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Tax Policy Reforms in the GCC Countries: Now and How?

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EXECUTIVE SUMMARY[1]

GCC countries need to overhaul their tax systems and increase tax revenues. This is an important part of implementing a comprehensive medium term fiscal adjustment strategy, which should include three other main elements: raising domestic energy prices; containing recurrent spending, particularly wages; and enhancing the efficiency of public sector investment.

Tax reform in the GCC should introduce modern and efficient tax systems to the region. Existing tax systems are characterized by very low rates and narrow bases. Dating back to the mid-20th century, GCC taxation systems are not very efficient and generate persistently low revenues. Tax reforms will help mobilize tax revenues, provide the region with the opportunity to modernize tax laws and institutions, and create the foundations for financing the provision of government services when oil reserves dwindle. In addition to encouraging greater accountability, these systems will help promote equity and perceptions of fairness, while aligning GCC countries with international practices.

GCC countries should choose a combination of modern efficient tax instruments. These could be based on a low rate broad-based VAT tax together with selected excises, a business profits tax, and possibly a recurrent property tax. The combination of these taxes can ensure efficient and progressive tax systems in the region. Taxes should be at low rates with limited exemptions, with the aim of collecting revenues in line with country budget needs and constraints.

The VAT is an ideal revenue instrument for the GCC countries. It is a modern consumption tax that is highly effective in mobilizing tax revenue while avoiding economic distortions. Countries should move ahead with announcing the broad principles of the GCC VAT framework as soon as possible. International experience suggests that it will take 18–24 months from the time that a decision is made to implementation.

Tax reforms need to start as early as possible, preceded by careful coordination, planning, and communication. The budgetary impact of the low oil prices is immediate, while building the required modern tax institutions takes time. While coordination and harmonization across GCC governments would be beneficial, reforms should not wait for the last-mover. Individual countries can develop and implement tax reform as soon as they are ready politically and administratively. Early moves by some countries could provide a useful demonstration effect to other countries. Tax reforms need to be supported by a communication strategy to muster support for the reforms and overcome skepticism about the usefulness of modern taxation systems in oil-rich countries.

[1] Prepared by Ali Alreshan, Nabil Ben Ltaifa, Tim Callen (all MCD) and Mario Mansour (FAD). Research support was provided by Ben Piven and editorial support By Diana Kargbo-Sical

A. Introduction

1. GCC governments remain reliant on oil revenues to finance their expenditures. Oil revenues accounted for between 70 and 95 percent of total government revenues during 2011–14 across the six countries. The large decline in oil prices has led to deteriorating fiscal balances and fiscal adjustment is needed. Under current policies, the fiscal deficit for GCC countries is projected at almost 13 percent of GDP in 2015, and to remain in deficit of 6.5 percent of GDP in 2020.

2. In this light, it is important that the GCC countries overhaul their tax systems and increase the revenues collected from the non-oil sectors of the economy. Non-oil tax revenues averaged about 1.6 percent of GDP (about 3 percent of non-oil GDP) in 2012–14. Raising this revenue effort through the introduction of efficient taxes that do not distort economic incentives or adversely affect investment and growth is part of the needed fiscal reform strategy. The recent discussions on the GCC VAT framework are encouraging in this regard.

3. This paper discusses the main possible elements of a reformed tax system in the GCC, with a particular focus on the VAT. The paper is organized as follows. Section B provides an overview of the current tax systems in the GCC. Section C is divided into three subsections. The first reviews the main arguments in favor of modernizing the tax system, the second discusses the main potential elements of a tax system in the GCC, and the third looks in greater detail at a VAT taxation, including its main distinguishing features as well as its potential application in the GCC countries. Section D concludes with some policy recommendations.

B. The Current Structure of Tax Systems in the GCC

4. The development of tax systems in the GCC has been largely shaped by the role that oil exports and revenues have played in financing government budgets. While first attempts to raise tax revenues date back to the mid-twentieth century, increasing oil revenues—albeit with considerable volatility—led governments to modulate their tax policies in favor of promoting direct investment and attracting expatriate labor to support rapid growth in public/private sector investment and broader economic activity. Consequently, the development of domestic tax policies has been held back.

5. Efforts to introduce taxes in the region go back to the 1950s. Saudi Arabia introduced personal income, capital gains, and corporate taxes in 1950 on both nationals and non-nationals. Within six months of introduction, however, the tax law was reformed to exclude nationals and in 1975, income taxes on foreigners were suspended due to high oil revenues and the need to recruit expatriates to help build infrastructure and develop the economy. Kuwait introduced a corporate tax in 1955, and then other GCC countries followed suit. UAE introduced taxes in the mid-1960s and Oman in the early 1970s. Corporate taxes in the GCC were reduced substantially during the first decade of this century to promote foreign direct investment (FDI). Most countries established free zones and introduced tax holidays, thus further reducing effective tax rates on foreign corporations.

6. One of the main characteristics of tax systems in the GCC is that there is no personal income tax (Annex I provides an overview of existing tax systems in the GCC)**.** There are no wage income taxes for either nationals or non-nationals. Three countries—Oman, Qatar and Saudi Arabia—have very limited income taxes on non-nationals that carry out business or professional activities. National individuals and companies are subject to Zakat, which is levied at 2.5 percent of net worth.[2] However, the collection of Zakat is not fully enforced in all GCC countries. There are no property taxes in most of the GCC. Saudi Arabia imposes 2.5 percent Zakat on real estate if held for speculative purposes.

7. GCC countries distinguish between corporate taxes on oil and non-oil companies. The tax on companies engaged in petroleum and natural gas extraction ranges from 15 percent in Kuwait to 85 percent in Saudi Arabia and UAE (irrespective of nationality). On the other hand, with the exception of Oman, non-oil corporate taxes apply only to foreign companies and range up to 55 percent in UAE. Oman imposes a 12 percent flat tax rate on national and foreign-owned companies. However, within the parameters of the tax system, enforcement varies across sectors and countries.

8. Tax relief for losses and tax incentives are provided to foreign companies. In Saudi Arabia, companies subject to tax can carry losses forward indefinitely, while it ranges from 3 years in Kuwait and Qatar to 5 years in Oman. Bahrain and UAE do not have any rules governing this issue. In addition, the GCC countries provide incentives to encourage foreign investment. Free zones in UAE and Kuwait permit 100 percent foreign ownership and grant specific tax exemptions ranging from 15 to 50 years in UAE. Kuwait also provides a five-year tax holiday to non-Kuwaiti founders and shareholders of leasing and investment companies and up to ten years for qualifying projects. Oman grants a five-year tax holiday to companies carrying out certain specific activities.

9. Customs duties are unified among the GCC. After implementation of the new Common External Tariff (CET) on January 1, 2003, all non-GCC products, except for those exempted, are subject to 5 percent customs duty. Products of the GCC countries enter into each other's markets free of customs duties.[3] However, there are many items such as medicines, most food products, and capital goods and raw materials for industries which are exempt from duty.

10. Tourism, entertainment, rental property, and consumption taxes are present in a number of GCC countries. Bahrain, Oman, and UAE impose municipal/consumption taxes ranging from 3 to 10 percent on property rents, hotel income and entertainment, and some government services. In addition, Bahrain imposes a 5 percent levy on tourism and a 12 percent sales tax on gasoline, while Oman imposes a 2 percent consumption tax on electricity. The GCC countries also

[2] Zakat is an obligatory contribution of a certain portion of one's wealth (2.5 percent) in support of the poor or needy or other charitable purposes.

[3] Products are considered as originating in a GCC country if the value added to such product in the said country is more than 40 percent of the value of the product in question and if the factory that manufactured the product is at least 51 percent owned by GCC nationals.

collect different fees and stamp duties on government services—such as for the issuance of passports, commercial registrations, or driver licenses—and these vary from one country to another and yield little revenues.[4]

11. Taxes and fees to support national labor and provide on the job training are implemented in the GCC. Bahrain and Saudi Arabia impose monthly fees on foreign workers to finance training for nationals. Oman has a similar scheme, but determines the fee as a percent of the foreign worker wage bill. UAE imposes biannual work permit fees, while Kuwait imposes a 2.5 percent tax rate on the annual net profits of Kuwaiti companies listed on the stock market to fund training. Qatar is the only country that does not impose fees or taxes on wages.

12. Social security taxes are mandatory in all GCC countries. Employers and employees must pay the social insurance tax on the basic salary, including housing allowances and certain commissions. The contributions are shared equally between the employers and employees in Saudi Arabia, and in other countries, the employers pay a higher share. These taxes are only required for nationals. In addition, Bahrain, Oman, and Saudi Arabia require insurance against employment injuries and hazards for both nationals and non-nationals. Furthermore, Bahrain, and more recently Saudi Arabia, introduced a levy on the salaries of nationals in the private sector to provide unemployment compensation at the rates of 1 percent and 2 percent, respectivlely.

13. In sum, the various income and transaction taxes that exist in GCC countries on non-oil activities are all characterized by very low rates and narrow bases and consequently raise little revenue (Tables 1 and 2 below; and Annex 1, Table 1 with a detailed breakdown by country). Governments are therefore very reliant on revenues from hydrocarbon exports and from investment income on government assets. While hydrocarbon revenues increased sharply as a share of GDP from the early 2000s until last year, non-oil revenue hovered around 9 percent of GDP (18 percent of non-oil GDP) in 2012–14. The share of tax revenue to GDP averaged about 1.6 percent (3 percent of non-oil GDP) for the GCC countries during this period. There is, however, significant variation among countries. Oman has the highest non-oil tax-to-GDP ratio at 2.7 percent and Kuwait the lowest at about 0.8 percent of GDP.

[4] Stamp duties/registration fees on transfer of land and property are in effect in Bahrain, Oman and UAE, and range from 1.5 to 4 percent of the property value, depending on the country. Detailed data on fees and charges is not available to staff for the other GCC countries.

Table 1. GCC Countries: Revenue Structure (2012–14)

	2012	2013	2014	2012-14
	In percent of GDP			
Total Revenue	48.9	47.6	44.0	46.8
Non-Oil Revenue 1/	8.6	9.6	9.9	9.4
o/w Tax Revenue	1.6	1.5	1.7	1.6
Oil Revenue	40.3	38.0	34.1	37.5
	In percent of non-oil GDP			
Total Revenue	106.1	96.8	83.2	95.3
Non-Oil Revenue 1/	17.9	18.8	18.2	18.3
o/w Tax Revenue	3.3	2.9	3.0	3.1
Oil Revenue	88.2	77.9	65.0	77.0
	In percent of total revenue			
Non-Oil Revenue 1/	17.5	20.2	22.5	20.1
o/w Tax Revenue	3.3	3.2	3.8	3.4
Oil Revenue	82.4	79.8	77.5	79.9

1/ includes investment income

Table 2. GCC Countries: Breakdown of Tax Revenue (In percent of GDP)

	Total	Income	Goods & Services	Corporate	Trade	Property	Other
Bahrain	0.6	...	...	...	0.6	0.3	-0.3
Kuwait	0.8	...	...	...	0.6	0.03	0.2
Oman	2.8	...	...	1.4	0.7	...	0.6
Qatar	1.7	...	...	1.3	0.4	...	0.0
Saudi Arabia	1.4	...	...	0.0	0.9	...	0.5
UAE	2.5	...	...	1.0	0.7	...	0.7

Source: IMF estimates

Note: Latest data is for 2014 where available; Qatar total revenue is for 2013; Kuwait trade tax data is for 2012; Bahrain and Kuwait property tax data are for 2004 and 2012, respectively; Other taxes calculated as residual

C. Tax Reforms in the GCC – What is Needed and Why?[5]

Why is tax reform needed in the GCC?

14. Existing tax systems in the GCC countries are limited and do not meet rising budget financing needs in the context of a potentially prolonged period of low oil prices. Against this backdrop, should GCC governments consider a greater role for standard tax instruments, such as

[5] Parts of this sub-section draws from Mansour (2015).

income and consumption taxes, or forms of wealth taxes, such as a recurrent property tax?[6] The answer is yes, and based mostly on the argument of revenue diversification. In fact, given the volatility of oil prices (and hence oil revenues) and the fact that oil wealth is exhaustible, GCC governments cannot indefinitely rely on oil resources to finance their budgets in a sustainable manner, although revenue needs will differ accross countries in the short-to-medium term. In addition, there are other arguments in favor of developing modern tax systems that are discussed below.

15. First, a modern tax system can replace existing taxes in GCC countries and provide an opportunity to build institutions and capacity to enforce it. Broad-based income taxes (on individuals and corporations) and consumption taxes are the main component of tax systems in virtually all economies around the world. As noted earlier, most GCC countries have various forms of taxes that yield little revenue due to low rates, narrow bases, and in some cases, low administration/compliance. Therefore, a modern tax, be it on consumption, income, or wealth, will likely yield more revenue at a lower administrative cost than current systems. But to succeed, it must be supported by a modern tax administration. Experience shows that it takes time to build tax administrations or revenue agencies, and to develop a self-compliance tax culture.[7]

16. Second, reform of taxation will help mobilize tax revenues to the budget. GCC markets are characterized by regulations that create, in certain sectors, significant economic rent for local businesses. Competition in the provision of goods and services for local consumption and (to a lesser extent) production is limited in most GCC countries. Such barriers to entry confer extra profits to local enterprises that would not exist otherwise. It is therefore efficient economically to tax such profits since investors are unlikely to change their behavior as a result of the tax – i.e. the tax will cause a reduction in their profits, with little or no impact on real investment, employment, and prices.

17. Third, tax reform will improve equity and perceptions of fairness. Those who benefit most from government services today should pay a tax to finance the budget which would then leave more oil revenue for future generations, thus enhancing inter-generational equity. In particular, a tax on business profits generalized to include domestic as well as foreign enterprises will be perceived as equitable by foreign investors and will provide some progressivity in taxation.

18. Fourth, taxation will move GCC countries' in line with international practices without impacting foreign direct investment. This is particularly the case for a tax on profits that is applied to all businesses and not only foreign companies. This issue is increasingly relevant in the light of ongoing G20 work on base erosion and profits shifting (BEPS), and the pressure on countries with no taxes to introduce some minimum level of profits taxation. Moreover, since most countries

[6] We do not consider here trade taxes as a viable and appropriate revenue instrument tool given their distortive effects on trade, and domestic production and consumption. The level of trade taxes in the GCC, at about 1 percent of GDP, is today comparable to other MENA countries and non-MENA transition economies.

[7] Besley and Persson (2011) refer to this as *fiscal-capacity investments*.

around the world provide a foreign tax credit or an exemption in relation to profits earned in a foreign jurisdiction, a profit tax in the GCC at a low rate will not change the worldwide effective tax rates of foreign companies, and hence is unlikely to have any real impact on foreign direct investment in GCC countries.

19. Fifth, taxes establish a link between governments and citizens that encourages accountability in fiscal management and helps state building.[8] Although by definition taxes are compulsory payments for which individuals and companies should not expect a direct benefit, the transparency and accountability of fiscal management is likely to be superior when spending is partially financed from taxes on individuals and companies (as in reality, the public's expectations of government service levels rise with their increased tax contributions). Moreover, budget financing from taxes is likely to lead to higher government accountability, thus limiting the size of government spending relative to financing from oil revenue. However, different taxes provide unequal incentives for governments in terms of accountability vis-à-vis their citizens. A VAT or a personal income tax, even at low rates, are superior to a corporate income tax or trade taxes because they are visible and paid directly by individuals—even though the price impact of a VAT might be equivalent to that of a customs duty. Property taxes have a similar effect, especially when they serve as financing sources for local public services.

Main Elements of a Tax System in the GCC

20. While the reasons for introducing modern taxes in the GCC may be common to all countries, the architecture and timing of tax introduction may differ. It is likely that both the design of the tax system and the level of taxation across the region would vary depending on local needs and constraints. For example, in Oman and Bahrain, oil reserves are expected to be exhausted sooner than in the other countries and the need for alternate revenue sources is more pressing. The UAE is a federation where tax policy at the national level must attend to emirates' varying needs of revenue, which call for some forms of revenue sharing among emirates, either through an explicit assignment of taxation powers or through transfers.

21. Despite differences in local needs and constraints, taxes in GCC countries should start at low rates. This is because this allows for the design of simple and broad based taxes which are easier to administer for nascent modern tax administrations. Moreover, taxes, whatever their form, at low rates and broad bases, will have little or no efficiency costs and not stand in the way of efforts to diversify the economy.

22. Among the panoply of available modern tax instruments, GCC countries could consider a mix of the following taxes for implementation in the near future: a broad base consumption tax, with selected excises; a tax on business profits of both incorporated and

[8] On the relationship between taxation and state building, see for example Bräutigam, Fjeldstad, and Moore (2008).

unincorporated enterprises; and recurrent property taxes.[9] Given the structure of employment in the GCC with the large majority of nationals working in the public sector, a tax on wage income is lower down the priority list at this stage both because public employment minimizes the need for the redistributive role of personal income taxes and because it may prove hard for governments not to increase public sector wages to offset the taxes paid. In this regard, detailed impact studies would need to be undertaken as part of the design process to ensure policymakers are aware of how businesses in particular will be impacted by the reforms.

23. The VAT is an ideal revenue instrument for the GCC. If designed well, the VAT could generate as much as 1.5 to 2 percent of GDP (or about 2.5 to 3.5 percent of non-oil GDP) in revenue in the GCC even with relatively low rates. This would add significantly to what the region currently generates in non-oil tax revenue. In addition, the VAT is relatively simple to administer and will have no impact on foreign direct investment into the region or exports from the region. The IMF has provided technical assistance for the design of a VAT in the region, both regionally and to national governments since the late 1990s. A VAT for the GCC is discussed in detail in the next section.

24. GCC countries can also consider an expansion of selective excise taxes to raise revenues and address other policy objectives. Excises are already used in GCC countries. Examples of where other excises could be introduced include recreational vehicles such as cars and boats, tobacco, alcoholic and non-alcoholic beverages, telecommunication services, hotels, and energy products.[10] However, the presence of a VAT lessens the need to introduce a large number of excises, and it would be important to avoid the trend seen in recent years of more excises and narrower VAT bases.

25. Taxation of business profits could be made more effective in all GCC countries by extending current corporate taxes to all entities earning business profits. Current practices are discriminatory, ineffective, and inconsistent with a policy of encouraging FDI. A business profits tax on the net profits of all companies and individuals (above an exempt threshold) earning business income in a country would improve neutrality and equity in the taxation of profits and would raise additional revenues even if set at a low rate to preserve the competitiveness of the tax system. This would ensure that businesses that benefit from government services pay a contribution toward their provision. However, the law would have to be structured carefully in order to prevent businesses from converting taxable profits into wages.

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[9] Staff estimates for the 2015 Article IV consultations with Qatar and UAE estimated yields for such taxes. In Qatar, yields to the budget from CIT and VAT were estimated at 2 percent and 1.5 percent of non-hydrocarbon GDP, respectively; and for UAE, they were estimated at 4.1 percent and 2.7 percent of non-hydrocarbon GDP. A 15 percent excise on automobiles in the UAE was estimated to raise 0.6 percent of non-hydrocarbon GDP.

[10] Needless to say that given the political economy of energy pricing in the region, the medium-term objectives should be to bring energy prices to consumers, and especially to businesses, closer to pre-tax international prices (see accompanying paper on *Energy Price Reforms in the GCC*.)

26. One tax that has regained popularity in recent years and could be relevant to the GCC countries is the recurrent property tax. Despite its low revenue yield (typically below 1 percent of GDP), the recurrent property tax has become attractive (in developing countries) thanks primarily to its political economy and administrative capacity considerations. One reason for this is its potentially large base and the fact that it is amongst the most efficient tax instruments, due to its physical location – i.e. a condo in Dubai cannot be relocated to Abu-Dhabi. Both of these elements are very relevant to GCC countries, and the tax could be designed either nationally or locally. Rates could, for example, vary by municipality within a country and, if desired and appropriate, revenues could be kept by local governments to finance service provision instead of accruing to the central government.[11] Property tax could be also extended to vacant land as is currently being considered in Saudi Arabia. However, this type of tax does require an effective system of land and property registration which is not always present in the GCC countries.

27. These tax reforms would help fill gaps in the current tax structure, contribute to higher revenue collection from the non-hydrocarbon sectors, and allow the removal of some existing taxes and fees. The combination of a tax on business profits (with an exemption threshold for individuals) and a consumption tax such as the VAT would reduce the need to introduce personal income taxes. A VAT is equivalent to an income tax in the absence of savings and inheritance, which is usually the case for most low and middle-income individuals, and lessens the need to introduce income taxes on individuals, both citizens and expatriates. Combined with a business profits tax, the two would also act for most individuals as a progressive tax on income: for those earning wage income (and having a low savings rate), the VAT is the only tax paid; for those earning business income, the business profits tax is paid in addition to the VAT on income spent. The introduction of a VAT could eliminate the need for having the common external tariff (CET). At the same rate, a VAT would yield revenue at least equal to the CET revenue yield on imported goods—since domestic value added would also be taxed under the VAT. However, the revenue strength of the VAT, relative to the tariff, would come primarily from taxing services. Tax reform would also provide an opportunity to simplify the current system of fees and stamp duties which is complex in many GCC countries and yields little revenues.

Introduction of a VAT in the GCC

28. Full details of the agreement reached on the VAT at the GCC Ministers meeting in May 2015 have not been released or made available to IMF staff. The UAE's Ministry of Finance, however, announced in early July that progress has been made in drafting the UAE VAT law,

[11] In fact, property taxes yield most revenues in the context of federations, such as Canada, the US, and Australia, where such taxes are the exclusive domain of municipalities. For more detail, see the *IMF Fiscal Monitor* (October 2013).

including adopting the draft common VAT law framework agreed with the GCC countries. It has been reported that the following principles have been agreed for the GCC framework:[12]

- Each GCC country will have its own VAT law. This will be guided by common rules on VAT across the GCC, still under negotiation.
- The agreement is to implement the VAT simultaneously in all countries. However, no timetable for VAT implementation has been agreed yet.
- The initial VAT rate could be 5 percent or less. Negotiations are continuing to reach an agreement on the VAT rate and common exemptions.

International experiences in implementing a VAT

29. The VAT is a modern consumption tax that has proven highly effective in mobilizing tax revenue and avoiding the distortions to production and trade associated with the cascading of indirect taxes. The VAT is paid on a net basis on the difference between sales and purchases (of inputs) and there should be no break in the VAT chain (including through exemptions) to avoid tax cascading. Another important feature of VAT implementation is the destination principle which means that goods and services are taxed for VAT only in the jurisdiction where they are consumed. The VAT is a feature of tax systems in over 150 countries.

30. Ease of administration and ability to generate revenue are the main criteria that should guide VAT design. The success of the VAT is partly premised on having in place a modern and efficient VAT administration largely based on the principles of self-assessment of taxes by tax-payers and an effective monitoring of tax compliance, including through strong coordination among relevant tax administrations. A simple design of the VAT helps reduce the compliance burden on tax-payers and minimizes the risks of low compliance and/or tax corruption. Based on international experience, decisions about four broad and interrelated factors are important to the success of the VAT. These are the rate and structure, the base, registration thresholds, and exemptions.

The VAT rate and structure

31. VAT rates and structures vary substantially across countries. They tend to be generally more complex in countries with a legacy of high dependence on indirect taxes and lower in those countries that adopted VAT more recently to replace revenue losses from trade liberalization. Lower VAT rates (3–5 percent) are found in the Asia/pacific region (e.g., Japan, Singapore, Taiwan), while higher rates (20–25 percent) are generally found in Western Europe (e.g., Denmark, Norway, and

[12] An old draft version of the GCC VAT framework agreed in June 2011 set the VAT rate at 5 percent while maintaining the CET in place. It also provided for certain exceptions to specific sectors and/or goods and services. These included allowing specific sectoral thresholds and zero rating of supplies in health and education, a common compulsory list of exempted services in the financial sector, differentiated treatment relative to usage for gold and in real estate sector, and zero rating of oil and gas sectors.

Sweden). In the MENA region, rates are generally higher in the Maghreb (14 percent in Mauritania, 20 percent in Morocco) and lower in the Mashreq and non-GCC oil exporters (5 percent in Yemen, 6 percent in Iran). The Maghreb and Europe regions have generally more complex rate structures with multiple rates. Countries have generally started with low VAT rates and raised them over time as the need for more revenue is felt and after both the tax administration and tax-payers gain experience with implementation.

32. Efficiency and equity considerations have influenced the choice of the VAT rate and structure. However, while there appears to be limited evidence of a positive relation between rate differentiation and revenue raised, there is stronger support for a single VAT rate.[13] This is due mainly to concerns that multiple rates tend to be associated with high administrative complexities and generate little in the way of distributional gains. Furthermore, higher complexity increases the compliance burden on tax-payers and risks tax evasion and corruption.

33. The distributional gains from differentiated rates could be better achieved through other measures. These include the application of excises on certain goods and/or tax exemptions as well as targeted social spending financed from additional VAT revenue. Excises should, however, be limited to a relatively few goods with inelastic demand and applied as late as possible in the production/distribution chain to minimize their distributional and inefficiency impact on intermediate goods.[14]

The VAT base

34. Much support is found for a VAT system that is of the consumption-type, destination based, and implemented through the invoice-credit mechanism. Such a system requires that the VAT tax is charged on sales invoices (of registered tax-payers), a tax credit is allowed for VAT charged on inputs, and the VAT tax is applied to all imports while exports are zero-rated (i.e., no tax is charged on exports and VAT paid on inputs is refunded).[15] Accordingly, the final base of the VAT tax is broadly all consumption spending and registered vendors can claim tax credits/refunds on VAT paid on purchases of inputs (and capital expenditures). Moreover, the VAT extends to all registered vendors (broad based) independently of the nature of their activity, and it is paid only on consumption within the territory of the taxing jurisdiction.

35. The same considerations of efficiency and equity that affect the choice of VAT rate and structure guide the definition of the VAT base and scope. In particular, decisions regarding the eligibility of small traders for VAT registration are largely dictated by administrative capacity and equity considerations (see below). In addition, the treatment of specific sectors—including, real

[13] See Ebrill, L. et al, (pp. 68–82),

[14] See Ebrill, L. et al, (pp. 15–24) for more discussion on basic design issues and details on methods of determining VAT liability.

[15] Exception to this rule would be exempted economic activities and taxes VAT tax paid by non-registered tax payers (see below for more detail).

estate, financial services, extractive industries, health, and education—for VAT purposes is guided by factors such as the nature of economic activity, ability to define the tax base, social considerations, whether the activity is performed by the government or the private sector, and regional integration objectives.

The VAT threshold

36. The choice of the VAT threshold is crucial for the successful introduction of VAT. The simple rule of thumb is that the largest 10 percent of tax payers account for about 90 percent of total tax payments; thus the strong recommendation to set a high VAT threshold, at least in the initial phase. Nevertheless, the resulting gains from the reduction in tax administration and compliance costs need to be carefully assessed against the competitive distortions stemming from the difference in treatment among tax-payers on the two sides of the VAT threshold. While these are deemed generally limited, countries have tended to address these distortions through a combination of two important adjustments—allowing voluntary registration for tax-payers below the VAT threshold, and/or the application of a presumptive tax on companies falling below the VAT threshold.

Exemptions

37. The standard advice is to limit exemptions to the extent possible to basic social services and hard to tax outputs such as financial services. Experience shows that support for granting exemptions begins to wane only after a few years of VAT implementation. From the outset, countries have a tendency to grant exemptions across different sectors on grounds of efficiency, equity, or difficulty in identifying the taxable base (for example financial services). These exemptions generally lead to increasingly adverse effects including: (i) distorting production decisions when granted for certain inputs; (ii) encouraging vertical integration to avoid tax payments on exempted inputs; (iii) compromising the destination principle in international trade; and (iv) encouraging exemption creep that undermines revenue collections. However, this detrimental impact to the revenue objectives of the VAT and resulting challenges to tax administration become clear only later in the implementation process.

Potential revenues from a VAT in the GCC

38. The potential revenue raised from a VAT will depend primarily on the main design parameters, namely the rate and structure, the base, and the threshold. It will be also affected by other defining elements including tax exemptions, efficiency of the tax administration, tax-payer compliance, and more generally the ease and transparency of administration. Cross-country analysis also shows that VAT revenue increases with (i) the standard of living and literacy rate—as measures of development and of administrative capacity of taxpayers and tax collectors; (ii) the share of international trade in the economy (mainly imports) because it is easier to collect taxes at the border; and (iii) the VAT age or number of years since its adoption as revenue collection improves with gain in experience and subsequent adjustments in design—such as raising the VAT rate, removal of exemptions, etc.

Table 3. Cross-Country Comparison of VAT Rates, VAT and Tax Revenues, and C-efficiency Ratios

	Consumption (percent of GDP)	Standard VAT rate	VAT Threshold (US$)	Tax Revenue (percent of GDP)	VAT Revenue (percent of GDP)	C-efficiency ratio
Oil Producing Countries						
Nigeria	82.8	5	-	7.3	0.1	0.02
Norway	62.8	25	8,192	30.8	7.8	0.50
Indonesia	67.6	10	65,966	11.9	3.7	0.55
Canada	76.8	5	26,951	25.6	3.9	1.02
Other Middle East Countries						
Algeria	59.1	17	1,420	31.8	3.5	0.35
Lebanon	103.2	10	33,167	14.0	4.6	0.45
Jordan	106.2	16	14,104	16.5	10.4	0.61
Other Comparator Countries						
Singapore	46.8	7	652,204	13.9	2.5	0.77
Japan	81.3	5	84,094	n.a.	2.8	0.69
New Zealand	75.5	15	28,478	28.3	9.7	0.86
Average	**76.2**	**11.5**		**20.0**	**4.9**	**0.58**

Source: IMF staff calculations

39. The additional revenue from a VAT is likely to be significant for most GCC countries. The potential revenue that could be raised from a VAT in the GCC countries is estimated by taking the average C-efficiency ratio for a selected sample of non-GCC countries and applying this to the product of the VAT rate and consumption (as a percent of GDP) (Table 3). The C-efficiency ratio is a measure of how effectively the VAT taxes the consumption base. The estimates suggest that the potential revenue from a 3 or 5 percent VAT ranges from 0.5–1.6 percent of GDP depending on the country and the chosen rate (Table 4, Panel 1).[16] The differences in estimates across countries are driven by differences in the shares of consumption in GDP. This revenue gain could possibly more than double the tax revenue-to-GDP ratio in Bahrain, Kuwait, and Saudi Arabia, while in Qatar the revenue gain is estimated to be lower. Moreover, the potential revenue that could be raised in each country will be obviously impacted by the respective country's administration efficiency as well as all the additional factors discussed above.

40. The net revenue gains from a VAT, however, will also depend on other tax decisions that are taken. For example, the net revenue gains would be limited for most GCC countries if the VAT tax replaces the existing CET unless a higher VAT rate is considered. However, It is worth noting that the gains from the introduction of the VAT go beyond revenue considerations to gains in improved tax administration and reduced corruption, with positive impact on higher tax compliance and accountability.

[16] Very similar revenue estimates could be generated through an alternative simplified calculation which applies the VAT rate to 90 percent of private consumption (as a percent of GDP)—assuming a 10 percent loss due to small business threshold and compliance gaps (Table 4, Panel 2).

Table 4. GCC Countries: Estimated VAT Revenue

		Using average C-efficiency ratio (0.58) of selected sample of countries with experience relevant to the GCC			Assuming the base = 90 percent of private consumption		
			Revenue at a VAT rate of			**Revenue at a VAT rate of**	
	Year	**Share of final consumption in GDP**	**3%**	**5%**	**Share of private consumption in GDP**	**3%**	**5%**
Bahrain	2014	56.6	*0.9*	*1.6*	41.0	1.1	1.8
Kuwait	2014	50.2	0.8	1.4	31.2	0.8	1.4
Oman	2014	51.6	0.9	1.4	24.8	0.7	1.1
Qatar	2014	29.6	0.5	0.8	15.1	*0.4*	*0.7*
Saudi Arabia	2014	58.9	1.0	1.6	32.5	0.9	1.5
UAE	2014	55.3	0.9	*1.5*	47.7	*1.3*	*2.1*

Source: IMF staff calculations

Consequences of a VAT for inflation

41. The first round impact of the VAT on inflation is expected to be limited. Because the VAT is levied on the value added—thus there is no cascading–its maximum direct effect on the price level should not exceed the tax rate.[17] Moreover, the zero-rating and/or exemption of certain groups of goods/services would reduce the inflationary impact. This is consistent with the findings of a 2011 simulation for Kuwait which estimated the inflationary impact of the introduction of a 5 percent VAT tax at the time not to exceed 4 percent.[18] While there may be some attempts by traders to use the introduction of the VAT to widen margins, and competition regulators will need to monitor market behavior carefully, cross country evidence shows that the introduction of the VAT generally has only a one-off effect on inflation.

Special considerations in a multi-jurisdictional context such as the GCC

42. The level of readiness of GCC member countries from a political, tax administration, and regulatory standpoint to introduce a VAT may differ. In this regard, important questions arise as to how long it may take from the time a decision is made to introduce a VAT to its actual implementation and whether all six countries should move simultaneously. Previous IMF advice on these issues suggests:

- Once a political agreement is reached, an additional period of 18 to 24 months should be allowed to enable countries to ready their institutional and regulatory infrastructure for the adoption of the VAT. This time is also needed for a communication campaign, including close

[17] The highest price impact would be equal to the tax rate for zero elastic (i.e. completely inelastic) demand.

[18] The simulation estimated under two scenarios the impact of a 5 percent VAT on prices. It found, assuming full pass-through, that the CPI-weighted average would increases by 3.6 or 3.9 percent, respectively depending on the coverage of exemptions.

consultation with main stakeholders, to increase the chances for a successful introduction of the VAT.

- While coordination and harmonization across the GCC on the introduction of the VAT would be beneficial, reforms should not wait for the last-mover. Individual countries can develop and implement reforms as soon as they are ready politically and administratively. However, individual country laws need to take the broad principles of the GCC VAT framework into consideration while designing their own tax policy. While it is possible that this approach could lead to some cross-border smuggling or movement of high value or very mobile purchases between countries, these issues do not seem likely to be significant at low tax rates. Further, there may be benefits of countries that are ready to introduce a VAT from moving earlier to provide a demonstration effect to other countries. The experience of the European common market is that different VAT rates and exemptions can exist across member countries.

- Common rules are needed for the treatment of intra-GCC trade. This is particularly the case for mobile services, which can freely move across borders within the GCC, and where physical border control is inapplicable. These rules will ensure that the place of supply is clearly defined in national laws, consistently across all GCC countries, and that only one country taxes the supply of a service—i.e. multiple taxation or no taxation is prevented. Examples of such rules include the treatment of financial services, leasing, medical services, internet services, etc. Other critical arrangements include how the VAT will operate at the first point of entry in the GCC in case fiscal borders are lifted.

D. Policy Recommendations and Conclusions

43. There is a need for a sustained fiscal consolidation in all GCC countries in the coming years, although the extent of this adjustment varies across countries. As discussed in the paper on *Economic Prospects and Policy Challenges for the GCC Countries*, this fiscal adjustment will need to be based around four elements: (i) raising domestic energy prices; (ii) firm control of current spending, particularly on public sector wage bills; (iii) improved efficiency of public sector investment; and (iv) increased collection of non-oil revenues.

44. GCC countries need to revive their strategies for reform of domestic taxation systems. Tax reforms can help put in place modern and efficient tax systems that will increase revenue collections from the non-oil economy while also enabling the streamlining or elimination of the inefficient fees and duties currently in place. As well as raising revenues in line with country needs to address current fiscal pressures, these reforms will also begin to put in place the tax system that will be needed to ensure government service provision when hydrocarbon resources are depleted. Raising more from domestic taxes and relying less on oil revenues will also enhance government accountability to the population given the more direct link that will be established between revenues and service provision.

45. GCC countries could choose a combination of modern tax options to meet their revenue needs. These include: a low rate broad-based VAT together with selected excises, a tax on profits of incorporated and unincorporated enterprises, and a recurrent property tax. A combination of these taxes can ensure efficient and progressive tax systems in the region. Taxes should start at low rates with limited exemptions. Such a system will be easier to administer and will have little or no efficiency costs to the economy.

46. Tax reforms will take time to implement as the institutional capacity needs to be developed. Experience from other countries shows that it takes time to build tax administrations or revenue agencies and to develop relationships with taxpayers that encourage self-compliance. This is why the reform process should be started as early as possible. Such efforts will require communication strategies at the national and regional levels to explain why taxation is needed and important with the aim to overcome ongoing skepticism about the usefulness of establishing modern taxation systems in oil-rich countries.

47. With regard to the VAT, it is important that the GCC countries announce the broad principles of the VAT framework they have agreed. Individual countries should then move forward with designing their own VAT law. International experience suggests it will take 18-24 months to introduce a VAT once agreement has been reached. However, the readiness—both administratively and politically—may differ across countries, and while it may be preferable for the six countries to move together, this coordination should not interfere with each country's own tax policy objectives. Rather, individual countries should move ahead with their own reforms and implementation strategies when ready, and this may provide a demonstration effect to other countries.

Annex I. Main Characteristics of Tax Systems in the GCC Countries

Country	Companies and Businesses	Withholding Tax	VAT & Goods and Services	Labor Tax/ Fees	Social Security Tax	Others
Bahrain	• 46% tax rate on hydrocarbon companies. • No tax on other corporates	• No withholding tax	• Hotel, short-term lease apartment rents and certain restaurants are subject to 5% tourism levy on the gross income. • 12% sales tax on gasoline included in the price.	• US$26.5 monthly fee per foreign worker used to provide on the job training and job search assistance for nationals.	• 9% employer's contribution. • 6% employee's contribution. • 3% insurance against employment injuries. • 1% unemployment insurance.	• 10% on the monthly rental of residential and business property. • 5 % government levy on gross turnover of hotel services and entertainment. • 1.5% to 3% stamp duty on transfer of land and property.
Kuwait	• 15% flat tax rate on non-GCC companies. • 15% tax rate on capital gains. • 15% tax rate on branch. • 1% tax rate on Kuwaiti shareholding companies to support the Kuwait Foundation for the Advancement of Science.	• No withholding tax. • Tax retention of 5% from each payment due to foreign companies until they present a tax clearance from the Department of Inspections and Tax Claims.	• No tax	• 2.5% tax imposed on the annual net profits of Kuwaiti companies listed on stock market as national labor support tax.	• 11.5% employer's contribution. • 8% employee's contribution	• None
Oman	• No tax for any business establishment, Omani company or permanent establishment (i.e. foreign branch) if taxable income is up to OMR 30,000. • 12% flat tax rate for taxable inomce over OMR30,000. • 12% tax rate on capital gains. • 55% tax rate for companies engaged in petroleum exploration. • Individual persons carrying on professional business in their individual capacities are taxable at a rate of 12% on income in excess of OMR30,000.	• 10% withholding tax	Consumption taxes include the following: • 3% tax rate on annual rental of leased premises and cinema tickets. • 2% tax rate on electricity bills in excess of OMR 50. • 5% tax rate on hotels and restaurant bills.	• 7% levy on the wages of foreign workers used to finance the training of nationals.	• 10.5% employer's contribution. • 7% employee's contribution. • 1% insurance against risks of occupational injuries and diseases.	Municipal taxes in Muscat and Salalah. Muscat municipal taxes are: • 5% tax rate on hotel income. • 3% tax rate of property rents. • 10% tax rate on leisure and cinema income. • 10% tax rate on home owners using the drainage system. • 3% stamp duty on transfer of land and property.
Qatar	• 10% tax rate. • 35% tax rate for companies engaged in petroleum exploration. • 10% tax rate on Individuals carrying on business as professionals or sole traders on net business income.	• 5% of gross amount of royalties and technical fees. • 7% of gross amount of interest, com mission, brokerage fees, director's fees, attendance fees, and other fees.	• No tax	• No tax or fee	• 10% employer's contribution. • 5% employee's contribution.	• None
Saudi Arabia	• 30 to 85% tax rate on companies engaged in natural gas investment activities based on internal rate of return. • 85% tax rate on entities engaged in oil and other hydrocarbon production. • 20% tax rate on other companies. • 20% tax rate on capital gains. • 20% tax rate on non-Saudi and non-GCC national individuals carrying on business or professional activity.	• 5% on dividends. • 5% on interest. • 15% on royalties.	• No tax	• US$53.3 monthly fees per foreign workers (if firm employs majority of foreign workers) used to finance training for nationals. • 2% tax of salary on nationals in the private sector only to proivde unemployment compensation.	• 9% employer's contribution. • 9% employee's contribution. • 2% occupational hazards insurance.	• None
UAE	• No taxes levied by Federal Government and no tax on capital gains. • Except for oil companies, individual Emirates impose income tax up to 55% on taxable income of bodies corporate (not enforced thus far) . • 55% to 85% tax rates on oil companies. • 20% tax rate on foreign banks' taxable income in Abu Dhabi, Dubai, Sharjah and	• No withholding tax	• No tax	• Biannual work permit fees ranging from US$80 to 1350, based on certain criteria.	• 15% employer's contribution. • 5% employee's contribution.	• Up to10% tax rate on hotel services and entertainment. • 5% municipal tax on the annual rental of residential property. • Property registration fee 2% for Abu Dhabi and 4% for Dubai.

Sources: Countires offical resources, PKF Worldwide Tax Guide, and EY Worldwide Corporate Tax Gudie

Annex I. Table 1. GCC Countries Fiscal Balance and Tax Structure

	In percent of GDP				In percent of non-oil GDP			
	2012	2013	2014	2012-14	2012	2013	2014	2012-14
Fiscal Balance								
Bahrain	-3.2	-4.3	-5.7	-4.4	-4.2	-5.8	-7.6	-5.9
Kuwait	33.2	34.0	26.5	31.2	104.1	98.5	71.6	91.4
Oman	4.7	3.2	-1.5	2.1	11.9	7.8	-3.5	5.4
Qatar	14.2	20.7	21.0	18.6	32.6	44.8	40.7	39.4
Saudi Arabia	12.0	5.8	-3.4	4.8	24.4	10.9	-6.0	9.8
United Arab Emirates	10.9	10.4	5.0	8.8	17.9	16.7	7.6	14.1
GCC	13.4	10.6	3.6	9.2	30.5	23.4	8.8	20.9
Revenue								
Bahrain	26.4	24.2	24.4	25.0	35.2	32.8	32.2	33.4
Kuwait	72.1	71.8	68.3	70.7	225.9	208.2	184.6	206.2
Oman	49.5	49.1	47.3	48.6	124.5	118.2	107.7	116.8
Qatar	40.4	46.0	45.1	43.8	92.7	99.7	87.2	93.2
Saudi Arabia	50.3	46.7	42.5	46.5	102.1	88.1	74.0	88.1
United Arab Emirates	40.1	41.0	37.8	39.6	66.1	65.4	57.5	63.0
GCC	48.9	47.6	44.1	46.8	106.1	96.8	83.2	95.3
Oil Revenue								
Bahrain	23.0	21.2	21.1	21.8	30.7	28.7	27.7	29.0
Kuwait	62.0	59.3	54.8	58.7	194.2	172.0	148.2	171.5
Oman	43.6	43.6	41.5	42.9	109.7	104.8	94.6	103.1
Qatar	36.5	42.1	40.1	39.6	83.7	91.3	77.6	84.2
Saudi Arabia	41.6	37.1	32.6	37.1	84.5	70.0	56.9	70.5
United Arab Emirates	28.9	28.2	24.0	27.0	47.6	45.1	36.5	43.1
GCC	40.3	38.0	33.9	37.4	88.2	77.9	64.8	77.0
Non-Oil Revenue 1/								
Bahrain	2.9	2.8	3.0	2.9	3.8	3.8	4.0	3.9
Kuwait	10.1	12.5	13.5	12.0	31.7	36.2	36.4	34.7
Oman	5.9	5.5	5.7	5.7	14.8	13.3	13.0	13.7
Qatar	3.9	3.9	5.0	4.3	9.0	8.4	9.7	9.0
Saudi Arabia	8.7	9.6	9.8	9.4	17.6	18.2	17.1	17.6
United Arab Emirates	11.2	12.7	13.7	12.6	18.5	20.3	20.9	19.9
GCC	8.6	9.6	10.1	9.4	17.9	18.8	18.4	18.4
Non-Oil Tax Revenue								
Bahrain	1.0	1.0	0.6	0.9	1.3	1.4	0.8	1.2
Kuwait	0.7	0.8	0.8	0.8	2.2	2.2	2.2	2.2
Oman	2.7	2.7	2.8	2.7	6.8	6.4	6.4	6.5
Qatar	2.4	1.7	2.0	2.0	5.6	3.8	3.8	4.4
Saudi Arabia	1.2	1.2	1.4	1.3	2.5	2.3	2.4	2.4
United Arab Emirates	2.4	2.4	2.5	2.4	4.0	3.8	3.8	3.8
GCC	1.6	1.5	1.7	1.6	3.3	2.9	3.0	3.1

1/ includes investment income and government fees and charges

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