USSBC Economic Brief
Economic Impact of VAT Increase

Overview

Saudi Arabia's dual shock of the coronavirus pandemic and a crash in oil prices has led to more than SAR270 billion ($72 billion) in stimulus spending and a significant deficit in the first quarter. Oil exports fell more than 65 percent in the month of April while the Kingdom's flagship crude grade Arab light hit a low of $14 per barrel as global oil demand collapsed. Saudi Arabia's decision to raise the value-added tax (VAT) to 15 percent is a bold, long-term decision that demonstrates the Kingdom's commitment towards its economic reform agenda. The pandemic has accelerated the need for increased non-oil income and raising the VAT is one of the avenues that will help achieve diversification. In the short term, there will be fiscal and economic challenges as citizens face increased consumer prices and businesses face lower demand amid a global recession in 2020. In the long term, the Kingdom's decision is geared towards retaining its fiscal strength in a post-COVID world and reaffirming a commitment to its Vision 2030 non-oil programs.

VAT Introduction

Saudi Arabia implemented the 5 percent VAT alongside the United Arab Emirates in 2018 as part of a broader framework agreement with GCC nations. Bahrain followed in 2019 with a 5 percent VAT and Kuwait plans to introduce a 5 percent VAT in 2021. Saudi Arabia's decision was in line with recommendations from the IMF that included energy price reform, public sector wage bill rationalization, and the introduction of a consumption tax to build a foundation for government non-oil revenues. The most recent IMF Article IV Consultation recommended that Saudi Arabia increase the VAT rate to 10 percent, though the recommendation was conditioned on coordination with GCC countries. The IMF further estimated the VAT rate increase to 10 percent would have a 2 percent positive impact on GDP by 2024, far exceeding water and wage reforms or savings from capital spending and interest payments.

The VAT, Saudi Arabia's first broad-based consumption tax, was introduced successfully with a business registration threshold of SAR1,000,000 ($267,000) annually. In 2019, the threshold was lowered to SAR300,000 ($80,000) annually in 2019 which broadened the tax base considerably. With the recent increase, the original list of zero-rated and exempted items will not change after July 1. These include the

Albara'a Alwazir
Economist
alalwazir@us-sabc.org

Jacob Dichter
Economic Research Assistant
jdichter@us-sabc.org

leasing of residential real estate, certain financial services, qualifying medicines and medical goods, some transportation and hospitality services, and all exported goods and services. The higher VAT rate does apply to electricity and water bills issued after July 1 and imported goods based on the date of importation.

Why is the VAT being raised?

The fall of oil prices and oil demand in the first quarter of 2020 led to a budget deficit of SAR34.1 billion ($9.1 billion) while total revenues declined 21.7 percent to SAR192.1 billion ($51.2 billion). In Q1, oil revenues fell 24 percent and non-oil revenues fell 17 percent on a yearly basis. The latest available trade data for April 2020 showed a 65 percent decline in oil revenues. Non-oil revenue is expected to decline further in Q2 as business lockdowns and curfews were fully in effect. The General Authority for Tax and Zakat (GAZT) has also postponed some taxes and fees until Q3 to alleviate pressure on families and businesses.

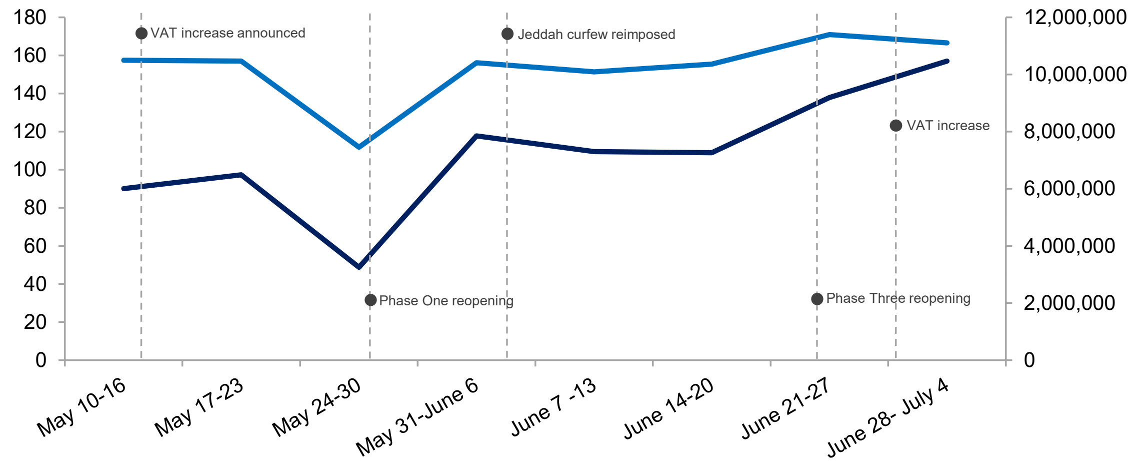
Along with the VAT increase, the government also announced it would cut the cost of living allowance on June 1 and initiate broad spending cuts in response to the economic crisis. The allowance of SAR1,000 ($267) per month to state employees was introduced in 2018 to help offset increased financial burdens including VAT and a rise in the price of oil. The announced government spending cuts thus far for 2020 has totaled SAR97.5 billion ($26 billion), accounting for approximately 10 percent of the budgeted yearly expenditures. By increasing the VAT and nullifying the cost of living allowance, the Kingdom is pushing ahead in its strategy to provide the government with more income resources. Together with the increase in VAT and cost of living removal, Saudi Arabia will further look to reduce its expenditures through continued energy and water price reforms, increases in expat levies, and higher custom tariffs.

What will be the effect of the VAT increase?

In the short term, we expect a negative impact on foreign direct investment (FDI) as business costs and consumer prices will generally increase. The higher costs for businesses will be especially challenging for large firms and SMEs still recovering from the coronavirus pandemic. VAT deferments offered by GAZT at the beginning of the pandemic will also come due around the time of the VAT increase. The VAT hike will also likely accelerate inflation in the second half of the year. Higher business costs will be passed onto consumers and may lead to a slowdown in consumer spending in the medium-term. The brief period between businesses reopening and July 1 has provided a short-term boost in spending. According to the latest data from the Saudi Arabian Monetary Authority, YTD point of sale (POS) spending by volume and value grew by 52.8 percent and 14.5 percent, respectively. Sectors that witnessed significant increases in the number of transactions ahead of the VAT hike such as building and construction materials (+71 percent), electronics (+42 percent), furniture (+26 percent), transportation (+22 percent), and food & beverage (+88 percent) highlight price sensitivities of Saudi consumers.

The growth in new businesses and consumer spending has put Saudi Arabia in a stronger position to pursue a transition to non-oil revenue sources such as a consumption tax. Although the depth of the current global recession continues to evolve, the long-term outlook of the VAT increase has a positive upside given the economic trends seen prior to the coronavirus pandemic.

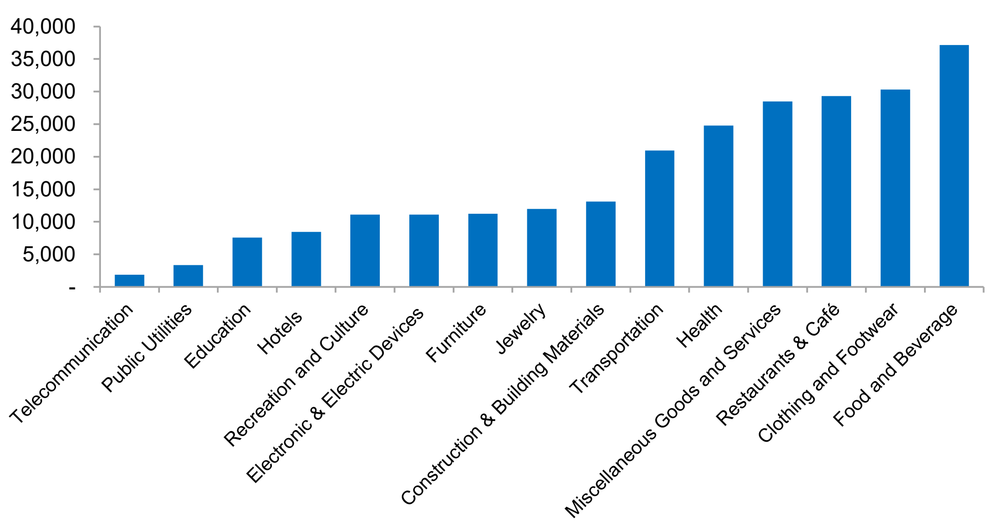
Average and Total Value of POS Transactions (SAR)



Source: Saudi Arabian Monetary Authority, Saudi Press Agency, USSBC

Food and retail sales have surged in Saudi Arabia over the past ten years as shopping and dining out are increasingly available and popular. Restaurants and cafes are one of the fastest growing businesses in Saudi Arabia; the value of POS transactions have grown at a 45.6 percent CAGR since 2016. Education, healthcare, hotels, culture and recreation, and construction materials are among other fast-growing spending segments. Many of these sectors, particularly travel and hospitality, are not expected to fully recover in the third or fourth quarter of the year. The resilience of consumer and business spending in H2 2020 will be an important measure to watch but the VAT increase is ultimately aimed towards a fiscal future in 2021 and beyond.

Value of POS Transactions by Sector (2019, SAR Million)



Source: Saudi Arabian Monetary Authority

According to Ipsos' Primary Consumer Sentiment Index, based on a survey conducted in early June following the announcement of the VAT increase, the proportion of Saudi respondents who cited taxes as one of their top three concerns doubled to 29 percent compared to the previous month. Taxes ranked as the third highest concern behind COVID-19 (65 percent) and employment (31 percent).

In Focus: VAT Impact on the Residential Real Estate Sector

The real estate sector will face added headwinds with the increase of the VAT to 15 percent. The slow down in construction stemming from the COVID-19 has caused delays to construction projects because of stay at home orders and the return of blue-collar expatriate laborers to their home countries. The increase in the VAT will pose challenges to real estate developers, as their input costs in construction and operation & maintenance will decrease their profitability. A developer with SAR100 million in projects will see their VAT related costs surge from SAR5 million to SAR15 million, a substantial increase for a sector that faces growing pressure on margins. The initial result could lead to delays in ongoing projects and a reexamination of future projects.

In the residential real estate sector, consumer behavior may shift towards a decrease in home purchases while potentially increasing rental transactions. Renting real estate will become more attractive as the VAT added on sales may price out potential home buyers. However, the Ministry of Housing has stepped in to limit the impact on new home buyers by covering the cost of VAT for homes priced SAR850 thousand ($227 thousand) and lower. This may encourage residential real estate developers to focus more on affordable housing schemes at a time when record mortgage lending is being witnessed in the Kingdom. According to SAMA, the year to date value of residential mortgages surged to SAR45.7 billion in 2020, registering an 82 percent increase compared to the same period last year. The robustness in demand for affordable housing will lure in more real estate developers as the Kingdom aims to increase home ownership to 70 percent by 2030.

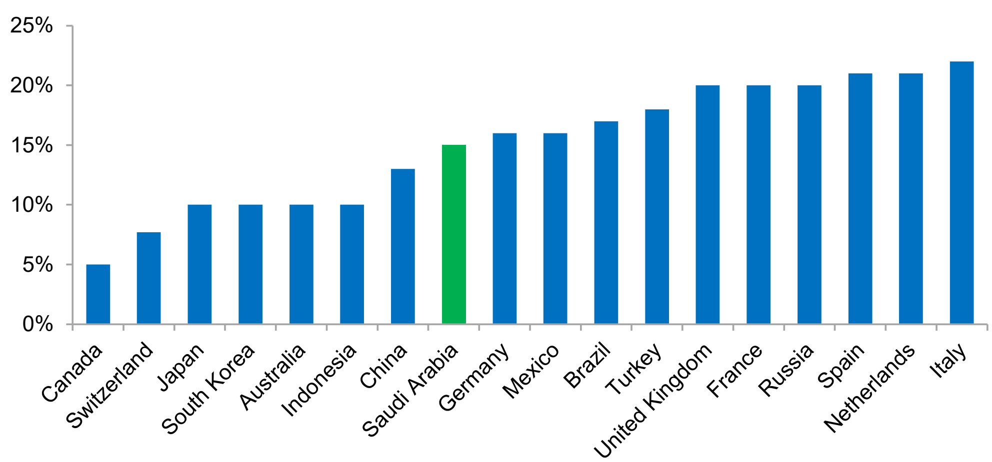
However, more respondents indicated they felt secure in their jobs compared to the prior month though a majority knew someone who had lost their job recently. 51 percent stated the economy remained strong and 70 percent believed economic conditions will improve in the next months.

Concerns of a second wave of COVID-19 persist as Saudi Arabia has witnessed an uneven decline in daily new cases and has not yet seen a significant decline in death rate. A global COVID-19 resurgence presents a significant downside risk to businesses and a successful transition towards the higher VAT rate.

How does Saudi Arabia's VAT rate compare to other nations?

Saudi Arabia's new VAT rate is in line with other G20 countries, though the rate of increase is unprecedented.

VAT Rates Among G20 Nations (2020)

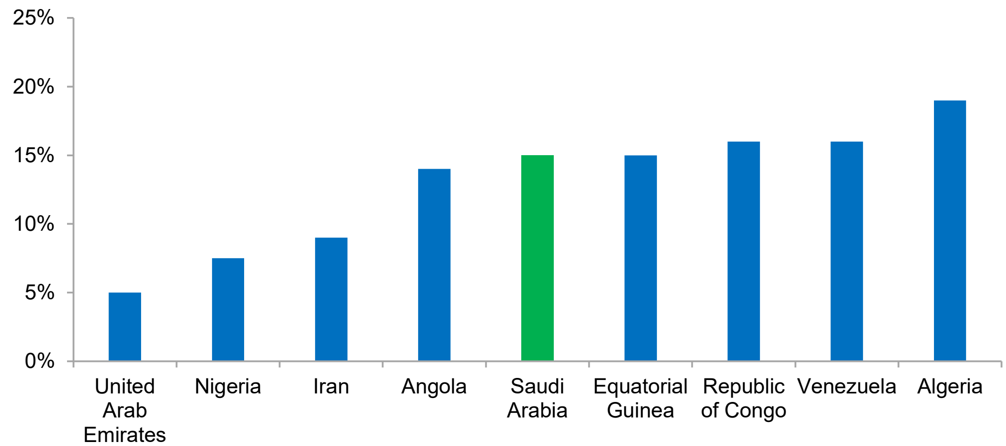


Source: Tax Foundation, Ernest & Young, PricewaterhouseCoopers
India is excluded from this chart as VAT rates vary widely by state. For Brazil, the ICMS rate is used.

According to the Organization for Economic Cooperation and Development (OECD), the average VAT rate across its member states stands at 19.3 percent. The European average VAT rate is an even higher 21.4 percent, and this includes Eastern European economies such as Poland (23 percent), Hungary (27 percent), and Belarus (20 percent).

Among OPEC nations, Saudi Arabia previously had one of the lowest VAT rates and now ranks among the group's median rate. Other major oil-producing nations like Russia raised its VAT rate from 18 percent to 20 percent in 2019.

VAT Rates Among OPEC Countries (2020)



Source: Ernst & Young, TradingEconomics
*Kuwait plans to introduce a 5% VAT in 2021

While the timing and degree of the VAT increase is sudden, the decision can be understood as reflecting the Kingdom's willingness to endure short-term difficulty for long-term benefit. The IMF also noted that Saudi Arabia's c-efficiency, an indicator of VAT compliance and efficiency, reached the median level of advanced and emerging market economies in its first year of implementation. The introduction of the 5-percent VAT in 2018 was considered to be minimally disruptive to the non-oil economy and inflation. The July VAT increase is likely to be more disruptive and compounded by the pandemic-related economic downturn. The Kingdom's bold fiscal moves ultimately reflect a reaffirmation of its reform agenda away from a reliance on hydrocarbon extraction.