Introduction

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The issue of fiscal reforms, and particularly the design of non-oil sources of taxation, in the Gulf Cooperation Council (GCC) countries has to be seen in the context of the plentiful natural resources in the region, the need for revenues in some member states, and for completion of the panoply of macroeconomic instruments in a modern economy. Most of the countries have non-oil taxes—these are largely based on customs tariffs, and corporate taxation of foreign companies. These forms of taxation have been inimical to foreign investment. In recent years, there has been a reduction and rationalization of rates in most (corporate rates have been reduced from more than 50 percent to 20 or 25 percent in most countries), and the move towards a GCC common market was preceded by rationalization of customs duties and the establishment of a common external tariff of 5 percent. Both reforms have led to a loss in non-oil revenues.

Indeed, the impetus to search for alternatives to customs duties arises out of a further loss in non-oil revenues due to the free trade agreements between the GCC and its major trading blocs—some of which have already been agreed, others that are in the process of finalization. The alternatives, including the VAT and a system of excises, were proposed following a series of technical cooperation discussions and missions involving Dubai (on behalf of the GCC Secretariat), the Secretariat, and IMF technical teams—the recommendations are summarized in Ahmad (Chapter 1).

GCC committees have agreed on several elements that would constitute a harmonized system of VAT and excises. As much of the customs revenues from the 5 percent common external tariff (CET) would be lost as a result of the free trade agreements (FTAs), it would be politically attractive to replace the lost revenues with a 5 percent VAT. It is possible to build on the experiences of the EU, for example, to prevent carousel fraud in the GCC. However, a final decision to implement VAT on a coordinated basis has not yet been taken. Ministers asked for further research to specify the effects of a VAT on prices and households in different circumstances, and the treatment of specific sectors. The concerns are largely political—how does a tax system fit in a situation of perceived “abundant oil wealth”, what
Fiscal reforms in the Middle East are the effects on the poor, and how might “losers” be protected as a result of the reforms? Similarly, weak administrative capabilities might lead to additional constraints. And in some countries, such as the UAE, how the resources are distributed among constituent Emirates poses an additional complication—which must be addressed as part of a package of reforms.

We present the background to the reforms in this chapter, and in the summary by Ahmad (Chapter 1). The remaining chapters are organized into two broad parts. The first part deals with design issues in an international context. The second part presents empirical assessments largely based on data made available for the UAE and some of the constituent Emirates, particularly Abu Dhabi and Dubai. This enables us to address many of the questions posed by the GCC Ministers, evaluate the recommendations of the GCC working group on the VAT, and also answer remaining questions on the detailed design of the VAT.

A OIL—A BLESSING OR A CURSE?

Oil windfalls have opened a window of opportunity for the Gulf States and created, at the same time, several challenges. The GCC countries, with the blessing of oil, have become more prosperous, have managed to build a modern infrastructure and provide comprehensive social services, and put in place a generous welfare system. Within the Middle East and North Africa (MENA) region, GCC countries are the most qualified to integrate into the world economy and benefit from globalization. High oil prices have had a positive effect on the economic and fiscal performance of these countries, have strengthened all the key macroeconomic indicators, and have helped to lay the ground for the creation of the most welfare-oriented societies in the Middle East. Notwithstanding these gains, the massive inflow of financial resources has brought significant drawbacks; severe adverse economic and social effects that were labeled in the economic literature as “the resource curse”, “Dutch Disease”, and “flawed prosperity”. These include, among others, an undesired sectoral reallocation of productive factors toward the booming sector, de-industrialization, higher real interest rates, and in the recent past, high and persistent inflation rates as a result of major fiscal expansion in the period preceding the crash of 2008.

Boom and bust periods in the oil market have been associated with higher than usual uncertainty, and large costs incurred by the corporate sector because of gluts or bottlenecks that tend to cause deflation/hyperinflation. Formulation and implementation of sound fiscal policy in this environment proved to be a formidable task. The GCC countries are
facing several challenges: the choice between consumption and saving, or current needs and future requirements, intra-generational equity issues, pro-cyclicality of fiscal policy, and lastly fiscal sustainability and the prudent management of revenues from exhaustible and finite oil reserves.

Despite the fact that the Gulf States are major suppliers of oil and gas and, combined, have a large share of both world oil and gas reserves and production, hydrocarbon resources are depleting at a very high rate. In some countries (notably Bahrain and Oman) proven oil reserves will last for only a few more years and these countries will become, eventually, net energy importers. Despite significant efforts made by the Gulf States to diversify their economic base away from oil over the past three decades, the petroleum sector continues to account for a major share of GDP, more than 80 percent of exports and in excess of 75 percent of total budget revenues. Fiscal operations, therefore, have been influenced by uncertainties surrounding the main determinants of oil revenues: petroleum prices and production.

To minimize the destabilizing impact of volatility in the international oil market, especially after the oil price collapse of 1985–86, all Gulf States have embarked on programs to reform fiscal policy. Public spending adjustments include: scaling down spending on subsidy and social support; streamlining public sector employment, wages, and pensions; curtailing recurrent spending; and substantially decreasing expenditure on arms and security; while increasing allocation to investment expenditure. Revenue measures include: fees and charges on several governmental services; cost-recovery measures in the utility sectors; and imposing limited corporate taxes. Notwithstanding these efforts, a major problem of fiscal reforms in the GCC has been the difficulty of lowering the share of current outlays in total expenditure, which still stands at more than 80 percent; more than three-quarters of it goes to wages and salaries.

What is most worrying for these countries is that oil wealth alone cannot be a sustainable source of overall growth and improvement of living conditions. High wages, low working hours, and munificent pension schemes have overshadowed other productive sectors of the economy and created rent-seeking behavior in large segments of the society, where emphasis has shifted from production and contribution to distribution and sharing. While several states have stressed the need not to deprive future generations from sharing the benefits from the oil wealth, in reality this proved to be easier said than done. The political-economy constraints are manifold—with several pressure and interest groups that force the governments to address the urgent needs of society. The need for public services will expand exponentially, given high fertility rates that produce an increasing number of young nationals joining the education system and the labor market.
With oil-funded public spending as the driving force determining the Gulf States’ growth path, and with exchange rates linked to the dollar, fiscal policy constitutes the pivot of macro management. However, with limited or insignificant non-oil tax instruments, fiscal policy was driven by spending from oil revenues that has manifested in high wages, public employment and numerous subsidies for nationals of each country. Thus, over the last 30 years, the countries of the GCC could be characterized as following pro-cyclical fiscal policies with respect to changes in oil revenue. The rise in global oil prices in the late 1970s and early 1980s saw government spending rise, resulting in public investment in infrastructure, industry, and an elaborate welfare system. Falling oil prices in the period from 1982 to 1986 were not accompanied by commensurate fiscal adjustments and, for example, spending decreased by the equivalent of less than half the fall in total revenue in Saudi Arabia and only 20 percent in the United Arab Emirates. Thus, the countries of the GCC found themselves facing growing fiscal and external imbalances. Previously “healthy” international reserves during the late 1970s and early 1980s were used to cushion large fiscal deficits, averaging 11.5 percent during the second half of the 1980s and during the first half of the 1990s. Saudi Arabia, for instance, after the first Gulf War, also saw a sharp increase in its public deficit—from zero to over 100 percent of GDP in about ten years—exacerbated by a decline in oil prices to 1998. Given the absence of significant non-oil revenues, and welfare state social contracts, it was difficult to cut current spending and the main adjustment that took place was on capital spending, accentuating the stop-go effects on growth.

Prudent fiscal policy is essential to ensure sustainable economic growth given the volatility of oil revenues. However, many of the GCC oil-producing countries face the realities of oil as an exhaustible resource, and most, other than Saudi Arabia, are price takers. Even Saudi ability to influence prices in isolation is limited, given that much of the recent oil price volatility has been due to fluctuating global activity and demand. The absence of an effective taxation system and strong public pressure against changes limiting the generous welfare system currently in place have significantly limited the effectiveness of fiscal policy tools in the GCC region.

Where non-oil taxes existed, such as customs and taxation of foreign companies, high rates led to significant distortions and impediments to foreign investment and trade. Rationalizing such taxes has been of high priority in individual countries, such as Saudi Arabia and Kuwait, and given a greater impetus by the coordinated actions to create a common external tariff and common market, together with the removal of tariff barriers between major trading blocs.
B GENESIS OF WORK ON VAT AND TAX REFORMS IN THE GCC

As indicated above, non-oil tax systems in individual GCC countries date to the 1940s or 1950s, for example, in Saudi Arabia. These were based on high marginal rates of taxation of foreign companies, and relatively high customs tariffs, and some excises—reflecting the prevailing fashions of the day, and repeated in other GCC countries as they gained independence from Britain in the 1960s.

Oil price adjustments of the 1970s led to significantly increasing revenues, and dissipated the incentives for fiscal reforms, particularly more efficient forms of non-oil taxation. The creation of a GCC common market, and its precursor, the common external tariff of 5 percent, provided the first attempts to coordinate policies among the six members of the GCC—leading to a reduction in tariffs for some countries, such as Saudi Arabia, but for the UAE this meant an increase in tariffs. Most of the GCC countries have, until now, relied on tariffs, fees, and stamp duties as the main non-oil sources of revenues.

With the potential loss of customs revenues due to the FTAs, which could average between 60 and 80 percent of the main non-revenue base (see Ahmad, Chapter 1), the GCC countries are attempting to search for alternative sources. These include various sales taxes and excises. As is standard in tax reforms in an international context, the main criteria for the evaluation of indirect taxes include the impact on production efficiency and incentives, including trade and the investment climate, the ability to generate revenues, effects on households and distribution, and ease of administration (see Ahmad and Stern, 1991).

In order to evaluate the reforms, it is usual to examine the effects of possible policy options using household expenditure surveys, together with an evaluation of the effective taxes and price changes, for example, using input-output tables. The data to carry out such analyses (described, e.g., in Newbery and Stern, 1987 or Ahmad and Stern, 1991) are not available for all the GCC countries. While there is a concerted effort to generate consistent household income and expenditure surveys in the GCC countries, some data has been generated for the UAE and Dubai, and is used in Part II of this volume.

The Policy Instruments

The main options for indirect taxes include single point sales taxes, such as the wholesale or retail sales tax, and the manufacturer’s sales tax. Multi-stage taxes include the turnover tax and the VAT. It is usual to have
excises—meaning taxes on particular commodities—for additional revenues, addressing externalities, and possible distributional considerations.

These taxes would supplement the regime of tariffs that may be needed for a variety of reasons, including revenues, as well as protection. Tariffs are low in the GCC and will decline further. However, given the different needs and endowments in various GCC countries, it is not likely that these can be eliminated altogether. Some countries need time-bound protection for nascent industries on the grounds of employment generation, as in Saudi Arabia. On the other hand, Dubai has developed an efficient trade model, pursuing a Singapore-like strategy, and has less need for protective duties.

Single-point sales taxes were popular in the past, but are difficult to collect efficiently given that any evasion leads to the loss of the entire tax, unless implemented with a few tightly controlled points of taxation. In countries with weaker administrations, it is particularly risky to rely on single-stage sales taxes. Multi-stage sales taxes were also used extensively, including in developed countries. However, these resulted in considerable cascading. Thus, the effective tax, which includes the direct and indirect elements of taxation (through taxation of inputs) often differs substantially from the nominal taxation—which presumably better reflects the intention of the policy-makers (Ahmad and Stern, 1984). In addition, the imposition of multiple levels of taxation on the same product results in distortions of economic activity, for example (but not only) in creating an artificial incentive for vertical integration.

Both single-point sales taxes and turnover taxes affect the competitive position of the countries that levy them, as it is difficult to get exact remission of the taxes on exports. Very few countries now contemplate introducing turnover taxes or single-point taxes.

The VAT

With the introduction of the VAT in the 1960s (it was initially implemented in France—for a history of the VAT, see Tanzi, Chapter 2), most developed countries have abandoned the turnover tax and replaced it by the VAT, which zero-rates exports, does not tax investment in the formulation used by most countries, and does not undermine competitiveness. The VAT is a buoyant source of revenues. The VAT has now been adopted by more than 130 countries and raises about a quarter of the total tax revenue on average in those countries. Both developed and developing countries have moved to the VAT (see Chapter 3 by Bird, on international experience, and Boadway, Chapter 4, on the Canadian experience).

The VAT has also become a prerequisite for joining the European Union, where it is governed by the council Directives that ensure uniformity of
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standards applied to VAT design in different EU countries while allowing for some degree of flexibility across member states. The first two VAT Directives adopted in 1967 laid down the general structure of the VAT system but left the determination of coverage of the VAT and the rate structure to the member countries. Later in 1977 the Sixth Directive established uniform VAT coverage across EU member states, although it still allows for many possible exceptions and derogations (for example, zero rates in the United Kingdom and Ireland for basic food products, housing, and children’s clothing). Moreover, it allows for different standard VAT rates to be applied by the member countries. Currently, the standard rate ranges from a minimum of 15 and maximum of 25 percent. Member states can also apply one or two reduced rates of at least 5 percent (see also Waerzeggers, Chapter 5).

C SUMMARY OF THE CHAPTERS

Ahmad (Chapter 1)—makes the case for the VAT in conjunction with excises, in the GCC, drawing on the recommendations of the GCC taskforces, led by Dubai customs.

There has been agreement in various task forces on the need to start with a common rate and base in all GCC countries—this will considerably simplify the administration of a VAT without customs borders across member countries. For political economy purposes, it is proposed to start with a low rate, especially since there is no overwhelming revenue need at the present time. For instance, the task forces recommend a rate of 5 percent or lower, to largely replace the 5 percent import duty under the CET with an implementation date by 2012. Further, a broad range of agreements by GCC tax administrations on harmonizing tax procedures, adopting a single Tax Identifier Number system, leading to a unique number for each taxpayer in the GCC, will simplify the exchange of information and also significantly improve on the situation with the administration of the VAT in the EU.

The task forces also recommend the introduction of a harmonized law, drawing from a GCC “Directive” on the VAT—paralleling the EU procedure. However, unlike in the EU, the GCC Directive would also contain measures for the harmonization of administrative considerations. This, together with no zero-rating inter-GCC transactions, should also help prevent the “missing trader or carousel” fraud that has become a problem for the EU countries (the latter issue is also discussed further in the paper by Waerzeggers (Chapter 5).

While the recommendations of the GCC task forces were based on
theory and international experience, modified to meet the special circumstances and considerations in the GCC countries, Ministers asked for more specific details on the empirical effects of the setting of the threshold—which affects the number of registered VAT taxpayers and the burdens on the administration—the effects on prices and distribution in the GCC context, and further details on the treatment of the financial sector as well as the social sectors, including health and education.

Vito Tanzi (in Chapter 2) provides a brief yet thorough exploration of the VAT and its applicability to the GCC. He begins with a detailed explanation of the origin of the VAT and the history of its adoption in Europe, setting the stage for a comparison with the GCC given that the adoption of the VAT in the European experience came at a time when they were creating a common market. Tanzi then moves on to a characterization of the economies of the member states of the GCC before moving on to a thorough discussion of the role and applicability of the VAT.

Richard Bird (Chapter 3) reviews experiences with the VAT in various countries. He argues that evidence suggests that lower levels of government that exercise heavy expenditure responsibilities are more likely to do so sensibly if they are also responsible for raising a significant amount of their own revenues, particularly at the margin, thus making multi-level VAT a particularly attractive choice in such cases. While it was previously thought that a central VAT is the most optimal choice, however, several experiences have shown that extensive subnational VATs are equally successful, particularly as the Canadian experience shows, among some others.

Robin Boadway (Chapter 4) takes the issue of multiple jurisdictions further in an analytical approach using the Canadian experience. Canada is interesting as different arrangements apply in different parts of the country—and thus is a laboratory for multi-level countries, or economic unions, considering the imposition of a VAT. For Boadway the absence of border controls, which can be characteristic of economic unions as well as federations, paves the way for difficult collection and compliance, and presents the opportunity for tax evasion schemes to rise. Drawing from the Canadian experience, the author outlines the alternative ways in which the VAT can be successfully administered, paying special attention to two mechanisms: the Quebec Sales Tax and the Harmonized Sales Tax. For Boadway the successful administration of the VAT has several prerequisites including the formation of a common tax-collecting agency, a system with a common VAT rate across all jurisdictions, a clearing house mechanism to allocate revenues, and the existence of a revenue equalization system, among many others. The Canadian experience is one that has strong parallels to that of the GCC where multiple jurisdictions exist.
Waerzeggers (Chapter 5) outlines the EU experience with the VAT. As mentioned above, the VAT is a prerequisite for joining the EU—and there are standard tax policy measures that apply across all countries. The multiple effective rates, and lack of standardized operational measures, together with zero-rating of transactions across jurisdictions, open the way to considerable complexity as well as outright fraud. Other issues that cause difficulty are exemptions for social and financial services—although that was the way that the earlier VAT systems were set up. More modern VAT systems, such as in Australia and South Africa, have revisited the issue of exemptions (equivalent to input taxation, and recognized as such in the Australian legislation), and try to minimize input-taxed sectors. Paradoxically, this is seen to reduce inefficiencies as well as improving distributional outcomes—these issues are examined in Part II of the volume. Given that inertia sets in once policies and institutions are established, as seen in the EU, Waerzeggers argues that it is important to “get it right” from the outset, including both policy design as well as administrative harmonization and exchange of standardized information.

In Chapter 6, which deals with the countries that will form the Central American common market, Carlos Silvani provides a thorough overview of the VAT implementation with particular emphasis on the mix between policy considerations and tax administration and customs issues. For Silvani the rapid integration process among the members of the Central American Customs Union (UAC) is one that requires the harmonization of domestic taxes—particularly the rate structure and base of the VAT—and is strongly in favor of a single common rate. After a discussion of the VAT base, its rate, the treatment of investment, and special schemes for small taxpayers in each country, Silvani then proposes alternatives for taxing cross-border sales in a common market without internal customs. He then goes on to outline the basic requirements for the successful administration of VAT whereby he argues that this requires that the member states take on various initiatives to enforce the VAT in such areas as registration, audit, and control of VAT refunds as well as measures to prevent non-compliance. Thus, Silvani provides a general framework for the successful introduction of the VAT, drawing from the experience of Central American countries—an experience that can provide useful guidance for the GCC. Silvani’s sensible recommendations are also useful for individual countries in the GCC envisaging the introduction of a VAT.

The introduction of a VAT or any other new tax inevitably involves political economy considerations that affect its design and implementation. The latest introduction of a VAT in a large country was in Australia,
where the individual states agreed to a federally administered VAT on their behalf, superseding several local taxes. Yet, the political-economy agreement was not possible without an accommodation on the design of transfers that led to the VAT revenues being redistributed to the constituent jurisdictions using a transparent and agreed equalization formula. This may be relevant for the policy discussion in the UAE. However, for the GCC, this would only apply if there is a single tax administration—which is an unlikely event, as discussed in Chapter 1. In Chapter 7, Bob Searle uses the Australian experience with the operations of the equalization grants system, and how this was used to facilitate the agreement that the VAT should be administered by the central government. He then explains how an equalization grants system might be established, various formulations, and data requirements, as well as possible administrative modalities.

Part II of the volume focuses on key issues of relevance to the GCC in designing and implementing a VAT. Additional data from the UAE and Dubai permitted addressing key issues of interest to GCC policy-makers. These relate to the design of the VAT and the setting of the threshold, determining the number of taxpayers and the size of the administration (see Ahmad and Brosio, Chapter 8). This also permits the evaluation of distributional considerations and the treatment of the social sectors under a VAT—undertaken by Ahmad and Brosio in Chapter 9. A special issue of concern to policy-makers is the VAT treatment of the financial sector—a critical issue given the predominant role of this sector. It may be important in this case also to avoid the difficulties seen in the EU with the blanket exemption for the sector, as this has created distortions that are hard to remove. This issue is addressed by Poddar and Kalita in Chapter 10. A final chapter by Ahmad focuses on UAE-related issues, particularly the issue of who should administer the VAT, given the federal structure in the UAE.

In Chapter 8, Ahmad and Brosio explore the policy challenges of setting a compulsory threshold for the registration of VAT taxpayers. They outline the theoretical arguments against a high threshold—which involve distortions that might constrain expanding output and incentives to subdivide firms to avoid registration. These should be juxtaposed against the argument that the high threshold assists with tax administration, but limiting the workload associated with a myriad of small taxpayers that generate little revenues. While some countries, especially in Europe, are moving towards lowering, or abolishing the registration threshold, others such as Singapore are moving in the opposite direction. The highest threshold is that of Singapore, which has been increased to S$1 million (US$700 000). The proposal by the GCC working group to implement a threshold of US$1 million was examined by Ahmad and Brosio, using production data
for Dubai. It turns out that this threshold would include only 45 percent of the potential taxpayers, but 96 percent of the turnover. There is little justification to have a lower threshold in Dubai. If the Dubai pattern holds in other parts of the GCC, the proposal for a $1 million threshold is quite justified. The paper does not address the issue of whether or not different thresholds could be implemented in different countries—but in practice this should be possible.

In Chapter 9, Ahmad and Brosio use household income and expenditure data for 2007–08 from UAE—broken down by Abu Dhabi, Dubai, and the Northern Emirates, to examine the effects of the VAT on households in different circumstances. After carrying out various simulations they conclude that the VAT would not worsen inequality, whether it is introduced as an additional tax with the existing tariffs maintained, or largely as a replacement for customs duties lost as a result of the FTAs. Indeed, in the latter case, the rich bear a higher proportion of the VAT burden than the poor. In all cases, much of the VAT collected is paid for by the two highest deciles. There is a marginal impact on the poorest. However, these groups could easily be compensated fully by a relatively modest transfer amounting to less than 5 percent of the total VAT collection.

The exemption of health and education does not have an impact on the poor—they have a very small consumption of paid services, as they benefit from free public provision. The rich consume privately provided education and health care. Thus, taxing the social sectors may be progressive—as the public schools would receive refunds for VAT on inputs, permitting them to improve services or provide more benefits. However, private schools would be taxed, and the incidence would be on the rich. But, the high threshold would effectively exempt most of the social sector establishments—including the public schools.

Poddar and Kalita, in Chapter 10, consider the implications of a VAT system on financial services in the UAE. The authors explore the challenges associated with applying a VAT to financial services given the difficulty associated with measuring the value of financial services. This led the earlier VAT systems, such as in the EU, to exempt these services, but at the cost of creating distortions. This issue is one of particular importance and should be addressed at an early stage in order to ensure that financial services in the UAE maintain their competitive position, minimize tax base erosion, and that the VAT remains as “simple” to apply as possible. The authors then move on to a survey of international experience in the application of the VAT to financial services, exploring the different options that the UAE could consider in the design of the VAT system including explicit fees, and interest margins, among many others. A menu is presented that would need to be examined together with industry representatives in
preparing the treatment of financial services under the GCC/UAE legislation to follow.

Chapter 11 by Ahmad addresses the issue of how the VAT might be designed and administered in the UAE—the only federal country in the GCC. While it is possible to opt for separate administrations in each of the emirates, this would replicate all the complexity of managing the GCC VAT without borders within the UAE. Indeed, since much of the VAT would be generated in Abu Dhabi and Dubai, the other emirates may have little incentive to effectively implement a VAT—and could pose difficulties with refunds paid for by other emirates, or indeed, other GCC countries.

The chapter makes a strong case for a federal administration of the VAT in the UAE, but also argues for a simultaneous decision on the revenue-sharing mechanisms as part of a “package”. In this respect, the chapter complements the earlier discussion by Searle, in stressing the need for a transfer system. This is needed to ensure that all emirates have a stake in the VAT, along with the federal government. The VAT, together with the transfer system, would help in the political economy of creating a strong federation.

REFERENCES

