



April 2021

Middle East Economy Watch

Rethinking the role of expats and tax as we look beyond COVID-19

A year since the outbreak of the coronavirus, and it remains a material factor in daily life and economic trends here in the Middle East. Despite a new wave of infections this year, the rollout of vaccinations offers hope that the end is in sight and a recovery in the oil price - faster than most analysts expected - has provided further impetus.

However, the last year has changed our region, just as it has changed the world, and some of this will persist. In this issue, we look at two trends in the GCC which predate the crisis but have been amplified by it, as diversification becomes more important than ever: expats and taxation.

A loosening of the sponsorship system in the Kingdom of Saudi Arabia and a new program of naturalisation in the United Arab Emirates are two examples of these trends. The pandemic has led to a sharp outflow in expats, mainly because of lost jobs, but many GCC states are looking at ways of retaining and attracting them, particularly those who can make the largest economic contribution.

Part of that contribution is increasingly coming in the form of taxation, mainly indirectly. This is happening as the GCC is trying to diversify its revenue base in response to the energy transition. We estimate that the regional tax take more than doubled between 2016 and 2019 to 5.2% of GDP. However, there is a wide range between states, from 0.5% of GDP in Abu Dhabi, even with VAT, to 7.4% in KSA, as nations explore different options for diversification.

The growth in taxation is coming from new kinds of tax as well as higher rates, and more is to come, including personal income tax in places. However, the GCC will still retain one of the lowest and simplest tax burdens globally and exemptions are being made to support competitiveness. Tax policy can also be used to support development goals, as with the Saudi white land tax.

Given its importance, in this edition we have dedicated a section to the ever changing landscape of tax in our region.

COVID-19 rebound creates tailwinds after H2 recovery, and oil provides a boost

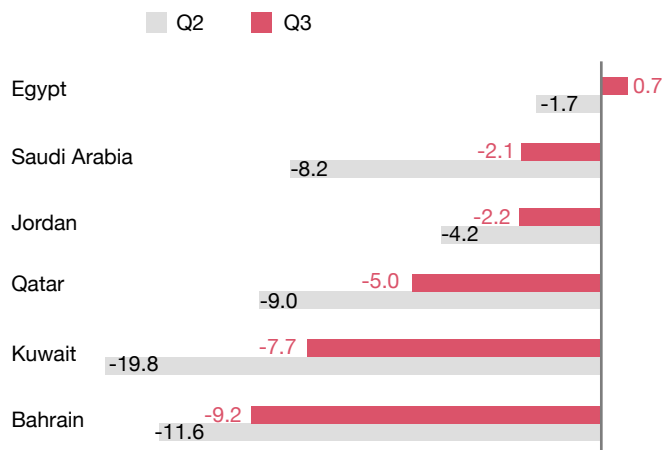
Strong rebounds in H2

Although the coronavirus has hit our region hard, due to both lockdowns and lower oil prices, there were already signs of a recovery emerging in late 2020. We noted this in our last Economy Watch in December, based on leading indicators such as mobility data. Since then, more detailed statistics have been published for this period, showing the overall recovery more clearly but also revealing nuances by sector and country.

The most detailed information comes from national accounts, which are now available for Q3 for most countries. Egypt, which saw the smallest dip in Q2, had already returned to growth in Q3, although this would still represent a contraction on a GDP per capita basis. Its growth picked up to 2.0% y/y in Q4. KSA is the only other regional state to have published Q4 data at the time of writing, showing its non-oil contraction narrowed to just -0.8% y/y in Q4. It had already seen the region's strongest non-oil rebound in Q3 (5.7% q/q).

However, other countries have struggled, partly due to the structures of their economies. Bahrain's more tourism-oriented non-oil economy remained in deep contraction in Q3 at -9.2% y/y, including a -20% decline in trade and hospitality, and its government has less fiscal space than its neighbours to provide stimulus.

Non-oil GDP growth (% y/y)



Source: National statistical agencies

Oil production remains constrained by OPEC+, although the group has begun to taper its cuts in 2021. Oil output has, in turn, restricted feedstock for downstream manufacturing, partly explaining why the sector was still down by -10% y/y in Q3, even in KSA. However, other sectors have performed better, notably financial services which was actually up y/y in both KSA and Qatar in Q3.

COVID-19 and oil both rebound in 2021

The first quarter of 2021 has been mixed for our region. A new wave of coronavirus infections, particularly in the UAE and Bahrain, has led to a fresh wave of travel restrictions and lockdown measures. Our composite index of GCC mobility, derived from Google data, hit a low of -16% below the pre-Covid baseline at end-2020, but had reverted to -22% by late January, the worst since August. However, there were signs of improvement in late February and we expect further improvements in the months to come, as vaccine deliveries pick up and other regional states emulate the strong rollouts seen so far in the UAE and Bahrain.

A more positive trend for our region has been the recovery of oil prices, which have risen above \$60 (and briefly above \$70) for the first time since January 2020. This is well above the prices budgeted by many states (for example \$40 by Qatar and \$45 by Oman) and if they persist then this should significantly ease fiscal stress across the region and provide governments with more capacity to support the post-Covid recovery phase.

Major residency reforms underway, as the GCC rethinks the role of expats

Reasons for the change

On March 14, KSA's Labour Reform Initiative came into effect, a few weeks after the UAE announced a new system of naturalisation.

These two developments are indicative of a broader trend of rethinking the roles and rights of expatriates, who were long assumed to be temporary residents in a transitional phase of development. The changes are partly due to international criticisms of the traditional kafala (sponsorship) system and the welfare of some workers, notably in relation to high profile projects such as the World Cup in Qatar. Moreover, as our region looks to diversify, it is better appreciating the value of expats as entrepreneurs, investors, consumers and, increasingly, as taxpayers. These changes in residency and labour rights help to attract and retain high-value expats and improve the business environment.

Long term status

The UAE's new naturalisation scheme, which permits dual nationality for the first time in the GCC, has attracted a lot of attention but is only likely granted on a very small scale. There is no formal application process and candidates are instead nominated by senior officials and royals. There are already laws in place for naturalisation in the GCC, but most have very strict requirements (e.g. decades of residency, Islam and Arabic).

Long-term residency schemes are a bigger development. Qatar was the first to launch this in 2018, but it is currently limited to 100 per year (although this will likely expand) and is currently geared mainly at children of Qatari women who, as is common in the GCC, do not acquire nationality by descent.

The UAE's Golden Visa scheme was introduced in 2019, when the first batch of 2,500 received it, and the eligibility was recently broadened. It comes in five and 10-year versions that are variously available to investors, scientists, entrepreneurs and even graduates with GPAs of at least 3.8.

KSA also introduced a permanent residency scheme in 2019, selling it for SAR800,000. These schemes build on longstanding systems in several countries for renewable annual visas for investors.

In a further innovation, Dubai is now offering five year visas for retirees who meet modest financial criteria. The city also responded to the coronavirus by offering annual visas to remote workers. These moves aim to bolster the economy which is suffering from a decline in expats. Standard & Poor's estimates that Dubai's population fell by -8.4% in 2020, the most in the GCC, with the regional overall seeing a -4% decline.

Reforming kafala

The kafala system, which ties residency to a sponsor who has a veto on employment and exits, has been widely criticised for enabling abusive work practices and harming the economy by limiting labour force flexibility. Since 2016 there have been various initiatives to ease it, largely shifting to a system of fixed-term work contracts.

Qatar has led the way, ending sponsor involvement in the issuance of exit permits and No Objection Certificates (NOCs). Oman scrapped NOCs in January, followed by KSA as part of its recent March reforms, along with permitting expats to apply directly for exit permits. Still, there is inflexibility. For example, in KSA a job change is only permitted if an employee informs their sponsor three months before their contract expires.

Separately, there have been efforts to improve worker rights. Qatar set a minimum wage of QR1,000 (\$275) last year and the UAE has introduced parental leave rights.

Nationalisation continues

Despite the improvements for expats, the goal of increasing the role of nationals in the labour force remains a priority, particularly in more fiscally constrained countries. KSA has been the most forceful with its nitaqat (traffic light) system, further tightened in 2020, which penalises firms that breach allocated nationalisation quotas, and also with the introduction of levies on both expat workers and their dependents. Oman introduced its own nitaqat system in 2019, successively banning expats from certain sectors and roles, and introduced higher new work permit fees this year (up to \$5,198).

Kuwait has taken the most forceful approach, not so much because of concerns about expats taking jobs, as most nationals work for the state, but because of their perceived impact on the national culture. The National Assembly passed a population law last year that requires the government to develop a plan to cut expat numbers. The prime minister has indicated a goal of reducing the expat share of the population from 70% to just a third. It is unlikely that other GCC states will emulate this approach.

From no tax to low tax: as the GCC relies more on tax, getting it right is critical for diversification



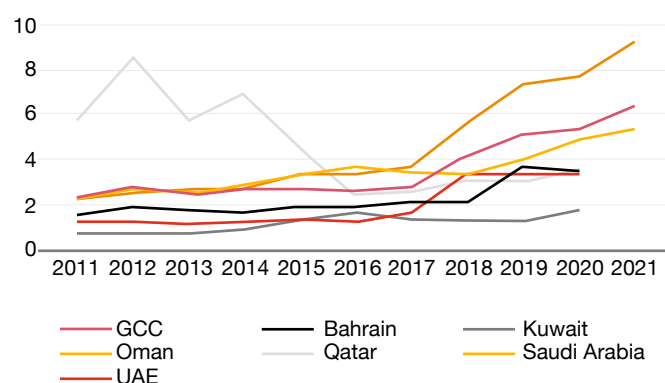
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Taxation expands

For most of our history, in the context of traditional taxes, the GCC has generally been a no-tax, or very low tax, zone, as governments have funded themselves from oil. This has been viewed as part of the social contract by nationals and has helped attract expatriate workers and investors to the region (and is part of the appeal of Dubai's new remote worker visa scheme). However, the tax environment is now changing rapidly, spurred by the challenge of lower oil prices since 2015 and by a growing appreciation, particularly over the last year, that the clean energy transition requires a rethink of the region's model. Efforts to diversify both economies and public finances are finally beginning to make progress, but the challenge is to prevent those two objectives from working against each other.

Tax revenue trends (% GDP)



Source: Ministries of finance (outturn 2011-19, budgets for 2020/21), IMF Article IV reports, PwC estimates

The bulk of the tax increases since 2017 have come from VAT, applied so far in three countries, and from so called "sin tax" excise duties, applied everywhere but Kuwait. Together, VAT and excise tax raised around \$24bn, more than a quarter of the total tax revenues in 2019. The tripling of VAT in KSA in July 2020 and the launch of VAT in Oman in April should see the take double again to about \$47bn this year- nearly half of all GCC taxation. The other major increase has come from KSA's expat levies, phased in since 2017, which raised about \$15bn in 2019.

Customs duties, which comprised over a third of regional tax in 2016, have been declining in nominal terms, on lower imports, and so their share fell to only 12% in 2019. The increase in some duties in KSA last summer will have some impact, but other states are expected to maintain the flat 5% rate on most goods. The scope and rates of corporate income taxes haven't changed much for years, except in Oman, and so this element of tax remains fairly stagnant in nominal terms. This means that proportionally, it has fallen from over half of regional tax in 2014 to less than a quarter in 2019.

The push/pull effect of increased international scrutiny

Our governments understand the importance of a good international financial reputation so will take their own steps to improve credibility,

but elevated cross-border business activity will automatically bring them under international compliance requirements. Evidence of this can already be seen, for example, in the introduction of the Economic Substance Regulations in the UAE, and the increasing number of double tax treaties entered into by regional governments, designed to increase investment into and through our region.

Offsetting the negatives

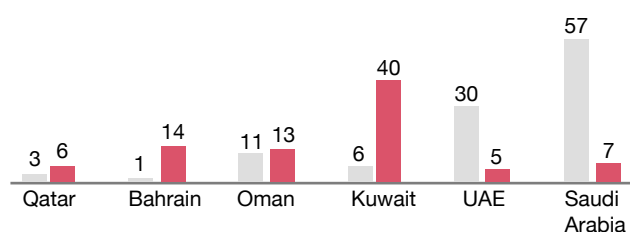
Boosting the tax take is a high priority, particularly for the countries with the least fiscal space and reserves, such as Oman, Bahrain and, to a lesser extent, KSA. However, there are risks that the increasing cost and complexity of taxes could weigh on local businesses, particularly during this difficult period of recovery from the pandemic, impeding efforts to attract foreign investment to help move economies beyond oil, and potentially generating social discontent.

One response has been to grant temporary exemptions. Most GCC states offered these during 2020, particularly to firms in the sectors most affected by local lockdowns. Even before the pandemic, KSA was providing exemptions for manufacturing firms and SMEs to the burdensome expat levy. Short-term exemptions are fine, but businesses also need longer-term predictability to facilitate investment and risk-taking.

One way that predictability can be provided is through free zones that are not subject to some or all onshore taxes, such as Qatar Science and Technology Park. This could help some of the region's free zones remain relevant at a time when the onshore business environment, including the possibility of 100% foreign ownership, is finally catching up with them. Even onshore, some countries are offering tax holidays as part of their incentives package to attract foreign investors. The most prominent current initiative is KSA's Programme HQ, which is offering tax holidays of up to 50 years to companies that relocate their regional hubs to Riyadh.

Tax policy (global rankings)

■ Paying Taxes (PwC, 2020)
■ Distortive effect on competition (WEF, 2019)



Source: PwC/World Bank, World Economic Forum. N.B. Kuwait's weaker rank from WEF is due mainly to its subsidies, not taxes.

Focusing on the positives

To put things in perspective, the GCC is still a very low-tax environment by international standards. OECD taxes, by comparison, average 34% of GDP and even KSA's tax take is still in the bottom decile globally. The GCC tax regimes also continue to rank among the best in the [Paying Taxes 2020](#) report, compiled by PwC and the World Bank, and have taxes that are considered among the least distortive to competition, according to the World Economic Forum. These good rankings can be maintained, even as the tax take increases, through structuring taxes appropriately and investing in efficient tax systems that minimise the administrative burden on companies (and on individuals, as Oman prepares to introduce the GCC's first personal income tax).

Tax policy can also be used to encourage positive outcomes; with careful policy design, taxes have the potential to provide a win for revenue generation, a win for cost of collection and, importantly, a win for competitiveness. KSA's White Land Tax is helping address the problem of undeveloped urban plots at a time of housing shortages and its expat levy, albeit controversial, aims to boost Saudisation in the private sector. Further innovation should be encouraged that incentivise energy efficiency and investment in renewables. Moreover, the increase in taxes required as part of economic diversification could work to phase out largely inefficient, overly complex 'service fees' commonplace throughout the GCC, absorbing these into broader-based, simpler forms of taxation. This approach would also create a more transparent approach to taxation, which is another clear positive.

Data and projections: April 2021

	GDP share (2020)		Real GDP growth (% y/y)			Inflation (% y/y)			Fiscal bal. (% GDP)	
	PPP	MER	Q3-20	2020e	2021p	Jan-21*	2020e	2021p	2020e	2021p
Middle East	100%	100%	-	-4.9	2.9	3.8	2.9	4.0	-7.1	-10.9
GCC	60.2%	68.6%	-	-5.1	2.1	2.3	1.1	2.8	-6.2	-9.1
Saudi Arabia	33.2%	33.6%	-4.6	-3.9	2.6	5.7	3.6	3.7	-10.6	-6.0
UAE	13.4%	17.5%	-	-6.6	1.3	-1.8	-1.5	1.5	-9.9	-5.1
Qatar	5.3%	7.3%	-4.5	-4.5	2.5	-1.3	-2.2	1.8	3.0	3.3
Kuwait	4.2%	5.4%	-11.5	-8.1	0.6	3.0	1.0	2.3	-8.5	-10.7
Oman	2.7%	3.1%	-	-6.4	1.8	-1.6	-0.9	3.9	-17.4	-5.4
Bahrain	1.5%	1.7%	-6.9	-5.4	3.3	-2.7	-2.3	2.8	-12.8	-9.2
Non-GCC	39.8%	31.4%	-	-4.5	4.7	7.1	6.8	6.6	-14.9	-11.3
Egypt	26.7%	17.9%	0.7	3.6	2.8	4.3	5.7	4.8	-8.0	-8.4
Iraq	8.2%	8.8%	-	-10.9	1.2	0.9	1.0	11.5	-20.3	-16.2
Jordan	2.1%	2.1%	-2.2	-3.0	2.5	-0.4	0.1	1.3	-6.8	-5.5
Lebanon	1.6%	0.9%	-	-25.0	-	146.0	85.5	-	-16.5	-
Libya	0.7%	1.1%	-	-66.7	76.0	2.8	22.3	15.1	-102.9	-43.2
Palest. Terr.	0.5%	0.7%	-11.2	-11.5	3.5	-0.6	-0.7	0.7	-7.6	-4.9

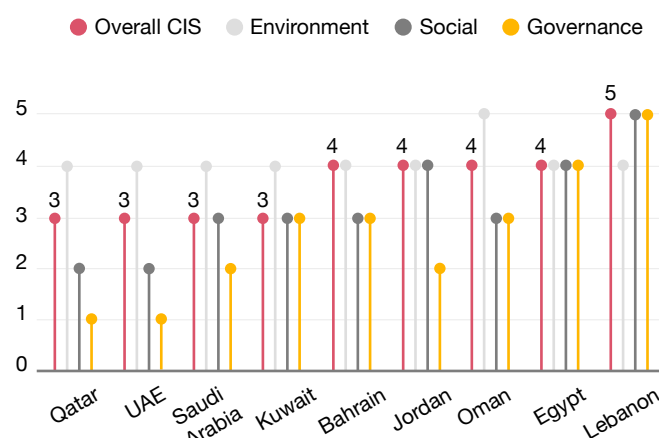
Sources: PwC analysis, National statistical authorities, IMF estimates and forecasts (WEO, October 2020 or more recent country reports, which tend to be more optimistic than the October WEO). *Older inflation series: Dec: Lebanon, Libya
Notes: The Middle East region is defined here based on PwC's business coverage (which excludes non-Arab countries, Syria and Yemen).

Chart of the quarter

Given the increasing focus on Environmental, Social and Governance (ESG) concerns by investors, and society more broadly, credit rating agencies have begun incorporating these factors into their sovereign rating methodologies. In February, Moody's published its first such assessment for Middle Eastern states, based on a simple 1-5 scoring system in which 1 is the best.

Its analysis shows that many Middle Eastern states share similar weaknesses, including exposure to arid climates and hydrocarbons as well as governance shortcomings and the potential for social unrest because of unemployment or human rights violations. Moody's awards the best overall Credit Impact Scores of 3 (which it still terms "moderately negative") to Qatar and the UAE, due to their strong governance and fewer social concerns. However, Oman, perhaps surprisingly, is classified as the weakest in the GCC due to greater perceived environmental exposure. Lebanon is the only country in the region with the worst overall CIS score of "5" due to its very visible governance and social shortcomings. Perhaps the measurement of these ESG factors will help spur improvements in the region.

Moody's ESG scores



Source: Moody's

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