	. . .	. . .	. . .
Pakistan	3.7	4.1	4.3	7.4	8.6	8.0	–1.1	–1.2	–1.3	6.2	6.7	6.5
Afghanistan	3.6	3.2	4.5	7.4	6.1	5.5	4.3	4.8	0.1	. . .	. . .	. . .
Israel[6]	3.2	2.5	2.8	1.5	0.8	1.8	2.0	1.9	2.0	6.3	6.0	6.0
Maghreb[7]	1.1	1.3	5.4	3.2	3.1	3.9	–0.8	–7.4	–6.8	. . .	. . .	. . .
Mashreq[8]	2.1	2.3	3.5	6.5	9.1	12.0	–4.7	–3.0	–5.3	. . .	. . .	. . .

Source: IMF World Economic Outlook, Oct 2014

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Implications of Falling Oil Prices for the MENA Region

Oil Exporters:

- Decline in Oil Revenues
- Tighter fiscal constraints & budget deficits: GCC fiscal surplus could decline to $100bn in 2015 from $275bn projected
- Decline in Current Account Balances & Net Foreign Asset accumulation
- Cut growth prospects by 1% if oil prices stay in $75-$80 range

Oil Importers:

- Lower spending on oil imports improves trade balances
- But lower FDI & remittances from oil exporters outweigh trade benefits
- Aid levels are likely to decline as well

∴ *fall in oil prices hurt oil importers as well as exporters*

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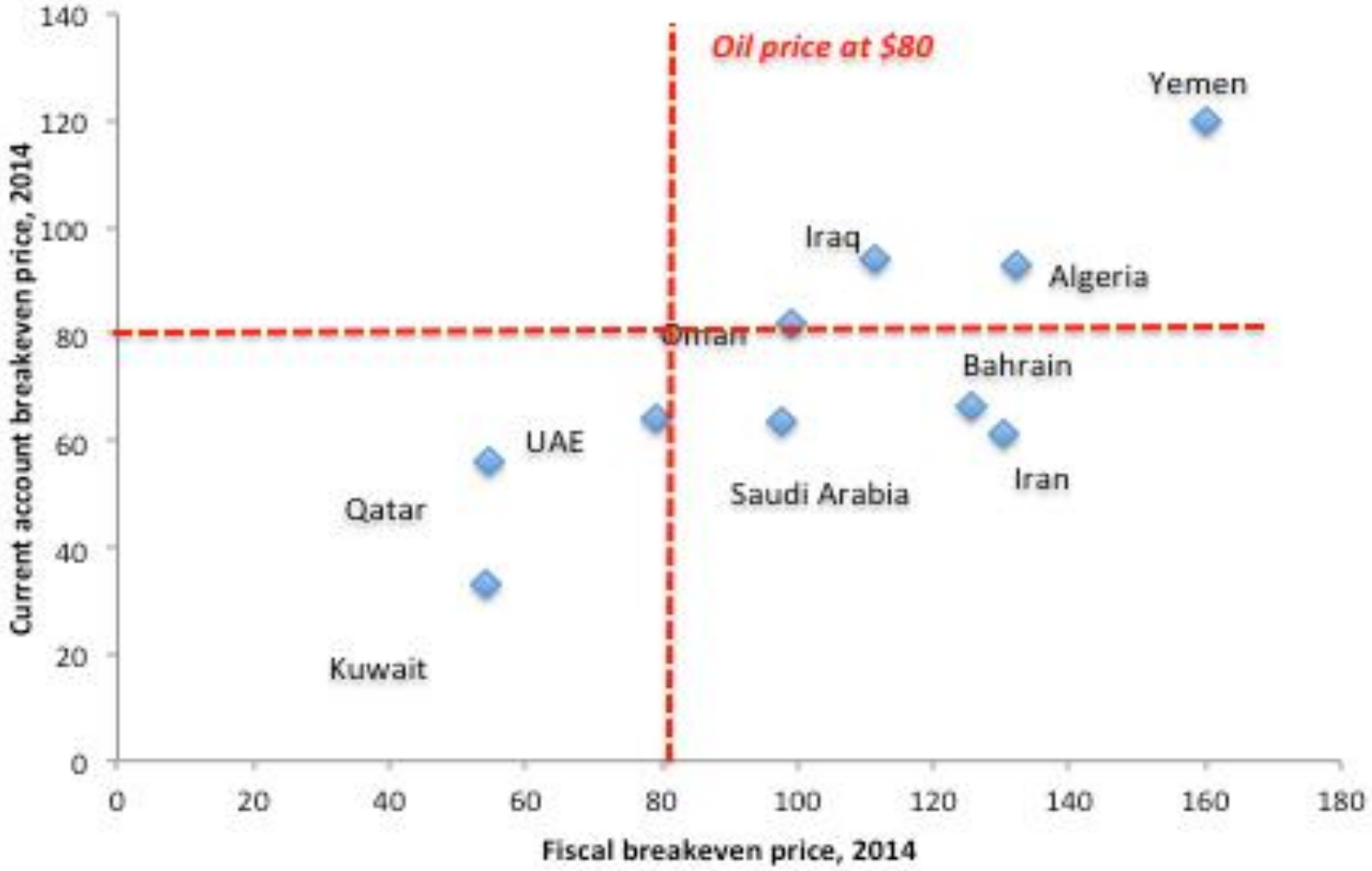
Deteriorating Fiscal & External Balances with Oil Exporters Vulnerable to Cheaper Oil



Source: IMF Regional Economic Outlook, 2014

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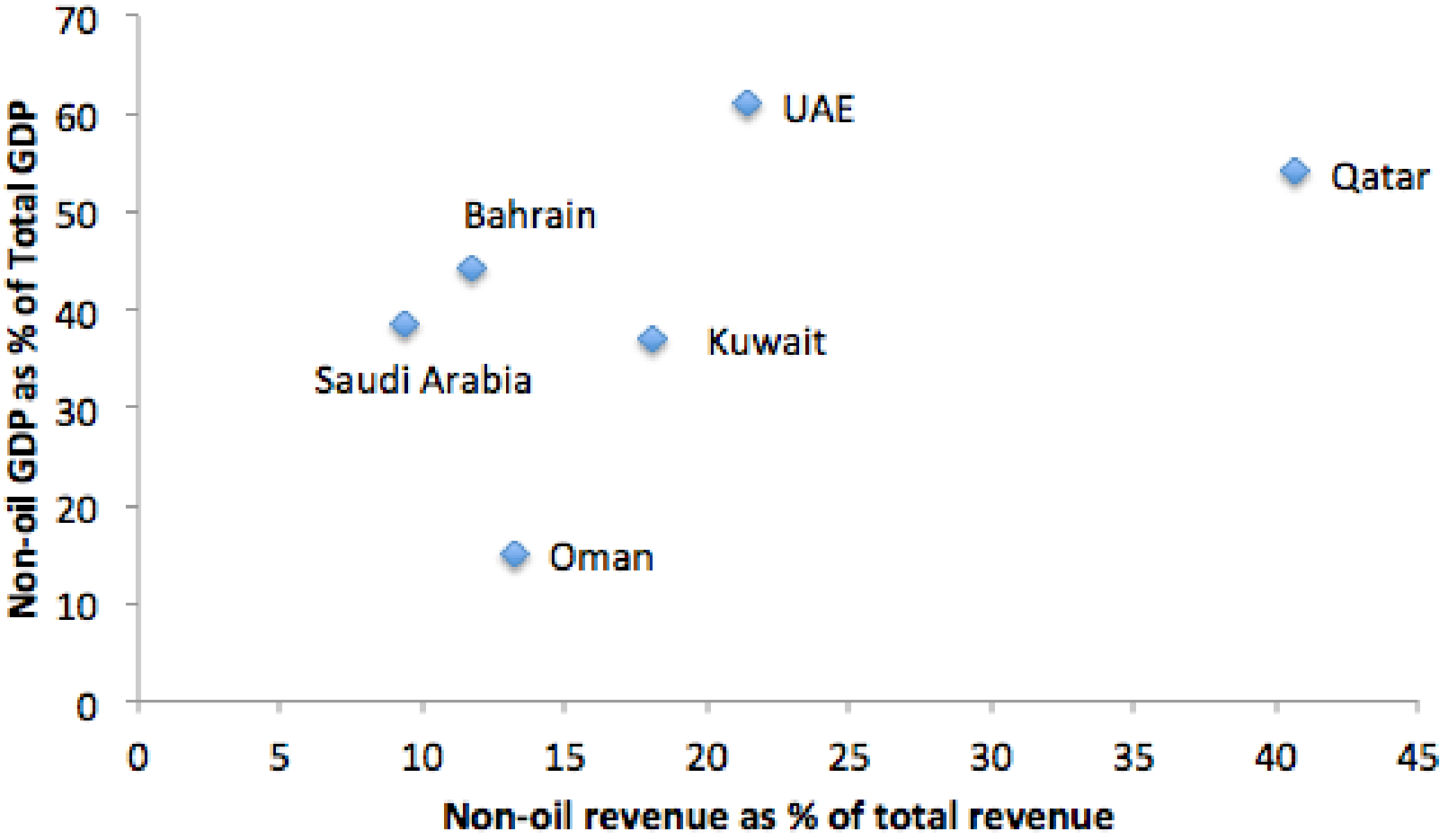
GCC economic diversification is a strategic priority for job creation, private sector expansion & international competitiveness. But **revenue diversification a priority** to avoid dependence on volatile oil revenues



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MENA Economic Policy Challenges

GCC

1. Job Creation in High Value Added, Export Oriented Sectors
2. Economic Diversification & Private Sector Participation
3. Remove Distortionary Energy Subsidies
4. Fiscal Sustainability

Arab Firestorm Countries

1. Job creation & "Pull–Up"/"Trickle Down"
2. Macroeconomic stability
3. Reduce Cost of Doing Business & Investment Barriers
4. Reduce subsidies & Increase Capital/ Infrastructure Expenditures

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MENA Energy Subsidies: about $240bn, 22.4% of government budgets or 8.5% of regional GDP!

Pre-tax Subsidies for Petroleum Products, Electricity & Natural Gas, 2011

As %of GDP

Country	Petroleum products	Electricity	Natural gas
Algeria	4.30	1.08	5.36
Bahrain	5.37	2.57	n.a.
Djibouti	0.00	0.45	n.a.
Egypt	6.74	2.30	1.60
Iran	4.20	3.61	4.83
Iraq	9.92	1.39	0.25
Jordan	2.15	3.81	n.a.
Kuwait	3.09	2.91	1.29
Lebanon	0.07	4.46	n.a.
Libya	6.40	1.85	0.59
Mauritania	0.00	0.85	0.80
Morocco	0.66	n.a.	n.a.
Oman	3.01	0.76	2.20
Qatar	1.22	1.20	1.07
Saudi Arabia	7.46	2.48	n.a.
Sudan	1.37	n.a.	n.a.
Syria	n.a.	n.a.	n.a.
Tunisia	0.77	2.23	n.a.
United Arab Emirates	0.48	1.86	3.37
Yemen	4.67	1.33	n.a.

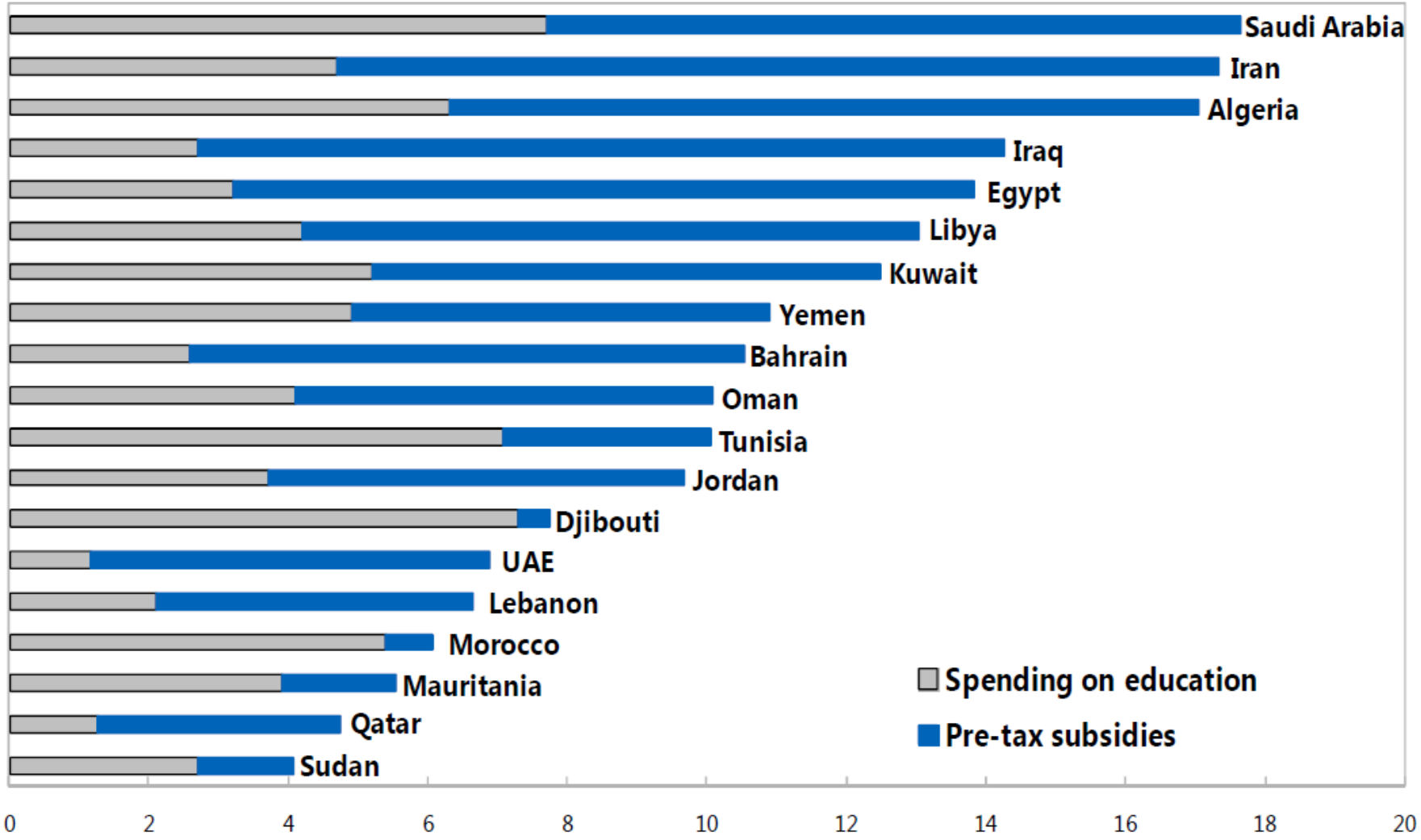
As %of govt revenue

Country	Petroleum products	Electricity	Natural gas
Algeria	10.84	2.72	13.52
Bahrain	18.96	9.08	n.a.
Djibouti	0.00	1.32	n.a.
Egypt	30.61	10.44	7.25
Iran	16.95	14.54	19.45
Iraq	12.69	1.78	0.32
Jordan	8.13	14.41	n.a.
Kuwait	4.57	4.30	1.91
Lebanon	0.32	18.96	n.a.
Libya	16.64	4.80	1.53
Mauritania	0.00	3.09	2.91
Morocco	2.40	n.a.	n.a.
Oman	7.28	1.83	5.31
Qatar	3.17	3.12	2.78
Saudi Arabia	14.00	4.66	0.00
Sudan	7.33	n.a.	n.a.
Syria	n.a.	n.a.	n.a.
Tunisia	2.42	7.02	n.a.
United Arab Emirates	1.38	5.32	9.61
Yemen	19.03	5.42	n.a.

Source: "Energy Subsidy Reform: lessons & implications", IMF, Jan 2013.

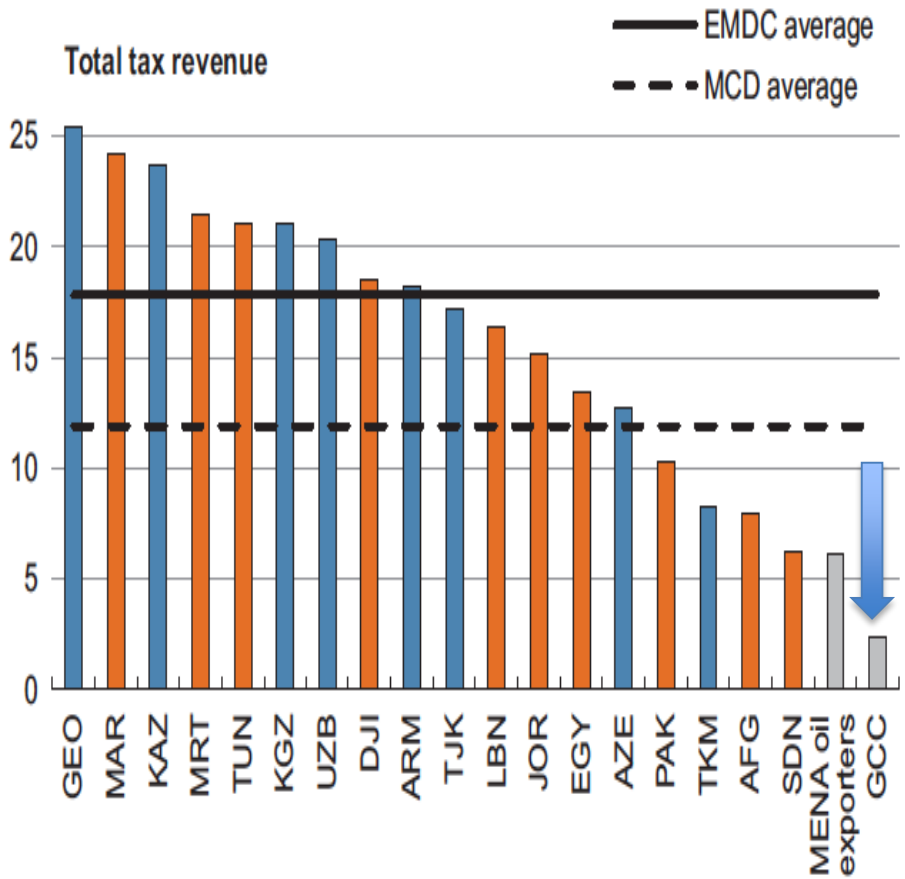
MENA Energy Subsidies cost $240bn: 8.5% of regional GDP, or 22% of government revenue. Despite young populations, more is spent on subsidies than on education!

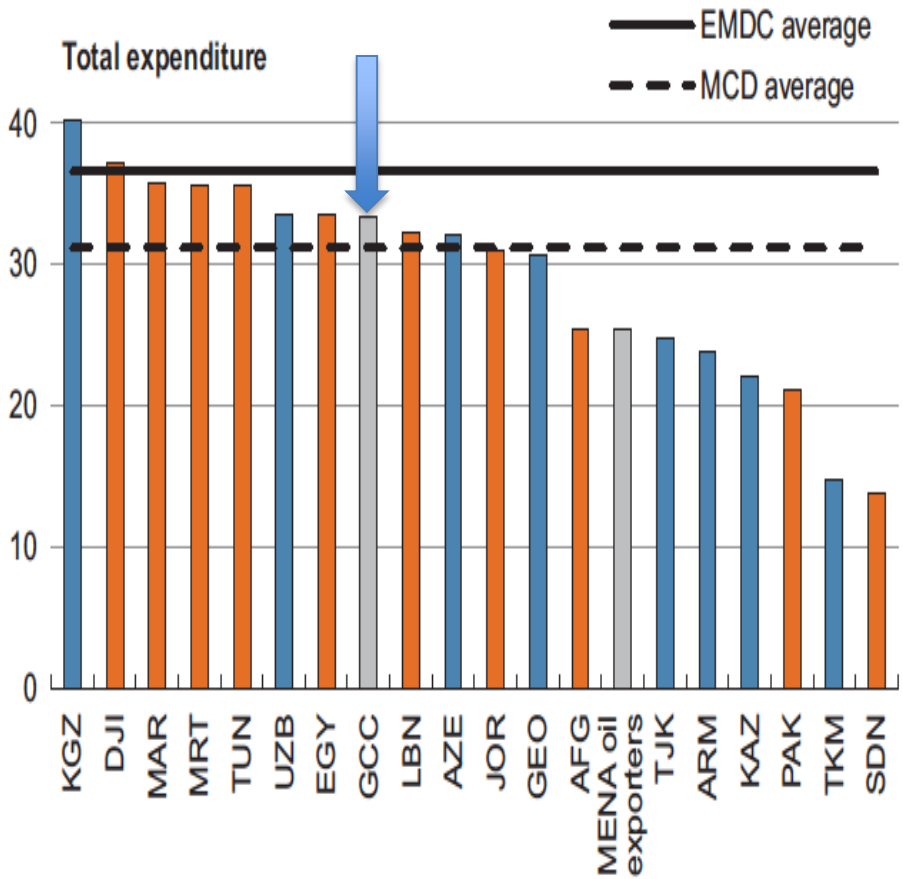
In % of GDP



Revenue Mobilisation & Spending Reorientation Imperative in MENA

Total Tax Revenue and Expenditure, 2012 (as % of GDP)





Source: IMF REO, Nov 2013
Note: EMDC refers to Emerging markets and developing countries

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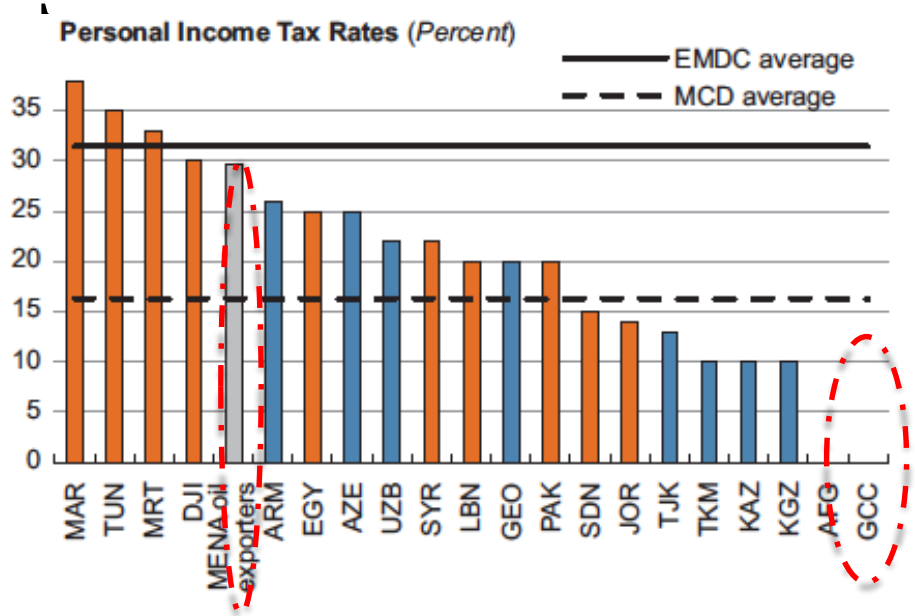
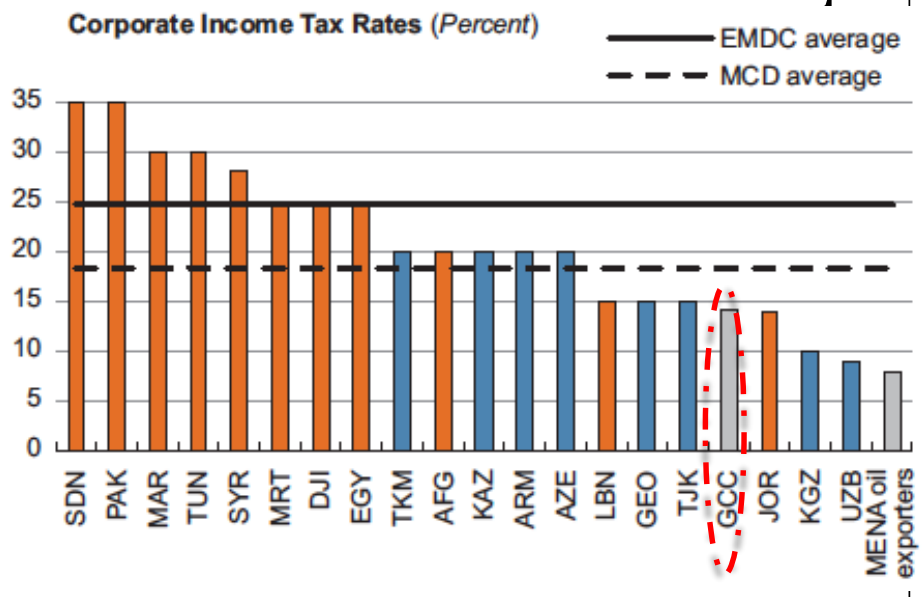
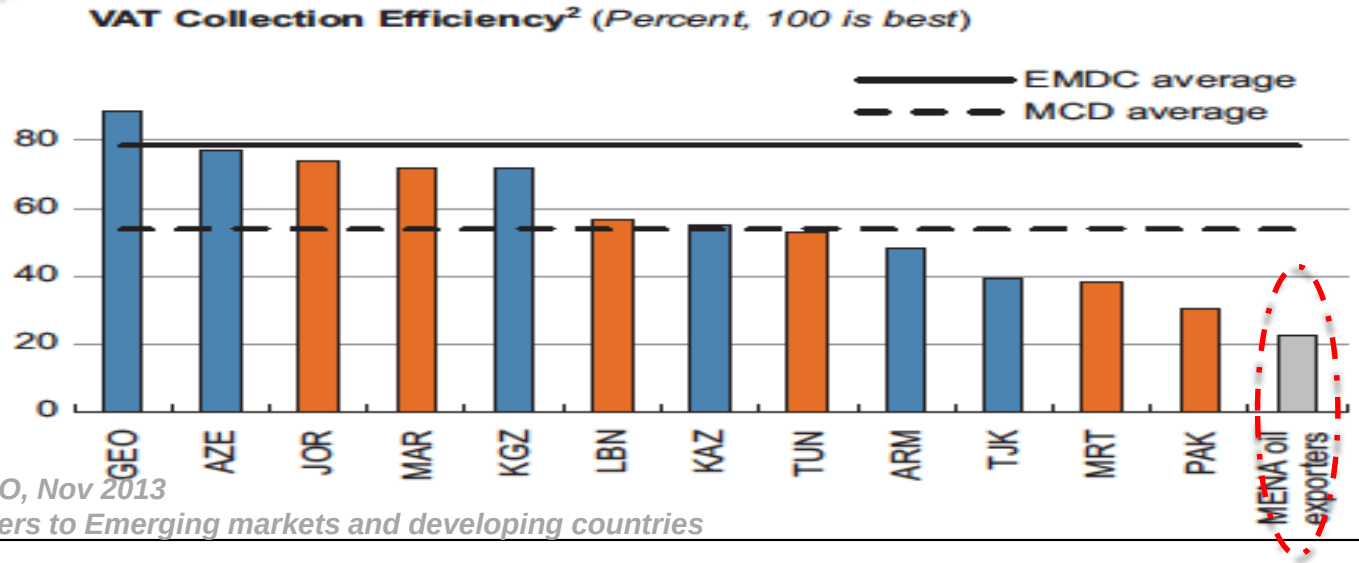
Revenue mobilization via broadening tax bases & establishing progressivity for social equity







Source: IMF REO, Nov 2013
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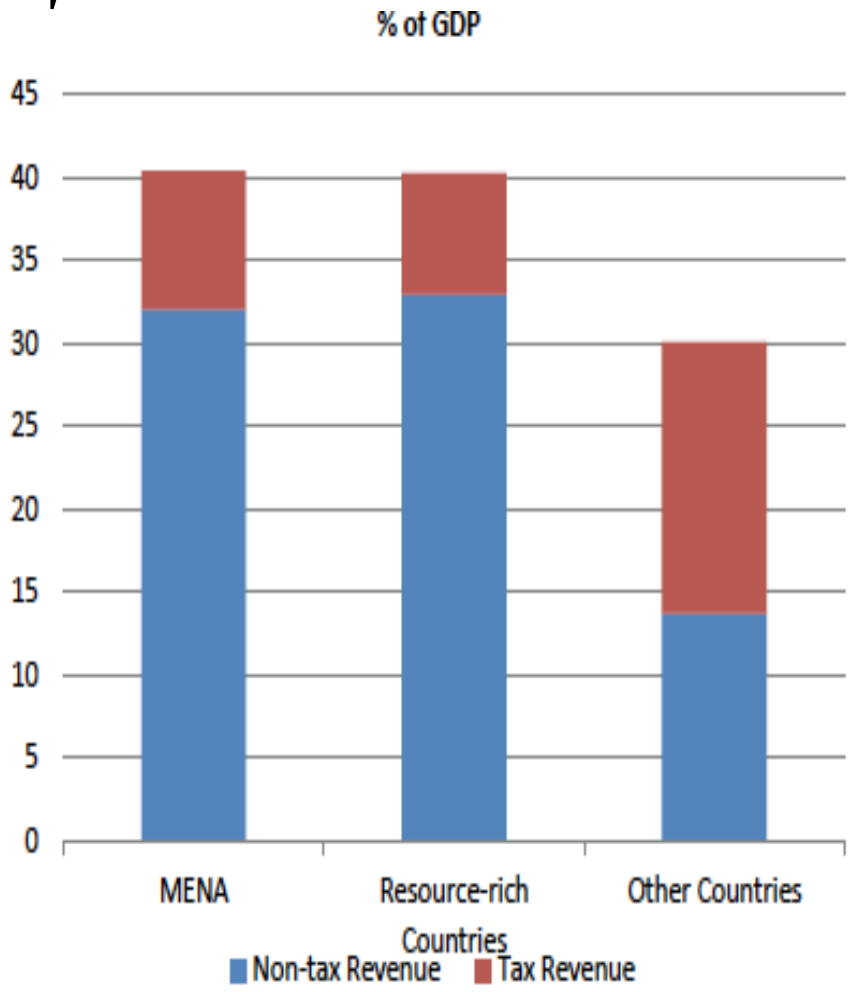
MENA: High Dependence on Non-Tax & Natural Resource Revenues=Vulnerability



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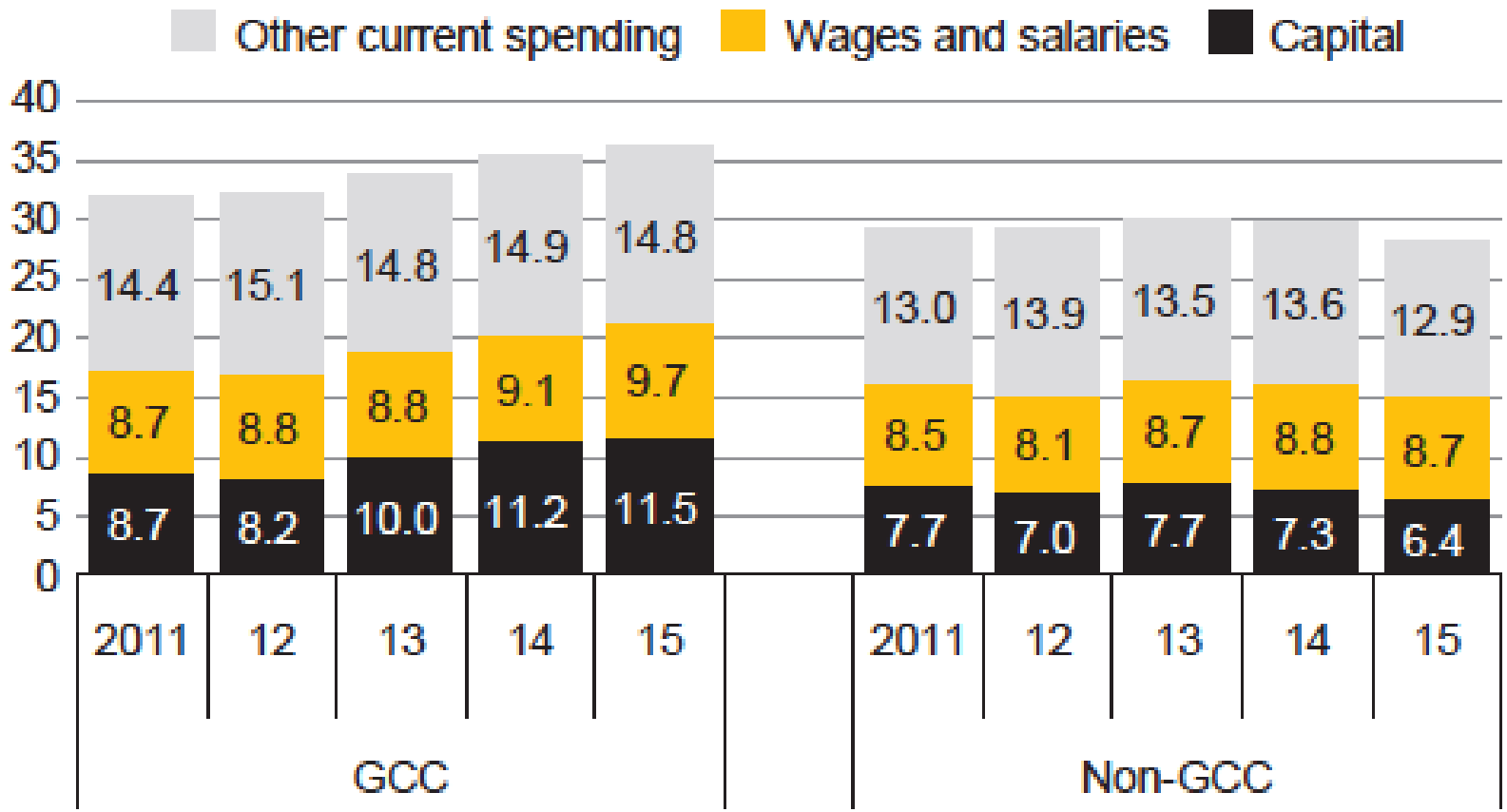
Arab Spring has led to profligate, unsustainable government spending

- Oil revenues have stopped rising, but government spending has not
- Gov't spending estimated to have risen by 7% per year in real terms between 2011 and 2015 & much of it on hard to reverse items: wages, subsidies



Source: IMF Regional Economic Outlook, Oct 2014

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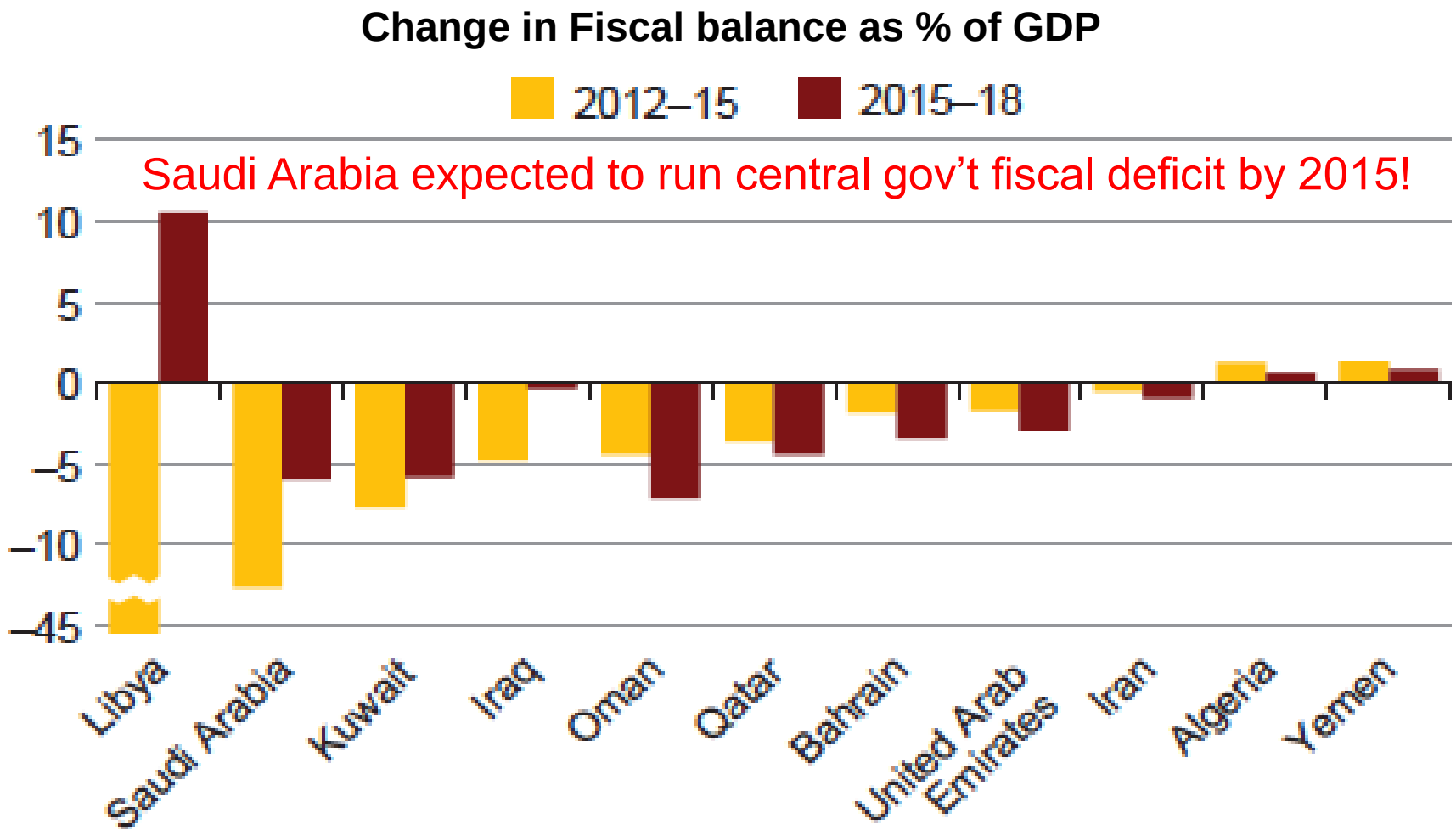
Fiscal Outcomes are Deteriorating threatening Fiscal Sustainability



Source: IMF Regional Economic Outlook, 2014

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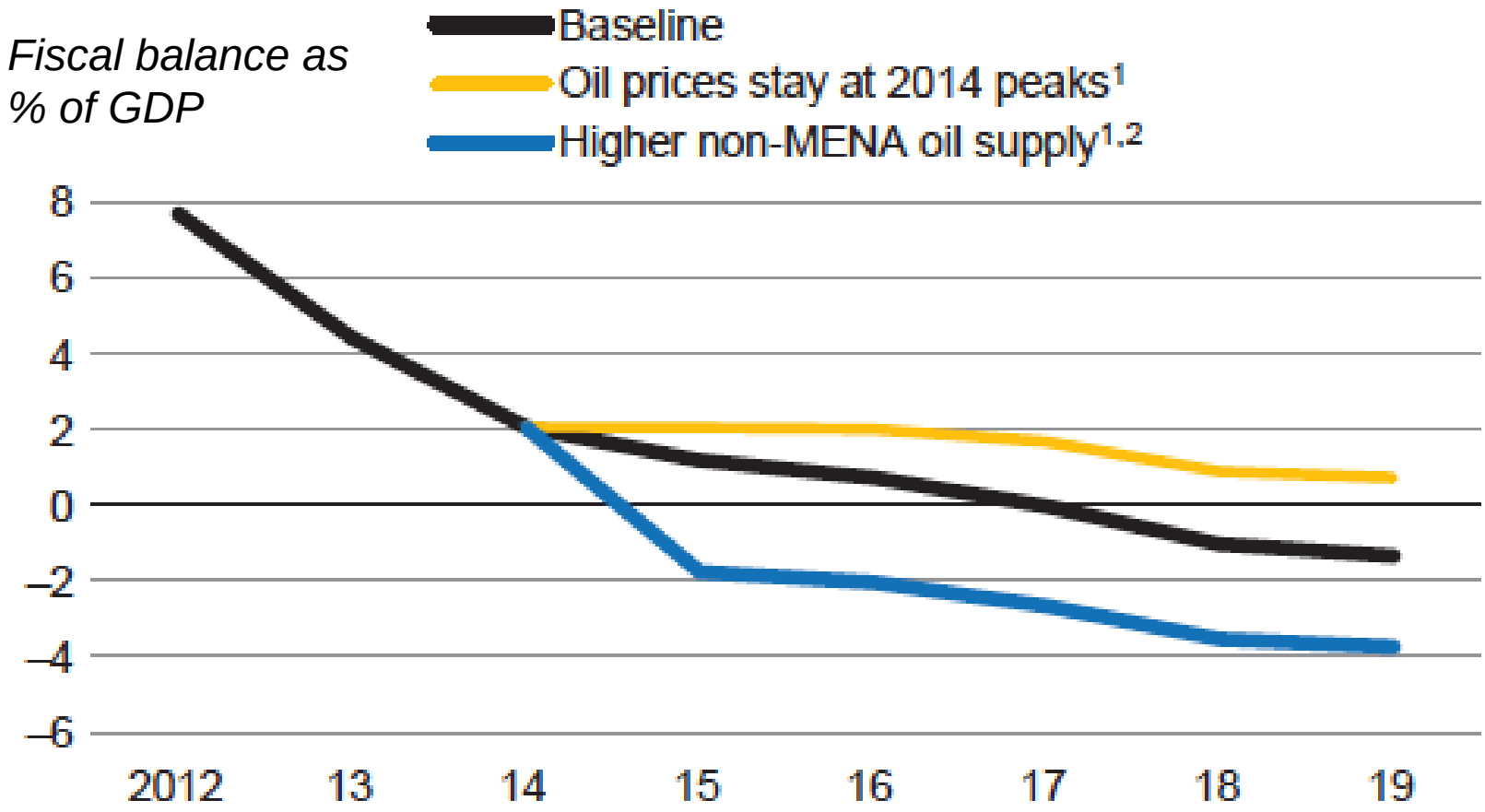
High Oil Prices Will NOT Save Fiscal Positions

Oil exporters' fiscal surplus is expected to be only 1.25% in 2015 (2012: 7.75% of GDP) and **to vanish by 2017**



Source: IMF Regional Economic Outlook, 2014

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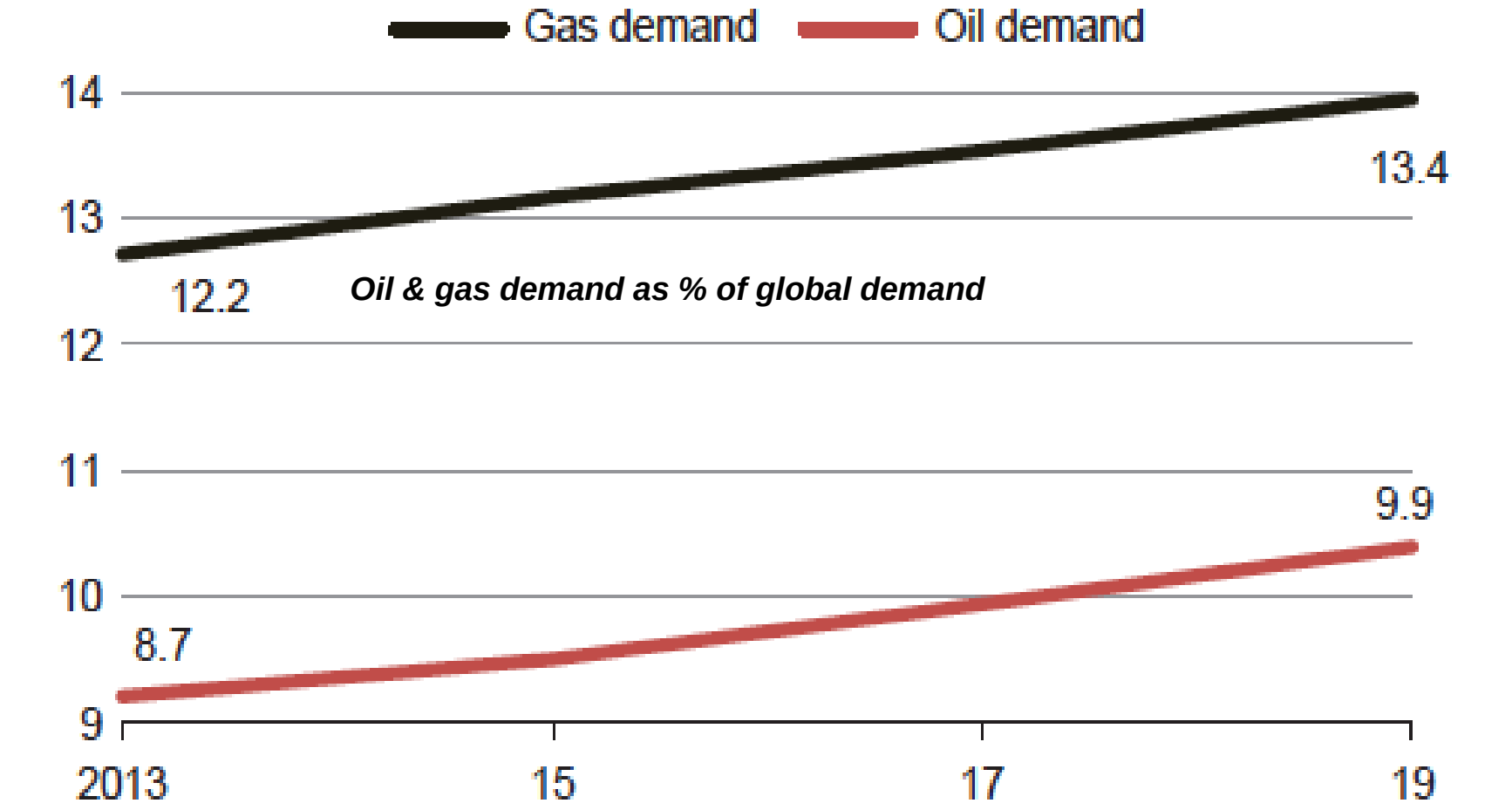
ME oil exporters energy consumption growth is outpacing RoW, given demographics, subsidized energy prices, energy inefficiency & economic structures



Source: IMF Regional Economic Outlook, 2014

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MENA Fiscal Policy reforms

- **Expenditure Reducing Policies**:
  - Gradual removal of oil, electricity, food and related subsidies; replace by Social Safety Nets & targeted Subsidies
  - Reform pricing of public utilities;
  - Invest & provide incentives to improve energy efficiency/renewables
- **Expenditure Switching Policies**:
  - Switch spending to Human Capital (education, health)
  - Invest in building Social Capital
  - Switch spending to productivity growth increasing infrastructure and investments that *crowd-in* the private sector (e.g. PPP) & improve international competitiveness
- **Revenue mobilisation & diversification**

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GCC have low tax levels & high dependence on oil exports & oil revenue

	Bahrain	Kuwait	Oman	Qatar*	KSA	UAE
Non-oil revenue (USD bn)	0.9	23.3	4.8	34.2	28.0	29.7
Total revenue (USD bn)	7.9	129.3	39.9	94.1	347.7	139.4
Total revenue (% of GDP)	24.3%	73.6%	51.7%	47.0%	46.5%	33.6%
Share of oil revenue in total revenue	88.5%	82.0%	87.9%	63.7%	91.9%	78.7%
Oil exports (% of total exports)	63.8%	87.1%	64.1%	86.1%	83.3%	27.4%
Tax revenue (% of GDP)	1.0%	0.7%	3.0%	5.8%	1.2%	2.8%
Tax revenue (% of non-oil GDP)	1.4%	1.8%	5.3%	19.9%	3.2%	4.6%
Direct tax (% of tax revenue)	0.0%	21.3%	46.4%	92.0%	36.7%	3.2%
Budget balance (% of GDP)	-1.9	32.1	8.1	15.4	8.7	6.5
Budget balance (% of non-oil GDP)	-34.6	-81.7	-78.9	-23.1	-53.2	-33.9

*** Qatar data include investment income from public enterprises (including hydrocarbons), corporate tax revenue & other non-tax revenue**

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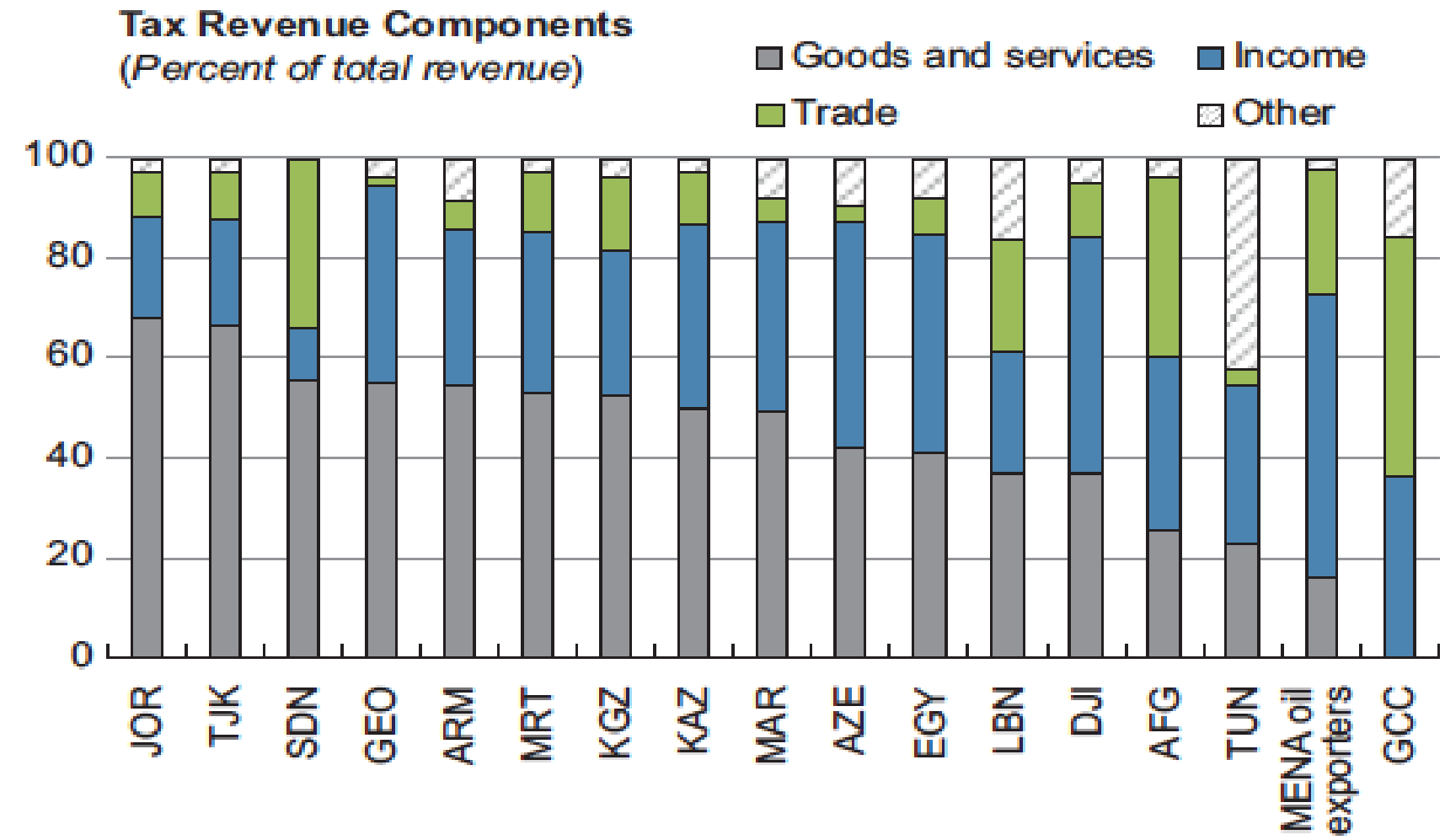
Trade Taxes Form Bulk of GCC Tax Revenue



Source: IMF REO, Nov 2013

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GCC Fiscal Policy Objectives for Fiscal Sustainability

1. **Diversify revenue sources away from dependence on oil revenues**. Oil revenue dependence + balanced budget policies lead to pro-cyclical fiscal outcomes that aggravate oil-induced boom-bust cycles
2. ***GCC economies are maturing & require new fiscal policy tools***:
   - Broad-based taxation for fiscal stability & to provide elastic, buoyant source of revenue: VAT or GST
   - Excise Taxes on selected products to achieve revenue & policy objectives (health, environment): alcohol, gasoline, diesel, tobacco
3. **Finance of infrastructure** –including maintenance- on a sustainable basis through financial markets/public debt & Sukuk markets
4. **Provide efficient, equitable pricing of public services & utilities**
5. **Maintain foreign investment tax attractiveness** in order to support economic diversification policies

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Benefits of VAT for Oil Exporters/GCC

- Oil exporters have an extremely narrow, volatile tax base which limits ability to mobilise revenue & conduct contra-cyclical fiscal policy
- A large number of small fees are collected from individuals/ businesses leading to cumbersome procedures & higher cost of doing business
- **Potential to implement VAT as a potential revenue earner** increased:
  - Fiscal stimulus packages have pushed break-even oil prices higher;
  - Previous plans to introduce VAT were shelved in part due to inflationary pressures in 2008 and to Arab Spring concerns
  - FTAs causing around 70-80% loss of revenues: VAT would help recoup these losses after its implementation.
  - Introduce VAT at a low rate of 5% but with limited exceptions
  - Implement VAT in conjunction with a consolidation/removal of the small, distortionary collection of fees and charges that increase transactions costs to reduce cost of doing business

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Constraints on GCC Trade Tax Policy Options

- **GCC are considering increase in taxes on tobacco**
- **GCC Customs Union**: a uniform duty structure for products across all countries
- **WTO obligations**: compliance with a maximum import duty, known as the ‘bound’ rate
- **Bilateral FTA obligations**: Bahrain and Oman each have a separate bilateral agreement with the US; removal of tariffs by 2015 and 2018 respectively
- Limited **revenue administration** capacity

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WTO Bound Rates on Tobacco in GCC

Country	WTO bound rate on "ordinary customs duties"	WTO bound rate on "other duties & charges"
Bahrain	100%/ 35%	0%
Kuwait	100%	15%
Oman	150%	0%
Qatar	200%	3%
Saudi Arabia	200% or SAR 200 per 1000 cigarettes, whichever is higher	SAR 0.03/ packet
UAE	200%	0%

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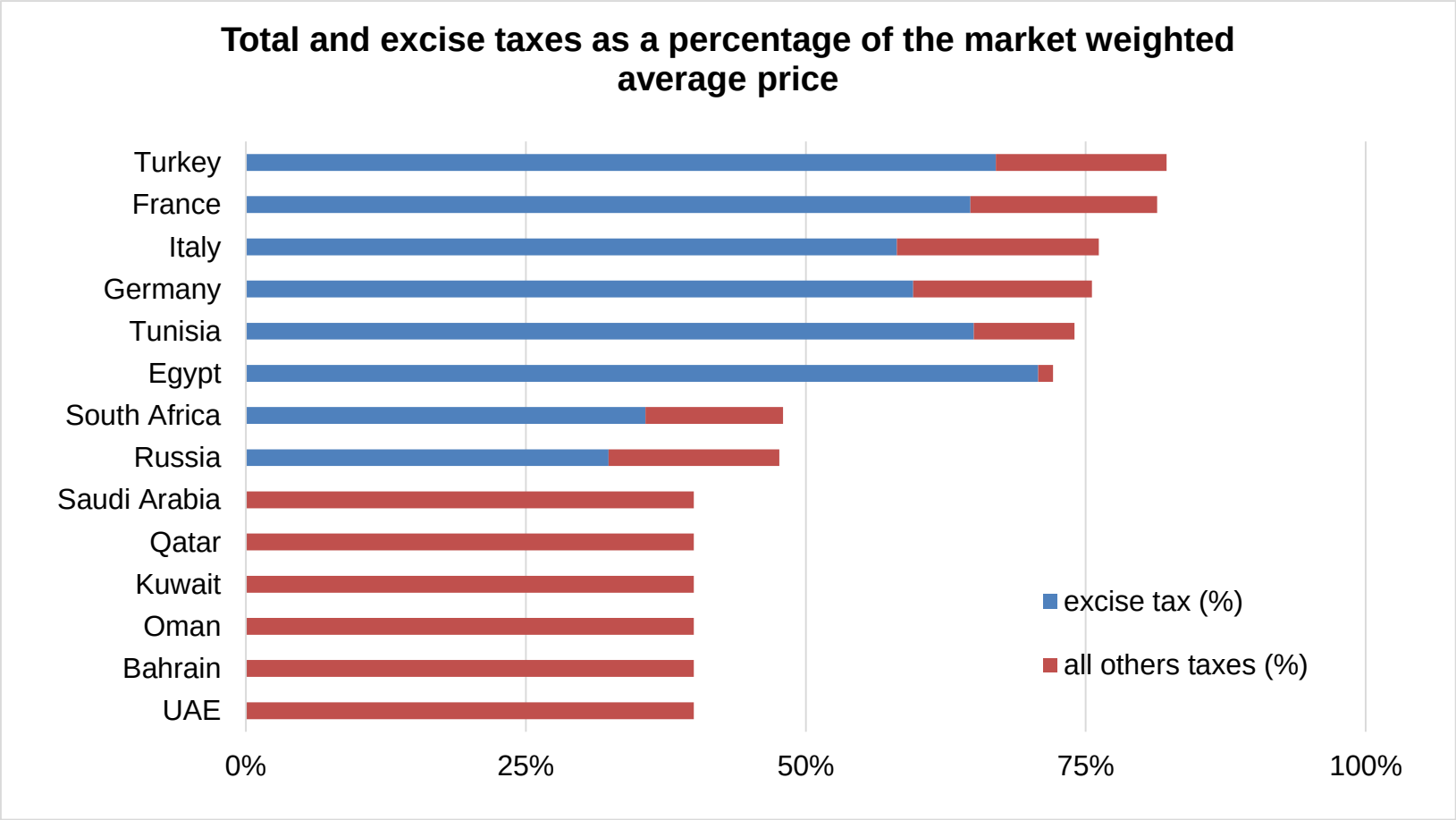
International Tobacco Taxation

Excise Taxes on tobacco products are the major component of the prices paid by consumers of these products, with notable exception of the GCC



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Excise Taxes on Cigarettes: by form of Tax

Type of Tax	No of Countries
Total covered	186
Specific Excise only	56
Ad Valorem Excise only	50
Mixture of both excises	60
No excise	20

Source: WHO Report on the Global Tobacco Epidemic, 2013

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Proposed GCC Tobacco Excise Tax I

- Agreement of the GCC countries to introduce domestic excise taxes on products like gasoline, alcohol, tobacco etc.
- Excise duties should be set at a rate in line with international best practice. GCC Finance Ministers can choose higher excise duty rates to meet health and/or revenue objectives.
- Introduce specific nominal excise duty; e.g. fixed amount per 1,000 cigarettes & equivalent for OTP to achieve more reliable source of revenue. Adjust periodically for inflation.
- Excise duty should apply equally to imports and domestic production, including from FZs
- GCC excise duty should be harmonised, introduced in synchronised manner and be the same in all member states to prevent arbitrage, market fragmentation & illicit trade

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Proposed GCC Tobacco Excise Tax II

- Excise duty is a domestic tax payable to the national revenue authority. Use digital markers as this enhances supply chain security and helps fight illicit trade.
- New excise duty would be administered by revenue units at Ministries of Finance
- Set-up of an excise revenue administration facilitates introduction of other excises e.g. on alcohol, gasoline, diesel …
- Bahrain and Oman will have to phase out their tariffs given their US FTAs by 2015 and 2018. Other GCC countries need to take administrative & other measures to avoid trade diversion towards Bahrain & Oman.

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Policy Reform Implementation Issues

- ✓ Harmonization & synchronization of policy across GCC
- ✓ Build Tax/Revenue administration capacity
- ✓ Combating smuggling and illicit trade

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Key Takeaways

- Global economic growth is fragile and uneven with EMEs & China slowing, leading to lower demand for oil, while supply is growing & technological change favours new sources of oil
- Lower oil prices lead to declining fiscal surpluses for GCC which have low tax levels & high dependence on oil revenue
- Economic Diversification, Fiscal Consolidation & Reform are Imperative for Fiscal Sustainability in Oil Exporters
- GCC reforms include: Revenue Diversification + Gradual Removal of Subsidies +VAT/Excises on oil products, tobacco
- GCC needs to build Tax Administration Capacity, harmonise & synchronise introduction of new taxes

NS

Thank you

Dr. Nasser Saidi
nsaidi@nassersaidi.com

NASSER SAIDI
& ASSOCIATES