The Arab Gulf States Institute in Washington

Building bridges of understanding

Value-Added Tax in Gulf Arab States: Balancing Domestic, Regional, and International Interests

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The Arab Gulf States Institute in Washington (AGSIW), launched in 2015, is an independent, nonprofit institution dedicated to providing expert research and analysis of the social, economic, and political dimensions of the Gulf Arab states and how they impact domestic and foreign policy. AGSIW focuses on issues ranging from politics and security to economics, trade, and business; from social dynamics to civil society and culture. Through programs, publications, and scholarly exchanges the institute seeks to encourage thoughtful debate and inform the U.S. foreign-policy and business communities regarding this critical geostrategic region.

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About the Author

Robert Mogielnicki is a resident scholar at the Arab Gulf States Institute in Washington. An expert in the political economy of the Middle East and North Africa, he previously served as a senior analyst with the Siwa Group and head of public relations and marketing for Oxford Strategic Consulting, a United Kingdom/Gulf Cooperation Council-focused research consultancy. Prior to his consulting career, he worked as a journalist covering political and economic developments in post-revolutionary Egypt and Tunisia. His work and commentary on the region have appeared in Axios, Forbes Middle East, Al Jazeera's Inside Story, MEED, Al Bawaba, The National (UAE), Gulf Daily News, Tunisia Live, Egypt Oil and Gas Magazine, and Egypt Daily News.

Mogielnicki received his PhD from the University of Oxford's Magdalen College, where he conducted research in conjunction with the Oriental Institute and Middle East Centre. Drawing on extensive fieldwork in the United Arab Emirates, Oman, Qatar, Bahrain, and Kuwait, his dissertation examines the political economy of free zones in Gulf Arab countries. He earned his MA in modern Middle Eastern studies from St Antony's College, University of Oxford, and completed a master's thesis on labor policy formulation and implementation in the emirates of Abu Dhabi and Dubai. He received his BA from Georgetown University as a double major in Arabic and government, graduating magna cum laude and Phi Beta Kappa.

Executive Summary

Gulf Arab states remain in the early stages of implementing a value-added tax following the Gulf Cooperation Council's adoption of the Unified VAT Agreement in 2016. A VAT functions as an indirect tax on select goods and services – often referred to as a consumption tax – that is imposed wherever value is added along the supply chain. This fiscal measure is part of a series of economic reforms Gulf Arab states have introduced since the oil price shock beginning in 2014, seeking to diversify government budgets and boost non-oil revenue with new taxes and fees. International organizations, such as the International Monetary Fund, have strongly encouraged Gulf Arab states to introduce a VAT and also recommended an increase in the standard tax rate beyond 5%.

Progress to date has been mixed. Saudi Arabia and the United Arab Emirates each imposed the VAT in January 2018, whereas Bahrain began implementing the tax at the outset of 2019. Total revenue collection figures in Saudi Arabia and the UAE exceeded initial expectations, averaging 1.55% and 1.79% of gross domestic product respectively. Inflation jumped in both countries following the introduction of the tax, but price increases are expected to moderate over the coming years. Saudi Arabia, the UAE, and Bahrain simultaneously passed measures to minimize the economic impact of the VAT on businesses and local citizens. These measures include zero rating (levying a VAT at the rate of 0% on a product or service), exemptions, and VAT-free zones. Preferential treatment not only reduces the overall tax base – and consequently the total revenue potential – but also complicates the future integration of each country's VAT system.

The remaining GCC states have delayed the VAT implementation. Kuwait, Oman, and Qatar are expected to launch domestic VAT systems by 2020 or 2021. The reasons behind the delays are not entirely clear. Kuwait's slow-moving political bureaucracy, Oman's challenging economic environment, and the boycott of Qatar posed genuine challenges to an implementation of the tax by the beginning of 2018. These countries have achieved more progress in the adoption of a modest excise tax, in accordance with the GCC's Common Excise Tax Agreement of 2016. Qatar and Oman adopted an excise tax in 2019, and Kuwait plans to introduce the tax in 2020.

Despite beginning as a regional policy and being strongly encouraged by international organizations like the IMF, the VAT in the Gulf is becoming an increasingly country-focused initiative. This approach may be required for individual countries to advance a VAT system that is palatable to political insiders, members of the economic elite, and other actors in key sectors. The regional context also shifted since the adoption of the Unified VAT Agreement in 2016: A less cohesive GCC hampers policy coordination among the bloc's member states. Variation in the timing of implementation and technicalities of tax policy designs could increase competitive dynamics among states. Moreover, uncoordinated development of local tax systems complicates the regional integration of tax systems needed for the smooth functioning of intra-GCC trade in goods and services.

Introduction

Gulf Arab states are pushing ahead with the implementation of a 5% value-added tax – one of several new taxes and fees introduced since the oil price shock beginning in 2014. A VAT functions as an indirect tax on select goods and services, which is imposed wherever value is added along the supply chain. Thus, a VAT represents a consumption tax collected from the purchasing of raw materials to the point of sale. All VAT-registered businesses apply a tax to their sales prices, known as an output VAT. These businesses also pay an equivalent tax on goods and services purchased from suppliers, known as an input VAT. In simplified terms, the amount of VAT owed to a given government is determined by calculating the total output VAT and subtracting the total input VAT. In some cases, the input tax exceeds the output tax, which places the company in a refund position. Tax authorities usually permit companies in this position to either request a refund or apply the amount to a future VAT liability, known as a rollover.

The VAT serves as a useful fiscal policy mechanism for raising government revenue while avoiding many of the political risks associated with income taxes or other tax measures. A relatively simple and standardized form of taxation, a VAT exists across the majority of Organization for Economic Cooperation and Development countries, which helps align the Gulf region's evolving tax systems with global standards and practices. Opponents of the VAT, however, often argue that it places a disproportionate burden on low-income individuals, given that the same tax rate applies equally to all consumers. The higher costs for businesses and higher prices for consumers often associated with the tax can lead to drawbacks. A study by Ernst & Young and the Baker Institute, for example, found that a federal VAT in the United States would negatively impact spending, employment, and income.[1] The effectiveness of the VAT as a revenue source for Gulf Arab governments depends upon the regional policy design (which includes the collection of a VAT on intra-Gulf Cooperation Council trade and the timing of implementation), the standard tax rate, and the tax base.

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The experimentation with the VAT in Gulf Arab states is still in its early stages. During a Supreme Council meeting in Riyadh on December 9-10, 2015, the GCC states agreed to implement a VAT. They formalized a legal framework through the Unified VAT Agreement adopted on November 27, 2016 and charged the Supreme Council's Financial and Economic Committee with overseeing the common imposition of the VAT.[2] The coordinated plan involved the implementation of a 5% VAT across the region by January 2018. However, only Saudi Arabia and the UAE implemented a VAT by the agreed deadline. Bahrain introduced a VAT on January 1, 2019; Oman, Kuwait, and Qatar have delayed implementation of the tax.

1 Robert Carroll, "The Macroeconomic Effects of an Add-On Value Added Tax," *Ernst & Young*, October 2010.

2 "Common VAT Agreement of the States of the Gulf Cooperation Council (GCC)," United Arab Emirates Ministry of Finance, November 27, 2016.

Implementation of the VAT is just the first step. The Gulf states' agreed 5% VAT is among the lowest in the world. European states, such as Germany, the United Kingdom, Italy, and France, have imposed a VAT at around 20%. The International Monetary Fund recommends that Gulf Arab countries increase the VAT beyond 5%.[3] Moreover, questions concerning the management of taxing intra-GCC trade abound. The Unified VAT Agreement calls for an electronic service system to track cross-border transactions of goods and services between GCC states and to facilitate equitable payments. This system did not exist by 2018, nor had the majority of GCC states imposed a VAT by that time. Until the system is operational, Saudi Arabia has instituted a transitional measure whereby the country applies a VAT rate of 0% on all exports to other GCC countries and charges a VAT on imports from GCC countries in the same manner applied to non-GCC imports.[4]

The perception that Gulf Arab states are tax-free environments is historically inaccurate. Saudi Arabia introduced personal income, capital gains, and corporate taxes in 1950. But six months after they were implemented, the tax law was amended to exclude Saudi citizens.[5] Saudi Arabia's Department of Zakat and Income Tax was established in 1951.[6] Abu Dhabi, Dubai, Sharjah, and Ras Al Khaimah implemented various forms of income tax through royal decrees between 1965 and 1969.[7] The UAE's constitution, adopted in 1971, affords the country's federal government with the authority to levy taxes, but prior to the imposition of the VAT, only the excise tax had been imposed at the federal level. In Bahrain, Amiri Decree Law 22 of 1979 imposed a tax on locally sourced income.[8]

While Gulf Arab states have historically imposed few personal income taxes, there are a range of corporate taxes on foreign and national corporations. Oman's 1981 Law of Income Tax on Companies established a sliding scale of income tax rates ranging from 5% to 50% for non-Omani firms.[9] Kuwait also imposes a corporate income tax of 15% on foreign companies. Foreign companies operating in the oil and gas sector are subject to taxes ranging from 15% in Kuwait to as high as 85% in Saudi Arabia.[10]

VAT negotiations coincided with discussions over an excise tax, which offers a comparative case study for the evolution of Gulf Arab tax systems. The GCC's 2016 Common Excise Tax Agreement aimed for regionwide adoption by the last quarter of 2017.[11] Only Saudi Arabia,

3 "Saudi Arabia: Staff Concluding Statement of the 2019 Article IV Mission," *International Monetary Fund*, May 15, 2019.

4 General Authority of Zakat and Tax, *VAT General Guideline: Version 1* (Riyadh: General Authority of Zakat and Tax, November 2018).

5 International Monetary Fund, *Diversifying Government Revenue in the GCC: Next Steps* (Riyadh: International Monetary Fund, October 26, 2016), 4.

6 Organization for Economic Cooperation and Development, *Global Forum on Transparency and Exchange of Information for Tax Purposes Peer Reviews: Saudi Arabia* (Paris: OECD Publishing, 2016), 28.

7 Organization for Economic Cooperation and Development, *Global Forum on Transparency and Exchange of Information for Tax Purposes Peer Reviews: United Arab Emirates* (Paris: OECD Publishing, 2012), 15.

8 Organization for Economic Cooperation and Development, *Global Forum on Transparency and Exchange of Information for Tax Purposes Peer Reviews: Bahrain* (Paris: OECD Publishing, 2011), 12-13.

9 "Taxation of Cross-Border Mergers and Acquisitions: Oman," *KPMG*, May 2014.

10 "Global Oil and Gas Tax Guide: 2018," *Ernst & Young*, June 2018.

11 "Excise Tax Agreement of the States of the Gulf Cooperation Council Agreement," United Arab Emirates Ministry of Finance, accessed August 1, 2019.

the UAE, and Bahrain met this deadline. Qatar and Oman adopted an excise tax in 2019, and Kuwait plans to introduce the tax in 2020. The excise tax applies a rate of between 50% and 100% to tobacco products, energy drinks, sugary drinks, and alcohol, where applicable. It is a relatively modest tax compared to the VAT: Oman's policymakers expect the country's excise tax to generate just $260 million annually.[12] Additional taxes on regional tourism, entertainment, and consumption offer more revenue. Total tax revenue collection in the Gulf, however, remains low. GCC tax revenue as a ratio of gross domestic product averaged just 1.7% from 2012-15.[13] In OECD countries, the average tax-to-GDP ratio reached 34.2%.[14] Gulf Arab governments view the VAT as a method of boosting nonhydrocarbon tax revenue from their low threshold.

Political conflicts among regional states will complicate future efforts needed to harmonize tax regulation structures.

Local, regional, and international factors influence how VAT taxation dynamics unfold across the region. Although VAT revenue for 2018 accounted for less than 2% of GDP in Saudi Arabia and the UAE, the new tax has impacted consumer confidence. Political conflicts among regional states will complicate future efforts needed to harmonize tax regulation structures. The VAT has not been implemented concurrently across the region, and a clear lack of alignment in the regional policy approach toward the VAT heightens the potential for competition between autonomous territories and sovereign states in the Gulf. Global blacklists for tax evasion and money laundering provide additional incentives for Gulf Arab states to employ a VAT as an example of ongoing efforts to build modern and transparent tax infrastructures.

VAT Implementation

Saudi Arabia and the UAE implemented the VAT in January 2018, whereas Bahrain launched the tax at the outset of 2019. Therefore, only three of the GCC's six member states currently oversee functioning VAT regimes, and only Saudi Arabia and the UAE have completed a full fiscal year with the tax in place. Early estimates of VAT tax revenue generation in the region's two largest economies exceeded expectations; however, economic policymakers have faced pressure to alleviate the burden of the VAT on local citizens across each of the three states. The resulting measures threaten to reduce the effectiveness of the tax in the long run and may encourage privileged insiders to exploit the system.

Saudi Arabia

Saudi Arabia finalized its Value Added Tax Law on July 28, 2017 through Royal Decree No. 113, and the General Authority of Zakat and Tax was charged with overseeing the imposition of the new tax.[15] This timeline provided businesses with several months to complete their

12 "15 Days to Pay Sin Tax in Oman," *Times of Oman*, June 11, 2019.

13 International Monetary Fund, *Diversifying Government Revenue in the GCC: Next Steps* (Riyadh: International Monetary Fund, October 26, 2016), 7.

14 Organization for Economic Cooperation and Development, *Revenue Statistics 2018: Tax Revenue Trends in the OECD* (Paris: OECD Publishing, 2018), 2.

15 "Value Added Tax Law," General Authority of Zakat and Tax, accessed July 8, 2019.

registrations before the tax took effect at the start of 2018. Not all firms in Saudi Arabia were required to register for the VAT. Any company with annual sales greater than 1 million Saudi Arabian riyals (approximately $266,680) needed to register for the VAT by December 20, 2017, whereas this mandatory registration threshold was further reduced to 375,000 riyals (approximately $100,000) by December 20, 2018. The latter figure, which functions as the mandatory threshold for the 2019 tax year, is compliant with article 50.2 of the GCC Unified VAT Agreement. As of July, the General Authority of Zakat and Tax had recorded 187,328 VAT-registered businesses in the kingdom.[16]

Saudi Arabia's total VAT revenue for 2018 reached around 45.6 billion riyals (approximately $12.16 billion), constituting 27.5% of the country's total tax revenue for the fiscal year and representing about 1.55% of GDP.[17] The annual average rate of inflation jumped from around -0.9% in 2017 to approximately 2.5% in 2018, in part due to the introduction of the VAT but also because of new fees on expatriate workers, Saudization policies, and a reduction of certain subsidies, such as those on fuel and electricity.[18] The IMF advised Saudi Arabia to consider raising the VAT rate beyond 5%, but this step remains unlikely in the short term.[19] For the time being, Saudi Arabia can easily tap capital markets for additional cash: The Saudi Aramco bond issue raised $12 billion in April, and the country's Public Investment Fund plans to raise debt at least twice over 2019.[20]

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The Saudi government undertook a series of policy measures to reduce the overall impact of the VAT on local citizens. Royal decrees issued in early 2018 increased salaries for Saudi nationals in the civil service and military by 1,000 riyals (around $267) and granted welfare and pension recipients with an additional 500 riyals (around $133) per month. The government likewise increased stipends for students at public universities by 10%, covered the VAT for citizens using private health care and education, and bore the VAT accrued by select, first-time home buyers.[21] VAT exemption certificates for first-time home buyers reached 58,792 in the first half of 2019 alone, and the government extended the initiative to include all Saudi citizens who sold their homes before or after the announcement of the scheme.[22] The VAT-specific expenses incurred by the government reached 2 billion riyals (approximately $533

16 "Home," General Authority of Zakat and Tax, accessed July 22, 2019.

17 Ministry of Finance, Budget Statement: Fiscal Year 2019 (Riyadh: Ministry of Finance, 2019), 28; This figure assumes a GDP of $782.48 billion in 2018 and is consistent with data cited by IMF officials.

18 Catherine Rosemary Bond, ed., "Gulf Economic Monitor: Building the Foundations for Economic Sustainability," *World Bank Group* 4 (May 2019): 14; "Inflationary Trends in Saudi Arabia: Impact on Price and Business," *KPMG*, August 2019.

19 "Saudi Arabia: Staff Concluding Statement of the 2019 Article IV Mission," *International Monetary Fund*, May 15, 2019.

20 Sam Meredith, "Saudi Arabia's Sovereign Wealth Fund Aims to Tap Debt Markets Twice This Year after 'Amazing' Market Response," *CNBC*, May 1, 2019.

21 Ruba Obaid, "Royal Decrees Issued to Help Saudis Cope with VAT, Price Rises," *Arab News*, January 7, 2019.

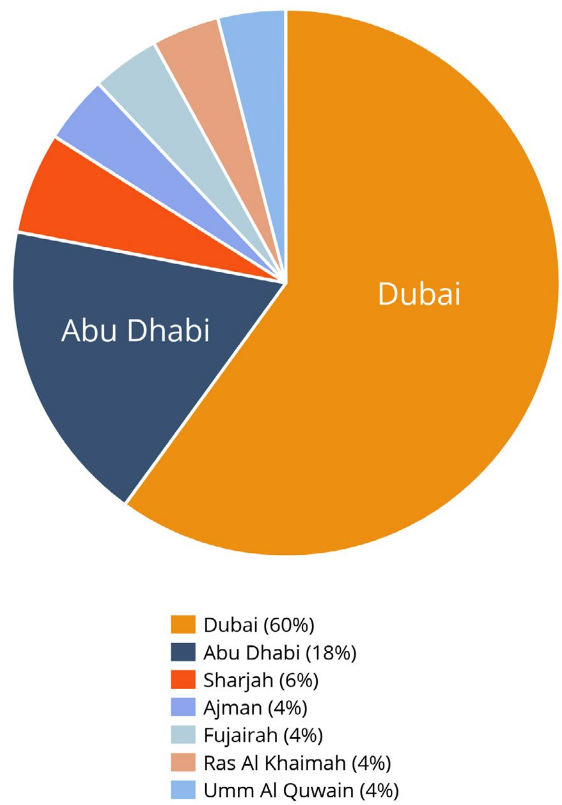
22 Nada Rifai, "Saudi Government to Bear VAT Cost for Former Home-Owners," *Zawya*, July 22, 2019.

million) in 2018, according to the Ministry of Finance.[23] King Salman bin Abdulaziz extended a broader set of government handouts through 2019 with an economic package costing an estimated 40 billion riyals (approximately $10.7 billion) – a sum approaching the total VAT revenue collected in 2018.[24]

United Arab Emirates

The UAE also rolled out the VAT in January 2018, following the introduction of Federal Decree Law 8 of 2017 on Value-Added Tax. The country's Federal Tax Authority was charged with coordinating tax revenue collection across the seven emirates. A mandatory registration threshold of 375,000 UAE dirhams (approximately $102,088) meant that the UAE was the only member state to comply with the threshold mandated by the unified agreement at the time of implementation. More than 307,000 businesses and tax groups had registered for the VAT as of August 2019.[25]

UAE VAT Revenue Distribution by Emirate



Source: "VAT in UAE: Ministry of Finance Explains Designated Free Zones," *The National*, January 12, 2018.

Although UAE policymakers expected VAT revenue of around $3.3 billion in 2018, the country reported tax revenue of $7.4 billion in 2018. This accounted for approximately 1.79% of the country's GDP. The UAE's VAT figures for 2018 even exceeded Moody's forecast of $5.45 billion in total VAT revenue for 2019.[26] Analysts adjusted their 2019 forecasts of VAT collections to between 30 and 50 billion dirhams (approximately $8.2-$13.6 billion).[27] The upcoming Expo 2020 in Dubai is expected to further drive VAT revenue.

The unique political structure of the UAE, wherein the seven emirates maintain substantial economic autonomy, complicated the collection and distribution of tax revenue. In June, the UAE Cabinet approved the distribution of 30% of the tax revenue to the national government and 70% to the emirate-level governments. Dubai received the lion's share of the revenue disbursed to the emirates, receiving approximately 60%. A substantial tourism industry, credentials as a commercial hub, and a large segment of its workforce that commutes from neighboring emirates drove VAT collection in the emirate.

23 Ministry of Finance, Budget Statement: Fiscal Year 2019 (Riyadh: Ministry of Finance, 2019).

24 Zainab Fattah, "Saudi King Extends Billions in Handouts for Another Year," *Bloomberg*, December 18, 2018.

25 Gavin Gibbon, "Expo 2020 Dubai to Help Drive VAT Revenues over $8bn This Year," *Arabian Business*, August 14, 2019.

26 Sarah Townsend, "UAE's VAT Revenues Beat Estimates, Moody's Says," *The National*, June 26, 2019.

27 Waheed Abbas, "Dubai Biggest Beneficiary of VAT Revenue," *Khaleej Times*, July 1, 2019.

The country's remaining emirates received substantially smaller allocations of the VAT revenue. Although Sharjah only received 1.61 billion dirhams (around $440 million) – 6% of total VAT revenue – this was around 16% of total government revenue for the emirate.[28] Abu Dhabi, which generates the majority of its government revenue from hydrocarbon exports and sovereign wealth fund investments, received three times the VAT revenue disbursed to Sharjah. However, this non-oil income constituted a mere 2% of Abu Dhabi's total government revenue. The remaining emirates of Ajman, Fujairah, Ras Al Khaimah, and Umm Al Quwain each garnered just 4% of the total VAT revenue in 2018.

Bahrain

Bahrain implemented the VAT on January 1, 2019, following Decree Law 48 of 2018. The law offered Bahrain-based firms multiple registration periods over the course of the year to align the registration thresholds with those of the GCC Unified VAT Agreement. Bahrain's National Bureau for Revenue is responsible for overseeing implementation of the tax. In July, the National Bureau for Revenue reported that 99% of VAT-liable firms had registered with the tax authority.[29] Although figures for Bahraini VAT revenue collection are not yet available, the IMF estimated that the country could expect around 1.9 percent of GDP in tax revenue – around $717.1 million.

Bahrain's VAT Registration Thresholds

Registration Deadline	Revenue (in U.S. dollars)
December 20, 2018	13.3 million
June 20, 2019	1.33 million
December 20, 2019	99,734

Source: PwC Middle East "Bahrain Announces Information on Phased Introduction of Value Added Tax (VAT), Filing and Other Matters," December 4, 2018.

The delayed introduction of the VAT in Bahrain cannot be separated from the political economy dynamics of the region. The Bahraini Parliament only ratified a VAT bill after neighboring Gulf states pledged an economic aid package of $10 billion to help Bahrain's struggling economy.[30] A subsequent royal decree then ordered Bahrain's Parliament to make a final decision on the tax policy, which sought to align the country's tax regulatory system with broader regional initiatives. The IMF encouraged Bahrain to minimize the total number of VAT exemptions to boost the effectiveness of fiscal consolidation measures. However, in early July, Prime Minister Khalifa bin Salman al-Khalifa raised the total number of VAT-exempt services for Bahraini citizens to 1,620.[31]

28 Waheed Abbas, "Dubai Biggest Beneficiary of VAT Revenue," *Khaleej Times*, July 1, 2019.

29 "99% of Firms in Bahrain Sign Up for VAT," *Zawya*, July 29, 2019.

30 "Bahrain Approves VAT, Spending Measures to Help Improve Fiscal Balance," *Oxford Business Group*, October 24, 2018.

31 "Bahrain Scraps Fees on 200 Government Services," *Arabian Business*, July 2, 2019.

Preferential Treatment: Zero Rating, Exempting, and VAT-Free Areas

Many countries apply preferential VAT rates for goods and services. Within the Gulf region, as is the case with global tax regimes, the VAT policy contains loopholes that reduce the total tax base. This process typically occurs by means of applying a tax rate of 0% on certain products and services or exempting specific activities from the VAT entirely. These mechanisms insulate firms in strategic sectors and vulnerable individuals from the economic impact of the new tax. While preferential VAT treatment can mitigate the negative impact of higher taxes on growth, it also possesses downside risks. The IMF estimated that zero rating, exemptions, and varying definitions of taxable sectors could potentially lead to a reduction of VAT revenue by 50%; therefore, the IMF recommended a higher statutory tax rate of around 10% for Gulf Arab countries.[32]

Zero-Rated Economic Activities

	Saudi Arabia	United Arab Emirates	Bahrain
Education-related goods and services		✓	✓
Oil and gas	✓	✓	✓
Supply of air, sea, or land transportation		✓	
International transportation of passengers and goods	✓	✓	✓
Transportation-related goods and services	✓	✓	
Supply and importation of food items			✓
Newly constructed buildings		✓	✓
Medicines and medical goods*	✓	✓	✓

***Zero-rated goods and services in the medical industry tend to focus on individual patients and not businesses.**

Sources: Saudi Arabian General Authority of Zakat & Tax, UAE Ministry of Finance, Bahrain Ministry of Finance

*Table is for comparative purposes and does not reflect a comprehensive list of zero-rated activities in any country.

32 International Monetary Fund, *Diversifying Government Revenue in the GCC: Next Steps* (Riyadh: International Monetary Fund, October 26, 2016), 12.

Gulf Arab states have zero rated several economic activities. Zero-rated goods and services are considered taxable; however, the VAT is levied at a rate of 0%. This preferential status permits companies to accrue credits for any VAT paid on inputs, so it is a cost saving measure for firms operating in designated industries. Saudi Arabia, the UAE, and Bahrain each zero rated economic activities relating to oil and gas and the international transportation of passengers and goods. These economic activities are central components of each country's economy.

Zero rating reduces the tax burden on consumers. Governments, for example, can limit the negative economic impact of a VAT on local residents by zero rating essential goods and services like food and utilities. All three countries zero rated medicines and medical goods, thus providing a buffer for the health care industry, an important component of residents' welfare. This preferential treatment does not extend across the entire medical industry. The UAE does not necessarily zero rate business-to-business transactions and services,[33] and Saudi Arabia charges the standard VAT rate for services carried out by private health care providers.[34] The UAE and Bahrain also zero rated activities related to education as an additional measure to ease the burden on local residents.

Exempted Economic Activities

	Saudi Arabia	United Arab Emirates	Bahrain
Specified financial services	✓	✓	✓
Residential real estate	✓	✓	✓
Diplomatic exemptions			✓
Military exemptions			✓
Domestic passenger transportation		✓	

Sources: Saudi Arabian General Authority of Zakat & Tax, UAE Ministry of Finance, Bahrain Ministry of Finance
*Table is for comparative purposes and does not reflect a comprehensive list of zero-rated activities in any country.

Unlike zero-rated activities, exempted goods and services are not subject to VAT procedures or systems. Firms selling exempt supplies do not charge a VAT at the point of sale nor are these firms able to claim any VAT credits on inputs from suppliers. The irrecoverable VAT can affect firms' bottom lines, and, in some cases, encourage producers dealing with exempt goods and services to pass higher costs on to consumers. However, these additional costs are likely to be

33 *VAT Implications for the Healthcare Sector in the United Arab Emirates*, *Deloitte*, accessed August 1, 2019.

34 General Authority of Zakat and Tax, *Healthcare Guideline: Version 1* (Riyadh: General Authority of Zakat and Tax, February 2018), 11.

less than those associated with the VAT levied at the standard rate of 5%. Governments often apply exemptions to goods and services wherein the value added is difficult to determine, such as financial institutions, and in industries that mix taxable and nontaxable activities. All three of the Gulf Arab states implementing the VAT have exempted specified financial services and residential real estate. Bahrain extended exemptions to include military and diplomatic activities.

Beyond zero rating and exemptions, classification and geographic elements of VAT systems in the Gulf region create further variation among taxation regimes. How each state defines a particular sector, industry, or economic activity has broad repercussions for future integration and harmonization of the region's tax structure. For example, the UAE zero rated international passenger transportation and exempted domestic passenger transportation. However, many vehicles and types of equipment have both international and domestic uses. Companies with branches in multiple GCC countries may likewise have to adjust to different VAT regulations according to how each country defines and categorizes similar business activities.

The UAE also exempted certain geographic areas within the country from the VAT by demarcating exclusive zones. Articles 50 through 52 of the UAE's VAT law refer to a "Designated Zone," which is considered "outside of the State" and is consequently not liable to pay tax.[35] The subsequent Cabinet Decision 59 of 2017 designated 20 free zone areas as designated zones. Emirates with expansive free zone sectors received a greater share of designated zones under the UAE's new law. Dubai received seven designated zones while Abu Dhabi only received three. Other commercial actors have sought to protect certain economic activities from the VAT: The Dubai Multi-Commodities Centre free zone petitioned the federal government for a designated zone status but has not yet received it.[36]

VAT-Free Designated Zones in the UAE

Emirate	Designated Zones
Dubai	7
Abu Dhabi	3
Ras Al Khaimah	3
Sharjah	2
Fujairah	2
Umm Al Quwain	2
Ajman	1

Source: "VAT in UAE: Ministry of Finance Explains Designated Free Zones," *The National*, January 12, 2018.

35 "Federal Decree-Law No. (8) of 2017 on Value Added Tax," United Arab Emirates Ministry of Finance, 2017.

36 Michael Fahy, "Dubai Free Zone Still Seeking Ways to Free Commodities Firms from VAT Liabilities," *Zawya*, February 12, 2018.

Delaying the Inevitable: Oman, Kuwait, and Qatar

Oman, Kuwait, and Qatar have not yet implemented a VAT. Oman expects to formally introduce the tax at the beginning of 2021, after multiple delays, and Kuwaiti policymakers have suggested a similar start date. The delayed implementation and general divergence from GCC conventions fits with the Omani and Kuwaiti stances toward the regional bloc. Both countries have attempted to preserve a degree of autonomy, especially in economic spheres, by charting independent, but not entirely conflicting, courses concerning regional policy initiatives. The motivations underlying Qatar's decision to delay VAT implementation are slightly different. Qatar has confronted a boycott from the GCC member states of Saudi Arabia, the UAE, and Bahrain since mid-2017. Therefore, Qatar effectively operates outside of the confines of the regional bloc; this is especially true of the country's economic policy. GCC-wide agreements, therefore, bear little on Qatar's current calculations surrounding tax reform. Nevertheless, each of these three countries are bolstering their taxation infrastructure.

Oman has delayed the implementation of a VAT for a number of years, despite increasingly urgent recommendations by organizations like the IMF.[37] Unlike Kuwait and Qatar, two resource-wealthy countries in strong fiscal positions, Oman is in urgent need of non-oil government revenue. The country's total government debt has increased tenfold since 2014, and its 2019 growth forecast was slashed to 0.3 percent by the IMF.[38] The Ministry of Finance made a statement on July 31 noting continued efforts on legislative issues surrounding the VAT and indicating that the Secretariat General of Taxation is in the process of "completing the administrative, technological equipment in preparation for applying this tax."[39] In a bond prospectus released earlier in July, the Omani government pushed the expected date of implementation to 2021.[40]

Unlike Kuwait and Qatar, two resource-wealthy countries in strong fiscal positions, Oman is in urgent need of non-oil government revenue.

Oman has managed to make headway in other areas of its tax system. The Omani government passed Royal Decree 9/2017 in February 2017, which, among other changes, increased the standard corporate tax to 15%, up from the 12% designated by the 2009 Income Tax Law 28.[41] As part of this law, Oman harmonized its system for corporate tax rates. The equal application of the tax on foreign and domestic companies should help to attract foreign direct investment, according to the World Bank.[42] On June 15, Oman also implemented excise taxes on tobacco, alcohol, pork, energy drinks, and carbonated drinks. The expected excise tax revenue is relatively small, accounting for an estimated $260 million each year.[43]

37 Sam Bridge, "IMF Urges Oman to Introduce VAT as Soon as Possible," *Arabian Business*, July 12, 2019.

38 "IMF Slashes Oman's 2019 Economic Growth Forecast to 0.3%," *Reuters*, July 4, 2019.

39 "No Plans to Postpone VAT, Finance Ministry Affirms," *Oman News Agency*, July 31, 2019.

40 Davide Barbuscia, "Oman to Delay VAT to 2021 amid Sluggish Growth," *Reuters*, July 30, 2019.

41 "Oman Government Passes Significant Changes to Income Tax Law," *Ernst & Young*, February 21, 2017.

42 Catherine Rosemary Bond, ed., "Gulf Economic Monitor: Building the Foundations for Economic Sustainability," *World Bank Group* 4 (May 2019).

43 "Oman to Impose Selective Taxes," *Asharq Al-Awsat*, June 10, 2019.

The Kuwaiti government has lagged behind other GCC states in rolling out tax policy measures. Kuwait's Parliament has ruled out the implementation of a VAT before 2021; however, the country's legislature has committed to finalizing an excise tax on selected products, like sugary drinks and tobacco, between 2019 and 2020.[44] Despite criticism from the country's central bank, members of parliament have repeatedly tried to adopt an additional tax on remittances from expatriates – the latest proposal involved a 5% tax on expatriate remittances exceeding $1,640.[45] Kuwait's delayed implementation of taxes, especially the VAT, is closely related to two factors. First, Kuwait enjoys a strong fiscal position and adequate financial buffers. Generating non-oil revenue through a harmonized VAT system is not needed as urgently as in other Gulf countries, like Oman. Second, Kuwait's Parliament plays a powerful role within the country's political system, and therefore the body can slow or prevent the adoption of tax policy measures despite high-level support from figures such as the emir.

Qatar also diverged from the VAT implementation date of 2018. Although the country's policymakers have kept a low profile with respect to VAT implementation, it is likely that Qatar will roll out a VAT at the beginning of 2020. Globally recognized professional services and accounting firms have been steadily working to prepare an adequate taxation framework and infrastructure for the country. Moreover, the country's General Tax Authority, established in 2018 as a replacement for the Qatar Tax Department, provides a visible reminder of the introduction of forthcoming taxes. According to one Doha-based expert, "it might not seem like a major development, but the prominent location of the tax authority [building] is a big deal for a Gulf country … and it sends a message." Indeed, Qatar imposed an excise tax at the outset of 2019.

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Unlike many of its regional neighbors, which urgently need to develop new nonhydrocarbon sources of government revenue, Qatar can be considered a "super rentier"[46] state, which pairs tremendous natural resource rents with a tiny population. The country's strong fiscal position and financial buffers reduce the urgency and necessity of new tax policy measures. Qatar's exclusion from many GCC processes, specifically those relating to the bloc's economic coordination, further removes any regional obligations for implementing the tax.

Although an urgent need for economic reforms and regional commitments are lacking, there are important factors motivating the VAT agenda in Qatar. The first is economic in nature. While the Qatari economy remains strong, it nevertheless experienced a short-term shock in the aftermath of the GCC crisis and required substantial government expenditures to stabilize the economy, reconfigure trading routes, and restore global investor confidence. Longer-term obstacles loom, such as those related to changes in the global natural gas market. As Qatar's

44 "Kuwait's Emir Says Economic Reforms Needed Despite Higher Oil Prices," *Reuters*, October 30, 2018.

45 Lorys Charalambous, "Kuwait Again Tables Expat Tax Proposal," *Tax-News*, May 10, 2019.

46 A term employed by Courtney Freer to describe states with the highest per capita income, lowest proportion of national citizens, and most generous rentier benefits. See: Courtney Freer, "Rentier Islamism in the Absence of Elections," *International Journal of Middle East Studies* 49 (2017): 480.

neighboring GCC countries have either already implemented a VAT or plan to in the coming years, the addition of a VAT in Qatar is an easy fiscal win and will not place the country at a commercial disadvantage vis-à-vis its neighbors.

International Considerations

Other global pressures aim to influence how tax regimes unfold across the Gulf Arab region. Enhancing tax infrastructures will bolster the ability of Gulf Arab states to counter money laundering, global tax evasion, and terrorism financing. The U.S. government is particularly concerned with Iranian influence in Qatar's banking sector and has engaged with the Qatar Financial Regulatory Authority on this front. A more robust tax system creates greater transparency in the economy and can help assuage these concerns from foreign governments and critical allies.

Tax haven blacklists, such as those managed by the European Union, have listed Gulf Arab states. In March, the EU added the UAE and Oman to the backlist of tax havens; Saudi Arabia managed to escape inclusion on this list after heavy lobbying and promises of reform.[47] In 2018, both the UAE and Bahrain were listed and then removed from the EU's blacklist, having made commitments to adapt their tax systems to EU standards.[48] Qatar also appeared on the EU's less severe gray list before demonstrating sufficient evidence of reforms and consequently being removed.

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The EU blacklist is intended to pressure countries to better tackle tax evasion and fraud issues. The tax haven blacklist does not amount to sanctions; however, any listed country faces additional scrutiny and procedural checks when dealing with European financial institutions. While inclusion on the blacklist shines a spotlight on a given country's tax system, it is unclear to what degree this concern factors into the calculations of Gulf economic policymakers. Indeed, the UAE's introduction of the VAT in 2018 did not prevent the country from being placed back on the EU's tax haven blacklist in 2019.

Conclusion

While regional and international forces have shaped the introduction of the VAT in the Gulf, domestic considerations have proved more consequential in determining the timing of implementation and the specific tax policy designs. The VAT began as a unified agreement among GCC member states, and the IMF has strongly encouraged Gulf Arab states to push ahead with tax implementation. However, the Qatar boycott and uneven timing of implementation has partially shifted the focus on the VAT from a regional level to a domestic one. This has permitted Gulf Arab governments greater flexibility to adopt tax policies tailored to the prevailing political and economic challenges confronting each state.

47 "EU States Block Blacklisting Saudi, Panama over Dirty Money," *Reuters*, March 7, 2019.

48 Francesco Guarascio, "EU Tax Haven Blacklist Set to Shrink Further, Causing Outcry," *Reuters*, March 6, 2018.

As the VAT slowly emerges in the Gulf's fiscal environment, local policymakers must balance the domestic costs and benefits of VAT implementation against the development of a broader regional tax system. Facing low growth rates and persistent budget deficits, Gulf Arab states have imposed new taxes and fees to diversify government revenue and create new, non-oil income streams. These recent measures, of which the VAT constitutes an important pillar, risk negatively affecting consumer and investor confidence in local economies. Yet without new taxes and fees, Gulf Arab governments will continue to struggle with revenue instability owing to fluctuations in the price of natural resources.

The standard tax rate of 5% is low by global standards, which limits both the total government revenue and negative economic impacts associated with the tax. The average tax-to-GDP ratio in OECD countries is around 34%,[49] whereas GCC tax revenue as a ratio of GDP averaged just 1.7% from 2012-15.[50] The introduction of the VAT is changing this dynamic. Tax revenue in Saudi Arabia, for example, grew by an estimated 89.4% from 2017-18.[51] While inflation has increased within countries that implemented the VAT, the rise in consumer prices is expected to stabilize. In 2018, inflation reached 3.1% in the UAE and 2.5% in Saudi Arabia, and the IMF forecasts inflation rates in both countries to rest around 2.1% over the next five years.[52]

Gulf governments have sought to limit the negative economic impact of the VAT on firms and individual consumers, especially local citizens. These VAT-focused initiatives take many forms: direct government assistance to citizens, public sector absorption of VAT liability, zero rating, exemptions, and VAT-free zones. Preferential treatment regarding the VAT is costly and creates distortions in the tax system. The price tag for Saudi Arabia's broader government assistance package to citizens in 2019, for example, was nearly equivalent to the country's total VAT revenue in 2018.[53] Zero rating, exemptions, and designated VAT-free zones can help to insulate strategic industries and vulnerable consumers from the negative economic impact of the new tax. However, the loopholes in each country's tax system also encourages rent-seeking behavior, as firms and individuals seek preferential tax treatment.

The uneven timing of the VAT implementation is not inherently problematic in the short term, but the uncoordinated timing of tax reform may increase commercial competition among regional states over the medium term. According to the IMF, Gulf Arab states possess the "scope to move separately," but should do so within a coordinated transition period of three to five years.[54] A phased process of VAT implementation provides late entrants with the opportunity to learn from the experiences of early adopters. Yet delayed implementation can also serve as a source of competitive advantage, as countries compete to offer investors a commercial environment with low taxes and fees.

49 Organization for Economic Cooperation and Development, *Revenue Statistics 2018: Tax Revenue Trends in the OECD* (Paris: OECD Publishing House, 2018), 2.

50 International Monetary Fund, *Diversifying Government Revenue in the GCC: Next Steps* (Riyadh: International Monetary Fund, October 26, 2016), 7.

51 Ministry of Finance, *Budget Statement: Fiscal Year 2019* (Riyadh: Ministry of Finance, 2019).

52 International Monetary Fund, "*DataMapper: Inflation Tate, Average Consumer Prices*," accessed August 1, 2019.

53 "Saudi King Extends Handout Payments to Citizens," *Arabian Business*, December 19, 2018.

54 International Monetary Fund, *Diversifying Government Revenue in the GCC: Next Steps* (Riyadh: International Monetary Fund, October 26, 2016), 3.

Over the longer term, some manner of regional coordination on the VAT is important to ensure that the tax generates a substantial portion of non-oil revenue for these countries' budgets. Coordination can limit the loopholes, exemptions, zero ratings, and other forms of preferential treatment concerning VAT liability across Gulf Arab economies. Too many exemptions and zero ratings will not only reduce the overall revenue generation potential of the VAT but also further complicate regional integration of the VAT system with cross-border trade and other transactions. When and how Oman and Kuwait – and to a lesser degree Qatar, given its strained relations with GCC neighbors – implement the VAT will be an important indicator of whether the tax will eventually resemble a regional initiative or rather a policy measure that is shaped predominantly by domestic considerations.

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