



UNITED ARAB EMIRATES

SELECTED ISSUES

August 2015

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July 13, 2015

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STRENGTHENING FISCAL POLICY AND BUDGET FRAMEWORKS IN THE UAE¹

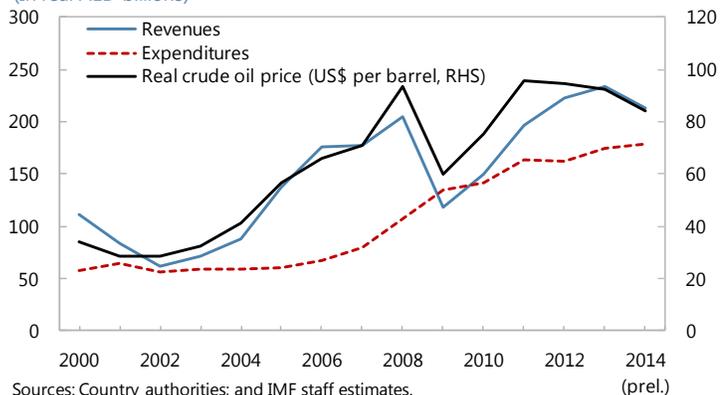
Given the large drop in oil prices, expenditure-containing measures are needed to reduce fiscal vulnerabilities and bring the fiscal stance back to consistency with intergenerational equity. These measures could target energy subsidies and other transfers, capital transfers to Government Related Entities (GREs), and other government expenses. Designing fair, simple, and effective tax systems could also contribute to fiscal consolidation efforts. Strengthening budgeting processes and developing a consolidated forward-looking fiscal framework would help achieve the desirable fiscal policies.

1. This paper proposes ways to ensure long term fiscal sustainability. It provides an overview of government’s revenue and expenditure developments. The paper presents fiscal sustainability analysis that is most relevant to such countries with large hydrocarbon wealth as the UAE. It discusses measures to contain expenditure growth—controlling the public wage bill, reducing subsidies and transfers, and stabilizing other expense in real terms. The paper also proposes options to increase nonhydrocarbon revenue such as broadening corporate income tax with lower rates, introducing a low rate-broad based value added tax, and levying an excise tax on automobiles. It also proposes ways of strengthening budgeting processes in Abu Dhabi to support fiscal policy implementation, and to prepare a consolidated fiscal framework for the UAE as a whole.

A. Revenue and Expenditure Trends

2. Total revenue and expenditure of general government have increased substantially since 2000 in real terms (Figure 1). Driven by increases in the oil price and hydrocarbon production, real total revenue grew by 11 percent on average in 2000–14. Such strong growth in revenue allowed increasing total expenditure substantially, by about 10 percent on average in real terms in the same period. While spending is usually procyclical to oil prices in the UAE, it was countercyclical in the aftermath of the 2008–09 global financial crisis when the authorities were implementing the policy of supporting weakened demand.

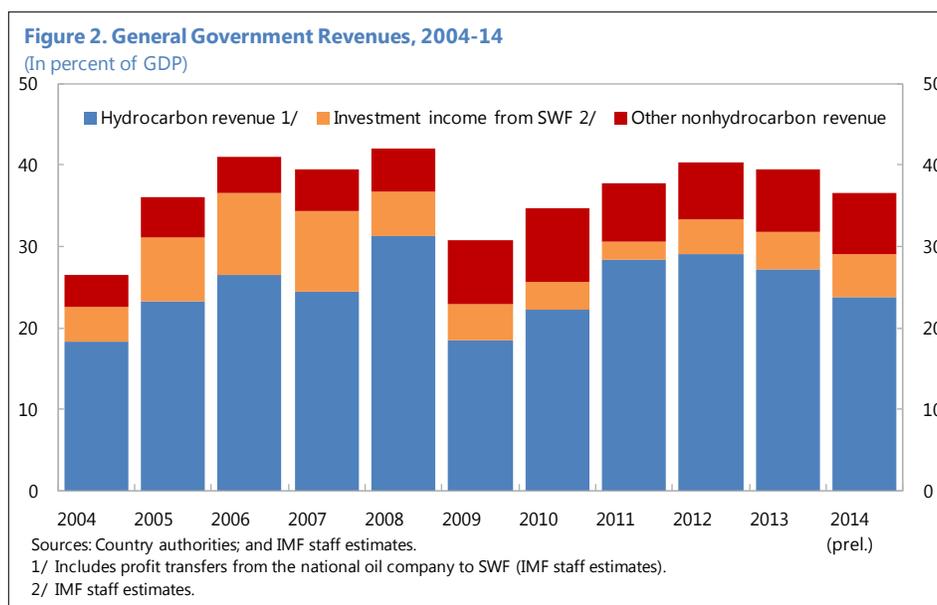
Figure 1. Total Revenues, Expenditures, and the Oil Price, 2000–14
(In real AED billions)



3. General government revenue depends strongly on hydrocarbon revenue. Oil and gas revenue amounted to 24 percent of GDP

¹ Prepared by Bahrom Shukurov under the guidance of Zeine Zeidane and with assistance from Juan Carlos Flores.

in 2014, up from 18 percent in 2004 (Figure 2).² In terms of total general government revenue, oil and gas accounted for 65 percent in 2014. Nonhydrocarbon revenue excluding investment income from SWFs increased to about 8 percent of GDP in the last five years from 4-5 percent in 2004-08, mostly from new fees for government-provided services. Investment income from SWF amounted to about 5 percent of GDP in 2014.³



4. Nonhydrocarbon revenue is mainly collected by the federal and Dubai governments.

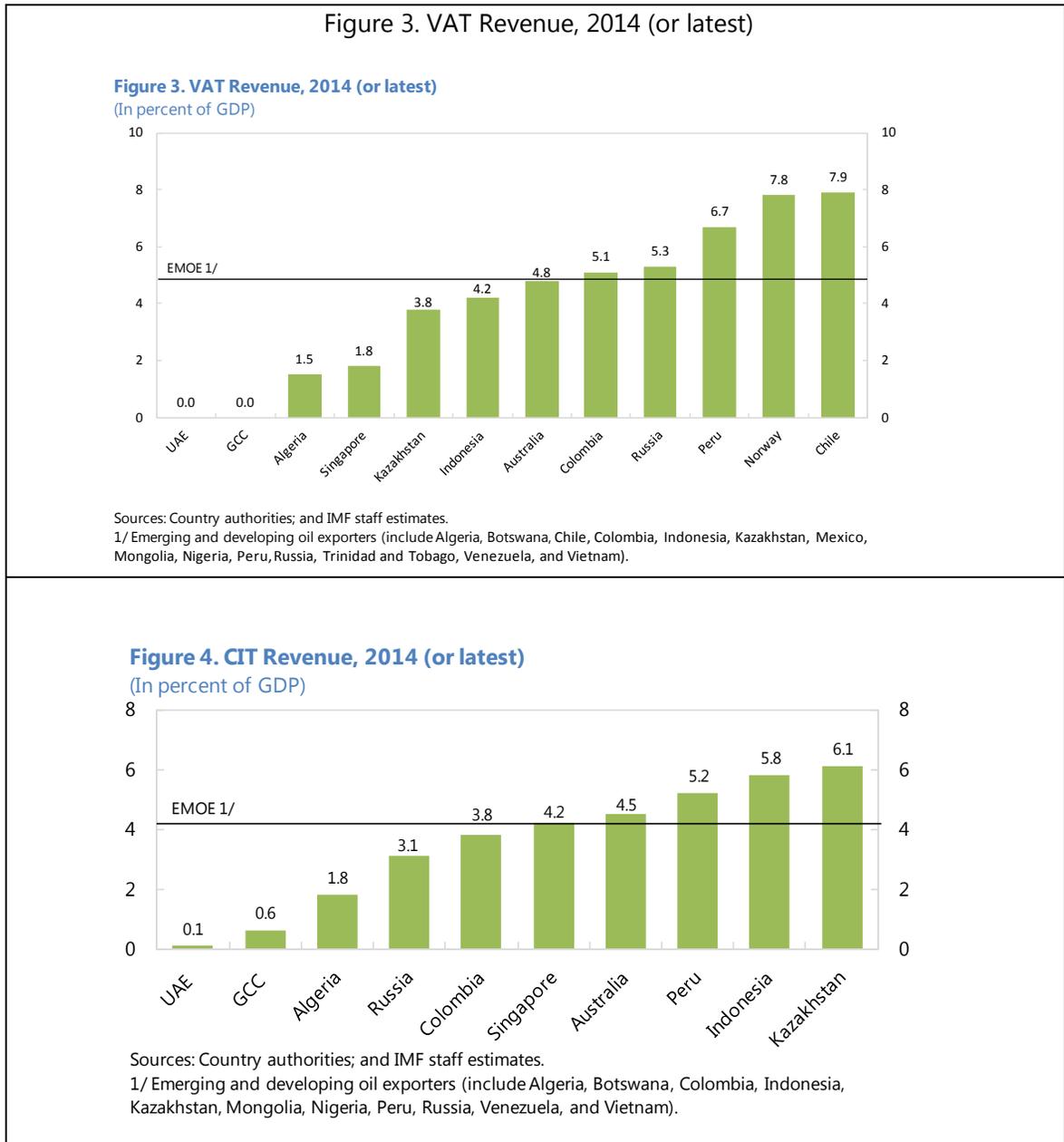
- Nonhydrocarbon revenue, excluding investment income, amounts to about 20 percent of total revenue or about 8 percent of GDP. Half of nonhydrocarbon revenue comes from Dubai. The federal government collects most of the remaining nonhydrocarbon revenue (about 3 percent of GDP).
- The tax structure is as follows: corporate income tax (CIT) of 20 percent levied on foreign banks in Dubai; local municipal property tax of 5 percent of the rental value; a 10 percent local hotel tax on hotel services; the GCC's common external tariff (a general rate of 5 percent, 50 percent on alcohol, and 100 percent on tobacco⁴) applied locally; and numerous fees on government services (applied by the federal and Dubai governments).

² Hydrocarbon revenue as presented here and in Figure 2 includes profit transfers from the national oil company to the sovereign wealth fund (SWF). These profit transfers are not reflected in the official budget statistics and are estimated by IMF staff.

³ Investment income flows from SWF' investment activities abroad are estimated by IMF staff and are not reflected in the official budget statistics.

⁴ There are no explicit forms of excise taxation in the UAE.

- The UAE, as other GCC countries does not collect VAT and excises, while collecting CIT only partially, missing an opportunity to diversify its revenues and strengthen the fiscal position—oil exporters in other regions collect VAT from 1.5 percent of GDP in Algeria to about 8 percent of GDP in Chile and Norway, and about 4 percent of GDP in CIT revenue and 1 percent of GDP in excise taxes (an average for emerging and developing oil exporters) (Figures 3–5).

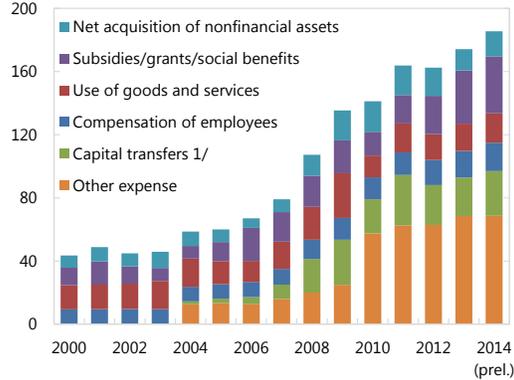




5. Total expenditure of general government increased because of strong growth in government expenses (Figures 6, 7). Government expenses grew by about 10 percent on average in 2000-14 in real terms. The largest contributors to the growth in government expenses were capital transfers to Abu Dhabi's government-related entities (GREs)⁵, other expense that includes security, defense, and administrative spending, and grants to foreign governments. Wages and net acquisition of non-financial assets increased more modestly, by 5 percent and 8 percent, respectively, in 2000-14 on average in real terms. However, wage growth was stronger over the last several years, at 10 percent on average annually, raising the average monthly wage in public administration to the levels compared with the highly profitable financial intermediation and mining sectors (Figure 8). Relative to GDP, total expenditure stabilized at 30 percent over 2011-13, but increased to 32 percent in 2014. UAE's total expenditure in terms of GDP is lower than in other GCC countries and advanced and emerging oil/commodity exporters on average (Figure 9). There is room, however, in rationalizing expense to bring it to lower levels (e.g. as in Chile and Singapore).

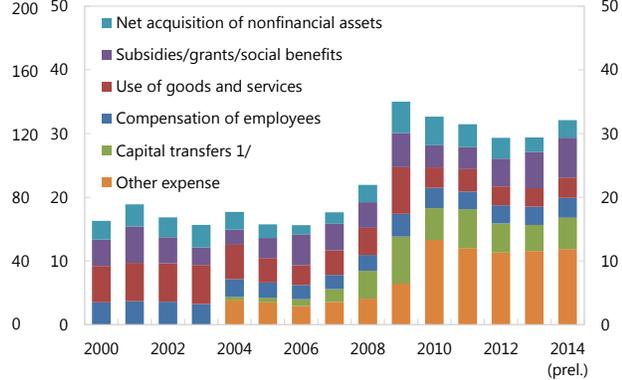
⁵ These capital transfers have started since 2008 with the Abu Dhabi government supporting the economy through GRE spending on development projects.

Figure 6. Government Expenditure, FY2000–14
(In real AED billions)



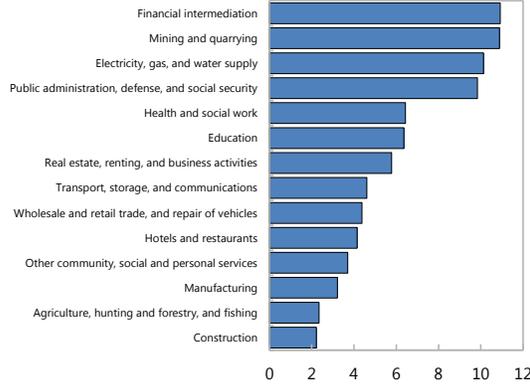
Sources: Country authorities; and IMF staff estimates.
1/ Abu Dhabi loans and equity to GREs.

Figure 7. Government Expenditure, FY2000–14
(Percent of GDP)



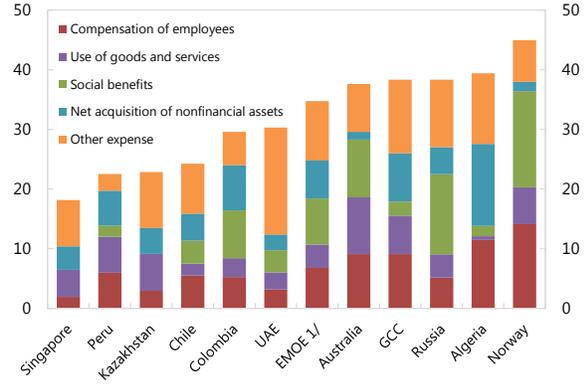
Sources: Country authorities; and IMF staff estimates.
1/ Abu Dhabi loans and equity to GREs.

Figure 8. Average Monthly Wages per Employee, 2008
(Thousands of Dirhams)



Source: Country authorities.

Figure 9. Government Expenditure in Commodity Exporters, 2014
(in percent of GDP)



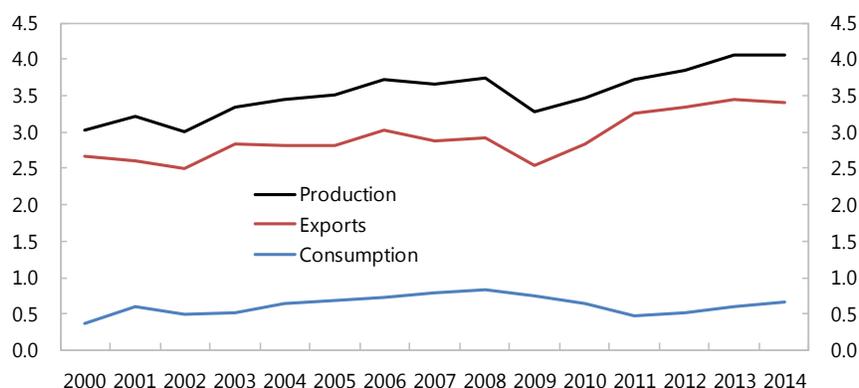
Source: World Economic Outlook (IMF).
1/ Emerging and developing commodity exporters (include Algeria, Botswana, Chile, Colombia, Indonesia, Kazakhstan, Peru, Russia, and Venezuela).

Subsidies

6. Low energy and water prices resulted in large subsidies and elevated consumption of energy products. Sizable subsidies in the UAE, as in other GCC countries, are government’s main way to share wealth, provide social protection, and support industrial sectors. These subsidies are the main reason behind substantial domestic consumption of energy products (Figure 10). On-budget subsidies in the UAE amounted to 2 percent of GDP in 2014 with Abu Dhabi’s water and electricity subsidies accounting for half of it. Total (implicit) energy subsidies were estimated at 5.7 percent in 2011.⁶

⁶ The 5.7 percent of GDP in energy subsidies is estimated by the IMF for 2011. The 2014 IMF paper uses the international fuel price as the benchmark price to estimate the cost of subsidies (the country would generally incur an opportunity cost if it simply sold the fuel at the domestic production cost).

Figure 10. Hydrocarbon Production, Consumption, and Exports, 2000–14
(Millions of barrels per day)



Sources: Country authorities and IMF staff estimates.

7. With lower oil prices and higher tariffs on electricity and water, these subsidies are expected to decline, but will still remain high. While the highest in the region, UAE's retail fuel prices are lower than international market levels (Table 1).⁷ This implies that implicit subsidies for petroleum products still exist. Abu Dhabi's higher water and electricity tariffs since January 2015 and lower oil prices are expected to result in budget savings of 0.5 percent of GDP in 2015. Because of lower oil prices, the UAE will save another 0.4 percent of GDP from lower natural gas implicit subsidies (Table 2). As a result, total (implicit) subsidies are expected to decline to 4.6 percent of GDP in 2015. The size of the subsidies is still high: for example, government spending on health and education was 3 percent of GDP in 2013.

Table 1. Retail Prices of Gasoline and Diesel
(June 2015 or latest; in US\$ per liter)

	Gasoline	Diesel
Saudi Arabia	0.14	0.06
Qatar	0.21	0.41
Kuwait	0.23	0.37
Algeria	0.23	0.14
Bahrain	0.27	0.27
Oman	0.31	0.38
Iraq	0.39	0.34
Iran	0.42	0.11
UAE	0.47	0.64
United States	0.74	0.76

Sources: Arabian Business, Bloomberg, Datastream, EIA, GlobalPetrolPrices, Ministry of Energy of UAE, Numbeo, and The Peninsula Newspaper.

Table 2. UAE: Pre-tax Subsidies
(In percent of GDP)

	2011	2015
Petroleum products	0.5	0.2
Electricity	1.9	1.4
Natural gas	3.4	3.0
Total	5.7	4.6

Source: IMF

⁷ UAE's retail fuel prices were close to international market levels in Q4 2014 – Q1 2015.

8. Water consumption rates and technical losses are high in the UAE, as in other GCC countries (Box 1). Because of water usage's low tariffs for individuals and industries, implicit natural gas subsidies are high, as natural gas is the main fuel used in producing fresh water in desalination plants. Inefficient agriculture, weak institutional arrangements, and poor management practices result in large water and natural gas subsidies.

B. Fiscal Sustainability Analysis

Fiscal vulnerabilities and intergenerational equity

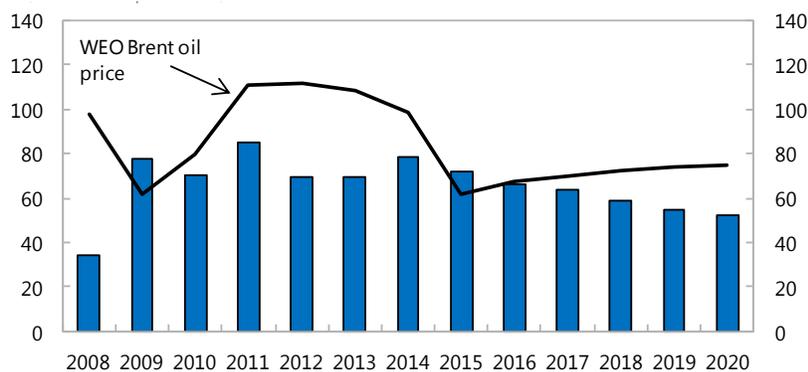
9. Fiscal consolidation is needed to reduce fiscal vulnerabilities. The fiscal break-even oil price of general government is estimated at \$72 per barrel in 2015, an indication of risks associated with permanently low oil prices. Under the authorities' fiscal consolidation path, the fiscal break-even oil price would fall below the projected oil price levels in 2016 (Figure 11).

10. Fiscal consolidation would also ensure that fiscal policy is consistent with intergenerational equity. Staff analysis based on the permanent income hypothesis suggests that under conservative baseline assumptions the government does not save its exhaustible oil revenue sufficiently for future generations, but favorable persistent shocks could imply a smaller gap.⁸ The gap between the projected deficits and the deficits consistent with a constant real per capita annuity is 11 percent of nonhydrocarbon GDP in 2014. With fiscal consolidation assumed by the authorities (the baseline), the gap is projected to almost disappear by 2020. If beyond the forecast period, consolidation continues in the same pace as envisaged for 2020 under the baseline, the fiscal stance would be fully consistent with intergenerational equity by 2022 (Figure 12). Another approach in estimating annuity would yield different results: the constant real annuity rule would imply a negative gap of 9 percent of nonhydrocarbon GDP in 2020. Both types of annuities are used in the literature.⁹

⁸ Long-term sustainability assumes intergenerational equity by calculating a constant real per capita government spending path (and related nonhydrocarbon deficit) that delivers a constant real per capita annuity to finance government spending after hydrocarbon revenues are exhausted. Projections until 2020 are based on staff's macroframework, including the WEO assumptions about the oil price. After 2020, the baseline scenario assumes flat hydrocarbon production and annual oil price growth of 2 percent, inflation of 2 percent, population growth of 1.5 percent, and real return on assets of 4 percent. Alternative scenarios assume (i) lower population growth by 0.5 percentage point, (ii) lower real return on assets by 1 percentage point, (iii) lower oil price by \$10 in 2015–20 and to remain constant thereafter, and (iv) higher oil price by \$10 in 2015–20 and to increase by 2 percent per annum in nominal terms thereafter.

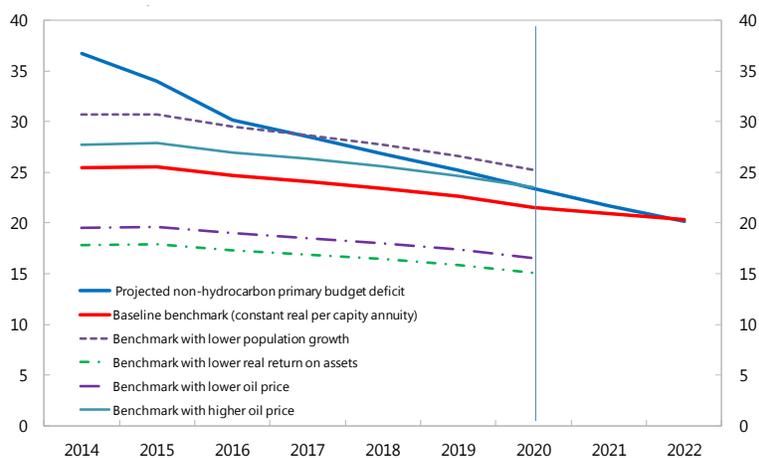
⁹ See Bems, R., and I. de Carvalho Filho, 2009, "Exchange Rate Assessments: Methodologies for Oil Exporting Countries," IMF Working Paper 09/

Figure 11. Fiscal Break-Even Oil Prices, 2008–20
(U.S. dollars per barrel)



Source: IMF staff estimates.

Figure 12. Fiscal Sustainability Analysis, 2014–20
(Percent of non-hydrocarbon GDP)



Source: IMF staff calculations.

Structural primary balances

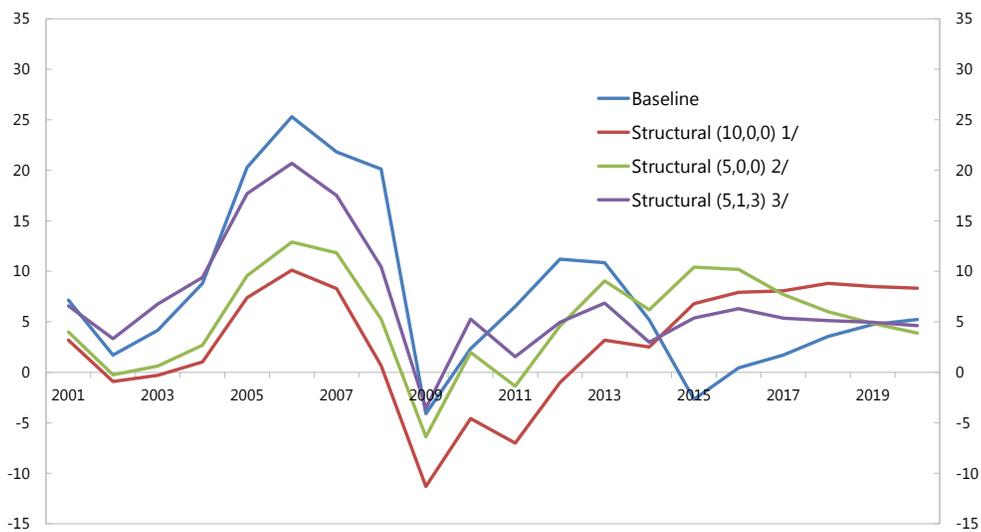
11. Targeting a “structural” primary balance can be a useful complement to the sustainability analysis presented above.¹⁰ The structural primary balance is defined as the primary balance excluding the cyclical component of resource revenues. The structural primary balance target could be set to ensure the sustainability of a fiscal policy framework, with the smoothing rule delinking expenditures from volatility in hydrocarbon prices that can result in a pro-cyclical fiscal

¹⁰ For more details, see *Macroeconomic Policy Frameworks for Resource-Rich Developing Countries*, IMF, 2012. For policy options in adopting various fiscal rules, see *Towards Stronger Fiscal Policy and Institutions in the GCC*, IMF staff paper prepared for the 2012 GCC Annual Meeting of Ministers of Finance and Central Bank Governors.

stance. An important decision to be made is to determine the reference price when computing structural resource revenues. International experience suggests two approaches: the reference oil price could be set by using an automatic formula (the most common approach) or by an independent committee. Both approaches can protect fiscal policy from the pressures of the political cycle.

12. The choice of a price formula will depend on a preference for smoothing expenditures and adjusting to changes in prices. Figure 13 depicts the behavior of structural primary balances under the different price rules in the UAE case (the baseline balances follow the same revenue and expenditure trends as discussed in the intergenerational equity analysis above). Price formulas with a short backward-looking horizon (5,0,0) or with a short backward-looking horizon combined with the current year and a short forward-looking horizon (5,1,3) result in primary balances that better track price changes but which at times may be associated with a more pro-cyclical fiscal policy. Price rules with long backward-looking formulas (10,0,0) imply smoother expenditure paths but may under- or over-shoot revenues if price trends change. The 5,1,3 price rule, applied to the revenue and expenditure paths that bring the fiscal stance to a broad consistency with intergenerational equity by 2020, suggests that the structural primary balances should be 5 percent of GDP in 2020. The 10,0,0 price rule, applied under the same scenario as the 5,1,3 price rule, would indicate the structural primary balances at 8 percent of GDP in 2020.

Figure 13. UAE Baseline and Structural Fiscal Balances, 2001–20
(In percent of GDP)



Source: Country authorities; IMF staff calculations.
 1/ A 10-year moving average of hydrocarbon prices (prices of the past 10 years).
 2/ A 5-year moving average of hydrocarbon prices (prices of the past five years).
 3/ A 9-year moving average of hydrocarbon prices (prices of the past five years and projected prices for the current and the next three years).

C. Sustainable Fiscal Policy Measures

Revenue options

13. A fair, simple, and effective tax system is needed to raise nonhydrocarbon revenues in order to strengthen sustainability and intergenerational equity. Given the UAE's significant surpluses from hydrocarbon revenues, the main principle for guiding tax policy in the UAE should be low tax rates and very broad bases. Such tax policy generally would limit negative effects on investor and consumer behavior. This principle would also be consistent with the economic diversification strategy. In parallel, tax reform efforts need to focus on strengthening administrative capacity.

14. A corporate income tax (CIT) with broader coverage but lower rates would raise additional revenue and would be seen as more equitable by foreign investors. The tax rate could be lowered to 10 percent from the current 20 percent and the coverage could be broadened by including all companies (foreign, domestic, GCC) except for those located in free economic zones. In addition, a broadened CIT, if applied to unincorporated companies, could provide some progressivity in taxation and would lessen the need to introduce a general income tax on individuals. This measure is estimated to yield 4.1 percent of nonhydrocarbon GDP (Table 3).¹¹

15. The value added tax (VAT) would serve well as a low rate-broad base tax. VAT is generally viewed as the most stable revenue source, which has the least detrimental effects on investments. In such a macro-fiscal environment as in the UAE, a low rate, for example 5 percent, VAT could be considered. A broad-based consumption tax such as VAT would raise revenue proceeds at a low efficiency cost. At the same time, its equity implications would be relatively insignificant in such a macro-fiscal environment as in the UAE, where taxes are minimal and government expenditures are financed by oil revenue. Tax administration would receive a significant and positive boost. The progress in this area depends on how soon VAT frameworks are agreed within the GCC, which are committed to implement a VAT in the medium term.¹² The estimated yield from introducing the VAT is 2.7 percent of nonhydrocarbon GDP.¹³

¹¹ The following methodology was used to estimate the yield from CIT: (i) calculating profits of nonhydrocarbon and nonfree zone corporations by subtracting compensation of employees, profits of hydrocarbon companies (assumed at 90 percent of hydrocarbon exports), and profits of free zone companies (assumed at 20 percent of free zone exports) from gross domestic product (all based on the 2013 data); (ii) applying the 10 percent CIT to the profits of nonhydrocarbon and nonfree zone corporations; (iii) applying the tax effort ratio of 58 percent that is observed in nonoil countries of the MENA region (IMF, 2013); and (iv) subtracting the existing corporate income tax revenue that is collected from foreign banks in Dubai from the CIT revenue calculated as per above.

¹² The UAE authorities have indicated their preference to proceed with a VAT reform jointly with the GCC.

¹³ The following methodology was used to estimate the yield from VAT: (i) applying the 5 percent VAT to the 2013 final consumption amount; and (ii) applying the tax effort ratio of 58 percent that is observed in nonoil countries of the MENA region (IMF, 2013).

16. Excises on passenger vehicles could also be considered for raising non-oil revenue.

Automobiles impose a number of costs on society. These costs include direct costs such as the cost of maintaining and expanding a network of roads, and indirect costs such as productivity losses due to traffic jams and health costs because of increased pollution. Imposing an excise tax on automobiles would shift costs associated with the usage of automobiles to the owners. Ad valorem tax of 15 percent would yield 0.6 percent of non-hydrocarbon GDP.¹⁴ Gains from excises on tobacco and alcohol would be insignificant.

17. Fees and charges for government-provided services should not be seen as a substitute for taxes.

If fees are lower than the cost of government goods and services (other than public goods and services), raising those fees would be a welcome step. Raising fees for revenue generating purposes could, however, become a complex and inefficient process. A number of relevant shortcomings are as follows: (i) fees distort supply and demand by (for example) encouraging government to keep supplying goods and services it is not efficient at producing; (ii) fees are inequitable and not transparent; (iii) fees are generally more expensive to administer. In addition, the only way to tax private transactions would be to extend fees to private contract – for example, in the form of stamp duties. The alternative to the fee system would be to introduce a single-rate transaction tax on provision of all goods and services, whether by government or private entities (e.g. VAT).

*Expenditure measures***18. Containing government expense and prioritizing investment would help buttress fiscal sustainability and achieve intergenerational equity.**

Policies targeting gradual adjustment in expenses could bring about 8 percent of non-hydrocarbon GDP of savings by 2020 with only mild impact on growth. Such gradual expense controlling measures could save about 15 percent of non-hydrocarbon GDP by 2026, helping to bring the fiscal stance in line with intergenerational equity thresholds (Table 3):

- *Controlling the public wage bill.* The authorities need to develop a clear medium-term strategy for the public wage bill to stabilize the size per capita and limit wage increases to correspond to productivity gains. This would help keep wages broadly constant as a share of nonhydrocarbon GDP going forward.
- *Continue reducing energy and water subsidies and slowing growth in other transfers,* while protecting those in need. Higher electricity and water tariffs in Abu Dhabi (since January 2015) in combination with lower oil prices will result in on-budget savings of 0.5 percent of nonhydrocarbon GDP in 2015. Further gradual increases in electricity and water tariffs could

¹⁴ The following methodology was used to estimate the yield from the excise tax on automobiles: applying the 15 percent excise tax on the 2013 value of net imports of automobiles (imports minus re-exports).

be implemented to bring additional savings of 0.6 percent of nonhydrocarbon GDP by 2020. Containing growth in or reducing other transfers would lead to savings of 1.1 to 3.1 percent of nonhydrocarbon GDP by 2020, depending on the pace of consolidation.

- *Lowering capital transfers to Abu Dhabi GREs* is needed to strengthen the Abu Dhabi government finances. In the long term, such capital transfers should be eliminated altogether with the GREs only implementing commercially viable projects. Lowering capital transfers to GREs would bring savings of 3.5 to 5.8 percent of nonhydrocarbon GDP by 2020, depending on the speed of consolidation.
- *Stabilizing other expenses in real terms.* Over the last four years, other expenses increased by 7 percent in real terms on average annually. Implementing this measure would provide savings of 3 percent of nonhydrocarbon GDP by 2020.
- *Maintaining government investment at unchanged levels relative to nonhydrocarbon GDP* and prioritizing investment projects would also help control spending growth. Capital spending should be based on a careful scrutiny of public investment projects. A resource envelope for all public investment projects needs to be prepared.

Table 3. Illustrative Menu of Options for Fiscal Adjustment

Illustrative Menu of Options for Fiscal Adjustment			
Expenditures	Estimated gains in 2015-20 1/		Comments
	IMF staff	Authorities	
Total	9.0	13.4	
Water and electricity subsidies	1.1	1.1	Removal of water and electricity subsidies
Other transfers	1.1	3.1	Slowing growth in other transfers
Capital transfers	3.5	5.8	Lowering capital transfers to Abu Dhabi GREs
Containing growth in other expense	3.3	3.3	Stabilizing other expense in real terms
Revenues	Estimated gains once fully implemented 1/		
	IMF staff-proposed revenue options		
Total		7.4	
CIT		4.1	Applying the CIT of 10 percent (to UAE, GCC, and foreign companies)
VAT		2.7	Introducing a 5 percent VAT
Excise tax		0.6	Introducing a 15 percent excise tax on automobiles

Source: IMF staff estimates.
1/ In percent of non-hydrocarbon GDP.

19. Reducing energy and water subsidies, explicit and implicit, will not only lead to a lower burden on public finances but will also reduce welfare costs that stem from the distortion of relative prices in the economy.¹⁵

- Subsidies on energy products foster overconsumption and are inefficient in supporting the poor. As mentioned earlier, overconsumption reduces exportable resources and external balances, and therefore limits wealth accumulation leaving fewer resources to future

¹⁵ For more details, see *Subsidy Reform in the Middle East and North Africa*; IMF, 2014

generations. Other negative effects include adverse impacts on congestion, health, the environment, and inefficient specialization of domestic production. Subsidies also crowd out productive spending on human and physical capital.

- Reducing energy and water subsidies and gradually replacing them with appropriate social safety net instruments, especially cash transfers, would lead to stronger social protection and higher priority expenditure on education and health amid strengthened fiscal positions. Modernizing agriculture, collecting more renewable water, and improving allocation and stemming water losses through better regulation should be implemented in parallel.
- In the short term, removing energy and water subsidies will have some inflationary impacts and may have negative effects on the competitiveness of industries that use subsidized products as inputs. In the medium term, removing subsidies will eliminate distortions, rationalize energy use, and enhance competitiveness, which are all positive contributors to sustainable economic growth.

20. The UAE has started to embark on energy subsidies' reforms, as other GCC countries.

The recent subsidy reforms in the UAE include raising retail fuel prices in 2010, developing a comprehensive water and electricity consumption strategy in Abu Dhabi, and increasing water and electricity tariffs. The UAE authorities recognize that subsidies encourage over-consumption and are currently studying the effects stemming from the existing energy subsidies—the study will be submitted to the cabinet soon. Other GCC countries have also been raising tariffs for gas, electricity, and water, preparing energy sector strategies, and improving energy efficiency standards and desalination technologies (Table 4).

Table 4. Recent Subsidy Reforms in the GCC

Recent reforms	
Bahrain	Industrial tariffs for gas in Bahrain were increased by 50 percent on January 1, 2012. Tariffs for electricity and water for non-domestic use were also raised (in October 2013).
Kuwait	A study on the impact of a differentiated electricity and water tariff structure has been completed in 2014. Subsidies on diesel have been discontinued.
Oman	Plans to double the feedstock gas prices by 2015. An energy sector study is ongoing, with a view to gradually reduce the overall fuel subsidy.
Qatar	Qatar raised the pump prices of gasoline by 25 percent and of diesel by 30 percent in January 2011. Diesel prices were again raised in May 2014, by 50 percent. Efforts are underway to improve desalination technologies and promote public awareness of sustainable use of energy.
Saudi Arabia	Saudi Arabia increased the average price of electricity sold to nonindividual users by 9.6 percent on July 1, 2010. Currently, to curb the rapid growth in energy consumption, the authorities are strengthening building and appliance energy efficiency standards, including in industry. Tighter vehicle emission standards and public transportation networks are planned over the medium-term.
United Arab Emirates	UAE increased gasoline prices in 2010 to the highest level in the GCC. Abu Dhabi is developing a comprehensive electricity and water consumption strategy, which led to an increase in tariffs in January 2015 (by 170 percent for water and 40 percent for electricity). Dubai raised water and electricity tariffs by 15 percent in early 2011.

Sources: Country authorities; *Energy Subsidy Reform: Lessons and Implications*, IMF, 2013; *Subsidy Reform in the Middle East and North Africa*, IMF, 2014.

21. International experience suggests that reforming energy subsidies is challenging, but implementable. An increasing number of countries around the world are reforming or have reformed energy subsidies (e.g. Brazil, Chile, Ghana, Indonesia, Iran, Mauritania, Nigeria, Peru, Philippines).¹⁶ The experience from these countries suggests that energy subsidy reforms can fail mainly because of the following: (i) too rapid increases in fuel prices and energy tariffs, (ii) lack of long-term commitment to reform, (iii) the inability to depoliticize pricing policy, (iv) failure to introduce appropriate social safety nets as part of the reform package, and (v) poor communication of the reform objectives and planned mitigating measures to the public. Box 2 presents an interesting experience of Indonesia in reforming energy subsidies.

22. The implementation of subsidy reforms will be successful if the reform package is comprehensive, transparent, gradual, and targeted. The reform package should consist of the following key ingredients:¹⁷

- *A comprehensive energy sector reform plan* that includes long-term objectives and an assessment of the impact of the reforms.
- *A comprehensive and well-planned communication strategy* that will help generate broad public support by informing the public of the cost of subsidies and the benefits of the reform.
- *Appropriately phased and sequenced price increases* that will allow households and enterprises to adjust.
- *Improved efficiency of state-owned enterprises* that will result in lower producer subsidies and therefore reducing the fiscal burden of the energy sector.
- *Targeted mitigating measures* that will alleviate the impact of energy prices' increases on the poor. Targeted cash transfers are the preferred approach to compensation.
- *Depoliticized price setting* that ensures a successful and durable subsidy reform. Adopting an automatic fuel pricing mechanism could be combined with a smoothing feature to avoid domestic fuel price volatility by allowing sharp increases in international prices to be only gradually transmitted to domestic prices. Responsibility for developing and implementing an automatic pricing mechanism can be given to an independent body. In the long term, fuel prices could be fully liberalized.

¹⁶ For more details, see *Case Studies on Energy Subsidy Reform: Lessons and Implications*; IMF, 2013.

¹⁷ Based on *Subsidy Reform in the Middle East and North Africa*; IMF, 2014 and *Case Studies on Energy Subsidy Reform: Lessons and Implications*; IMF, 2013.

D. Strengthening Budgeting Approach

23. Progress has also been made in reforming the federal and Dubai budgets, and preparing consolidated fiscal data. The federal government has introduced a three-year budget cycle. Spending ceilings are set top-down and spending is presented on a program basis with associated performance indicators. Dubai has a medium-term fiscal framework setting budget targets through 2017, though targets are not published. The Fiscal Policy Coordination Council, supported by the Ministry of Finance, now prepares consolidated historical fiscal data for the UAE as a whole, an important step towards developing a medium-term fiscal framework.

24. Abu Dhabi produces an unofficial report on the medium-term fiscal outlook and has started work on performance-based budgeting, but achieving greater predictability and credibility of the annual budget is a priority. Strong Public Finance Management systems (PFM) will need to be put in place to keep spending in check (firm expenditure controls, timely and reliable fiscal reporting based on international standards, transparency). In addition, setting a mechanism that would prevent frequent budget amendments during the course of the year would help achieve more credibility in the annual budget process.¹⁸

25. Once the annual budget process in Abu Dhabi has been strengthened, the following phases of developing a strong medium-term budgeting approach should be implemented:

- *First phase (near term):* preparing an official medium-term fiscal strategy document that would serve as the basis for annual budget preparation. This strategy would be based on the top-down resource envelope, which is basically a macroeconomic model estimating revenues, expenditures, nonhydrocarbon balances, and a fiscal anchor (e.g. based on the intergenerational equity and structural primary balance analyses).¹⁹ Fiscal risk analysis indicating the sensitivity of fiscal plans to different macroeconomic and hydrocarbon sector assumptions would also be part of this strategy.
- *Second phase (medium term):* matching a top-down resource envelope with a bottom-up estimation of the costs of existing policies (or in other words preparing a medium-term budget framework). The Abu Dhabi Department of Finance (DOF) would engage in bottom-up reviews by scrutinizing sector policies aiming at integrating the bottom-up sector programmes with the top-down resource envelope. At the end of this phase, the medium-term budget framework would be fully functioning and integrated in the annual budget process, with the annual budget becoming the first year of the former.

¹⁸ Revenue and spending overruns have been a usual practice in Abu Dhabi. The initial budgets have traditionally been amended over the course of the year leading to substantial gaps between outturns and initial budgets.

¹⁹ The Abu Dhabi Department of Finance already prepares a medium-term framework, but on an informal basis (it is not officially approved by the Abu Dhabi government).

- *Third phase (medium term)*: gradually turning the medium-term budget framework into a performance-based expenditure framework. The Abu Dhabi DOF has already embarked on developing performance-based budgeting. At this phase, budget funding will be linked to results (shifting the focus from controlling inputs to controlling outcomes and allocating resources according to the results achieved by programs).

26. Strong budgeting frameworks endorsed by the top level decision-makers would result in improved fiscal discipline. These frameworks would help the budget process facilitate counter-cyclical government spending (with medium-term perspectives built-in). They would also lead to better resource allocation through linking policy, planning, and budgeting, and therefore, more efficient use of public finances. The second and third phases of developing a medium-term budgeting approach as described above are part of the Abu Dhabi Comprehensive Financial Plan (ADCFP) currently under consideration. It is essential that the government approves and operationalizes the ADCFP swiftly.

27. It is important that the medium-term budgeting is fully integrated in the annual budget process. In practice, achieving such integration is challenging and a budgeting framework may remain a stand-alone document. For this framework to be successfully integrated in the annual budget process, top-down resource envelopes will need to be credible, while close coordination among the macro-fiscal unit, the budget department, and other relevant departments would be essential. A medium-term budgeting framework that is not endorsed by top policy decision makers—the Executive Council of Abu Dhabi—and/or prepared without the cooperation of the budget department is unlikely to maintain credible spending ceilings and, as a result, might not influence the annual budget process.

28. Box 3 presents Korea’s experience in introducing medium-term budgeting. As in the UAE, there were no imminent serious fiscal issues in Korea. Rather, there was widespread perception in the country of the need of budget reforms. Korea successfully introduced the budgeting framework in 2004 to incorporate longer term perspectives, including increasing social welfare spending, into the regular budget process. The Korean case highlights the importance of (i) having strong support for a medium-term budgeting framework from top policy decision makers; (ii) finding ways of integrating a medium-term budgeting framework into the budget process; and (iii) building capacity of relevant stakeholders.

29. Efforts in strengthening intergovernmental fiscal coordination should continue. In parallel to the strengthening of the Abu Dhabi budgeting process, the authorities should develop a consolidated forward-looking medium-term fiscal framework to set clearly the direction for fiscal policy for the UAE as a whole.

E. Conclusions

30. Expenditure-containing measures and revenue-raising options need to be considered to reduce fiscal vulnerabilities and ensure intergenerational equity. Driven by increases in the

oil price and hydrocarbon production, total revenue and expenditure of general government have increased substantially since 2000. Sizable government expenses present risks for fiscal sustainability in the medium to long term, especially in the context of low oil prices. Measures aimed at containing government expenses would help reduce fiscal vulnerabilities and bring the fiscal position back to consistency with intergenerational equity. Raising nonhydrocarbon revenues should also be considered to diversify revenues and contribute to fiscal consolidation efforts. The proposed revenue options include a corporate income tax with broader coverage and lower rates, a low rate-broad based consumption tax such as VAT, and excises on passenger vehicles. On the expenditure side, the proposed measures include controlling the public wage bill, reducing subsidies and capital and other transfers, and stabilizing other expense in real terms.

31. The paper proposes strengthening a budgeting approach and fiscal frameworks in the UAE. Priority should be given to achieving greater predictability and credibility of the Abu Dhabi annual budget by strengthening its PFM systems. The next step would be developing official medium-term budgeting in Abu Dhabi and preparing a medium-term fiscal strategy document that would serve as the basis for annual budget preparation. The medium-term budget framework would be integrated in the annual budget process, helping improve fiscal discipline. Over the medium term, the authorities would gradually turn the budget framework into a performance-based expenditure framework, with budget funding linked to results. In parallel to the Abu Dhabi budget reform process, the authorities need to develop a consolidated forward-looking medium-term fiscal framework to set clearly the direction for fiscal policy for the UAE as a whole.

Box 1. Water Consumption in the GCC¹

On a per capita per annum (pcpa) basis, GCC countries consume about 65 percent more water than the world average — 816 cubic meters (m³) pcpa, versus 500 (m³) pcpa. Renewable resources, notably from rainfall and groundwater are in short supply, and these countries depend on desalinating seawater, which is energy intensive, imposing a cost on the economy and the environment. For example, Saudi Arabia and the United Arab Emirates (UAE) consume between 10 and 39 times the amount of renewable water available to them, depleting their aquifers at much faster rates than they can be replenished by rainfall. Only Oman comes close to having enough water from renewable sources to meet its domestic demand. Reflecting the average population growth of about 3 percent and a sizable influx of expatriates since 1970, per capita freshwater availability dropped substantially, from 680 cubic meters in 1970 to 180 cubic meters in 2000.

To satisfy the growing demand, the GCC has been building and operating costly desalination plants. Desalination provides two-thirds or more of the potable water used in most of the GCC, but it carries enormous economic and environmental costs. Despite a considerable improvement in efficiency in the last decades, the cost to desalinate seawater is still a relatively expensive way of producing potable water. Moreover, seawater desalination is an energy-intensive process, accounting for 10–25 percent of energy consumption in the GCC on average (about 50 percent in Qatar). The desalination process has increased the temperature and salinity of the Gulf, with the latter estimated to have risen by around 2 percent over the last 20 years, with a negative impact on marine life and ecosystems.

Inefficient agriculture, weak institutional arrangements, and poor management practices present a significant drain on water resources. Demand from the agriculture sector in the GCC constitutes up to 80 percent of total water demand (the sector enjoys quite a few privileges such as the absence of agricultural water tariffs and various incentive programs that result in excessive cultivation of water-intensive crops). At the same time, agriculture contributes only a few percentage points of GDP to the GCC's economies. There are also enormous irrigation losses, up to 40 percent. Some of the GCC countries are now trying to limit water overconsumption in agriculture (e.g. by encouraging local farmers to grow crops that need less water and phasing out projects to export wheat). Weak institutional arrangements and poor management practices are contributing to wastefulness of water resources. On average, about 20 percent of domestic water is either lost to leakage or is not metered.

Sizable subsidies finance the inefficient structure that results in high water consumption rates and presents fiscal risks in the long term. Qatar, Saudi Arabia, and the United Arab Emirates consume almost twice as much as the global average for water consumption, while other GCC countries are also above the global average. While data on water subsidies in the GCC are generally not available, they may reach up to a few percentage points of regional GDP. Rationalizing the water usage and reducing waste could reduce consumption substantially (e.g. up to 40 percent in Qatar).

¹ See *Achieving a Sustainable Water Sector in the GCC: Managing Supply and Demand, Building Institutions*; PWC, 2014; *Water Resources in the GCC Countries: An Overview*; Water Resources Management 14: 59–75, 2000.

Box 2. Energy Subsidy Reform in Indonesia¹

Reforming energy subsidies in Indonesia has been challenging. The fiscal costs of energy subsidies were high at about 3 percent of GDP in 2008. The Indonesian authorities have implemented several measures since 1997 to reduce subsidies and strengthen the fiscal position as well as improve energy efficiency and protect the environment.

The reform has been implemented with mixed success since 1997:

- In the aftermath of the 1997 Asian financial crisis, the government attempted to cut energy subsidies by increasing the prices of diesel and gasoline by 60 percent and 71 percent, respectively. The attempt was not successful as the announced increases in fuel prices were too large (instead of being gradually phased-in).
- In 2000-01, fuel prices were raised for households and industries and in 2003, the government attempted to introduce an automatic pricing mechanism. As these reforms were poorly communicated, and some of the announced compensation programs did not materialize, the government was forced to roll back some of the price increases and discontinue the implementation of the automatic pricing mechanism.
- In 2008, with international fuel prices at their peak, domestic fuel prices were successfully raised (by 29 percent on average) and subsidies to larger industrial electricity consumers were discontinued.
- In 2010, the government announced plans for removing fuel subsidies in the period ahead, but at the end of the year, budget allocations for subsidized fuel consumption were raised.
- In 2013, the government raised fuel prices, by 44 percent for gasoline and 22 percent for diesel. Electricity tariffs were increased for almost all types of customers—the increase in tariffs was levied every three months up to total capped increase of 15 percent year-on-year.

In December 2014, the government announced the removal of gasoline subsidies. Because of lower international oil prices, gasoline and diesel prices were actually reduced in January 2015. A new pricing mechanism was introduced: (i) gasoline to be sold at market prices, but the distribution costs to continue to be subsidized and (ii) price changes to be announced every two to four weeks. The government has started raising electricity tariffs on a monthly basis while publishing monthly electricity tariff announcements since May 2014.

Programs to protect the poor were introduced to accompany the energy subsidy reforms. The government increased spending on health, education, and social welfare. The programs also included other compensating measures such as unconditional cash transfer payments targeted at poor households, the health insurance for the poor, school operational assistance programs, and expanded rural infrastructure support projects. The more recent programs include the Poor Student Education Support program, the Hopeful Family Program conditional cash transfer, and the Productive Family Program, which cover education, financial assistance, and healthcare support implemented with card technologies.

The Indonesian experience presents interesting lessons. First, a too rapid reduction of subsidies can generate opposition to reform. Second, durable and successful reform requires long-term commitment to it. Third, ad hoc price adjustments and the inability to depoliticize pricing policy will inevitably lead to the reemergence of subsidies. Fourth, targeted cash transfers can reduce opposition to subsidy reform and assist the poor. And finally, effectively communicating the reform objectives and planned mitigating measures to the public can help promote the acceptance of reforms.

¹ Based on *Case Studies on Energy Subsidy Reform: Lessons and Implications*, IMF, 2013; *Indonesia Energy Subsidy Review*, GSI/IISD, 2014; *Indonesia Energy Subsidy Briefing*, GSI/IISD, 2015.

Box 3. Korea's Experience in Introducing Medium Term Budgeting¹

The Korean case is interesting because there were no urgent serious fiscal issues to commence the reforms. The medium-term expenditure reform (MTEF) was initiated because of a strong demand for budget reform agenda from a new administration and widespread perception in civil society organizations and public officials of the need for PFM reform. The MTEF was introduced to incorporate longer term perspectives such as increasing government debt, aging population, and increasing social welfare spending, into annual budget process.

The MTEF or “National Fiscal Management Plan” (NFMP) was introduced in Korea in 2004 and has been successfully implemented since then.² The reform package consisted of MTEF, top-down budgeting, performance-oriented budgeting, and an integrated financial management information system. The Ministry of Strategy and Finance (MSF) prepares macroeconomic projections for the next four years; line ministries provide cost estimates of their programs and submit their own medium-term fiscal plans. Based on these, the MSF develops the first draft of the NFMP that covers major policy directions, the fiscal aggregates, and tentative ceilings for line ministries. The Fiscal Strategy Cabinet Meeting is then held to finalize the spending ceilings for line ministries. Subsequently, guidelines to budget preparation are issued to line ministries, which develop budget requests for submission to the MSF. Following negotiation between line ministries and the MSF, the NFMP and budget draft are finalized. Each NFMP covers five years: the current year, the budget year, and three following years. The NFMP is a rolling document, which is revised every year.

The Korean case provides three main policy implications for MTEF reform.

- First, strong support from top decision makers is crucial for MTEF to cover the entire government. In the Korean case, the support of top decision makers sustained the medium-term budgeting reform until the institutionalization of MTEF in the National Assembly was achieved.
- Second, a MTEF must be integrated into the budget process. In the Korean case, the link between the MTEF and annual budgeting was top-down budgeting. This implies that the MSF had an important task of preparing credible spending ceilings with the active involvement of the central budget office, which is responsible for annual budgets. As Korean reformers realized, a MTEF developed without the cooperation of the budget office is unlikely to maintain credible spending ceilings. As a result, a MTEF may not be integrated into annual budgeting in practice.
- Third, enhancing the capacity of line ministries was essential to fully realizing the benefits of a MTEF. With the reform, line ministries' budget divisions required the capacity to develop ministerial budget drafts, aligned with government-wide priorities. To strengthen the ministerial budget divisions, the MSF upgraded the teams' status and added personnel. Successful medium-term budgeting reforms usually require plans for building the capacity of stakeholders.

¹ Based on *Achieving Medium-Term Expenditure Framework Reform, a Case Study of Korea*, The World Bank Policy Research Working Paper, 2013.

² An earlier attempt at a MTEF took place in Korea in 2001 focusing on integrating the existing medium-term plan into a regular budget process and aligning resources with the policy directions of the government. This attempt failed mostly because of lack of support from top policy makers.

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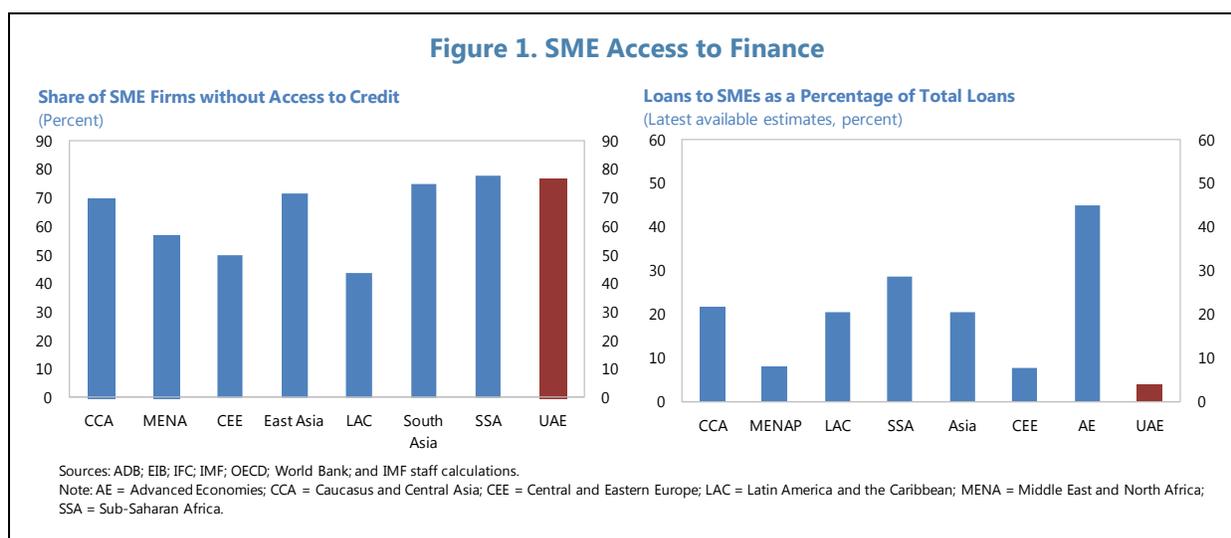
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SME ACCESS TO FINANCE IN THE UAE¹

A. Introduction

1. Access to finance ranks as a major constraint for the growth of small and medium enterprises (SMEs) in the United Arab Emirates (UAE). According to Khalifa Fund (2013), about 70 percent of formal SMEs have their credit applications rejected by banks.² In addition, the Dubai SME Agency has identified that 80 percent of start-ups—and 77 percent of SMEs—do not have access to credit. This lack of access is even lower than many countries in the Middle East and North Africa (MENA) and other regions (Figure 1). Although bank lending is its main source of funding, the SME loan portfolio consists of only 4 percent of total loans. The constraints are primarily related to cost of finance, lack of long-term finance products, high reliance on real estate collateral, and limited availability of other types of collateral. Leasing, factoring, and other credit products are also underdeveloped.



2. Expanding SME access to finance is crucial for economic growth and inclusion. Several indicators show that SMEs contribute to a large share of employment and social welfare in developing and emerging economies. In particular, SMEs contribute up to 86 percent of total employment and up to 60 percent of the non-hydrocarbon GDP in the UAE. The number of micro, and SMEs is estimated at about 300,000, representing 92 percent of all establishments in the Emirates. However, SMEs are unevenly distributed across the UAE, with most located either in Dubai (about 45 percent of total SMEs) or Abu Dhabi (about 32 percent). In addition, 73 percent of SMEs are in the trade and retail sectors.

¹ Prepared by Elias Kazarian and André Oliveira Santos.

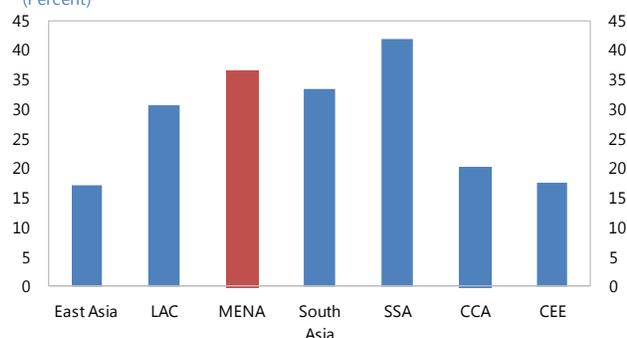
² Khalifa Fund is the independent Abu Dhabi government agency in charge of supporting SME development and growth.

B. Rationale for public intervention

3. Public sector support for SME finance could be justified when there is a market failure.

Public intervention could mitigate against the overall risk due to asymmetric information between lenders and borrowers. Higher lending costs are caused by the lack of effective financial market infrastructures such as accounting and auditing standards, credit bureau, credit registry, and secured transactions on immovable and movable property and solvency regimes. These facilities allow lenders to mitigate against risks and reduce lending costs, thereby benefiting borrowers. Public intervention may play an important role to support SME financing while the development of such infrastructure is under way.

Figure 2. Firms Identifying Access to Finance as a Major Constraint
(Percent)



Sources: ADB; EIB; IFC; IMF; OECD; World Bank; and IMF staff calculations.
Note: AE = Advanced Economies; CCA = Caucasus and Central Asia; CEE = Central and Eastern Europe; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa; SSA = Sub-Saharan Africa.

4. Public sector intervention could also be motivated by the lack of both collateral and sufficiently rigorous business records of borrowers. Lenders may be reluctant to grant loans to SMEs because of the lack of adequate collateral and financial statements, exacerbating the asymmetry of information—especially given the large percentage of expatriates in the population co-owning SMEs—and making lending to SMEs a risky and costly business. In addition, given the higher risk associated with SMEs, banks are required to hold higher capital accordingly. As result, lending rates charged to SMEs are higher than to established entities.

5. The institutional framework for SMEs is still under development. A new SME law has been approved that requires a uniform definition of SMEs across the Emirates, a minimum purchase of goods and services from SMEs in public tenders at the federal level, and grants other benefits. However, there is still no agreed definition of SMEs as the by-laws have still not been approved. The Abu Dhabi and the Dubai governments use different thresholds to define micro, small, and medium enterprises based not only on the number of employees but also on economic sector and turnover (Table 1).

Table 1. UAE: SME Definitions

	Employees			Turnover in AED Million		
	Micro	Small	Medium	Micro	Small	Medium
Abu Dhabi	<5	>5 and ≤19	>20 and ≤49			
Dubai						
Trading	≤9	>9 and ≤35	>35 and ≤75	≤9	>9 and ≤50	>50 and ≤250
Manufacturing	≤20	>20 and ≤100	>100 and ≤250	≤10	>10 and ≤100	>100 and ≤250
Services				≤3	>3 and ≤25	>25 and ≤150
UAE Banks Federation					≤50	>50 and ≤250

Source: Khalifa Fund SME (2013).

C. What Loans are offered to SMEs

6. The banking sector remains the main source of formal finance for the SME sector but the level of lending remains very low. More than 40 out of 52 banks provide credit facilities to SMEs. Products are customized to SMEs with credit facilities ranging from loans for working capital and investment, to receivables, asset-backed and real estate loans, and overdraft facilities, and vary according to the business purpose, collateral, term, amount, and other characteristics (Table 2). Even though there is a large number of products offered by banks, a large percentage of SMEs identify access to finance as the major constraint for business growth.

Table 2. UAE: SME Loans Offered by Banks

	NBAD	ENDB	ABCD	Mashreq
Working capital		Yes		
SME definition		Annual turnover of AED 50 million- AED 150 million	Annual turnover up to AED 100 million	Minimum annual turnover of AED 1.5 million
Amount	Up to AED 3 million		Up to AED 30 million	Up to AED 2 million
Tenor	Up to 48 months		Up to 48 months	Up to 48 months
Collateral	Free		Free Flexible	Free
Trade financing		Yes	Yes	NA
Amount	Up to Dhs5 million			
Tenor	Up to 48 months			
Collateral	Free			
Asset-backed		Yes	Yes	NA
Amount	Up to Dhs30 million			
Tenor	Up to 48 months			
Commercial real estate	Flexible	Yes	Yes	NA
Amount			AED 100,000 to AED 1.5 million	
Tenor			Upt to 48 months	
Overdraft	Flexible	Yes	Yes	NA
Term loans	Flexible	Yes	Yes	NA

Source: Company web pages.

D. Barriers to SME Development

7. There are many reasons why banks are hesitant to lend to SMEs. Banks' preference for name-lending, SMEs' financial literacy, and less developed infrastructure—including the credit registry, collateral enforcement, (movable) collateral registry, bankruptcy regime—can be listed as the main factors. As in other countries, SMEs' limited access to finance in the UAE reflects the interaction of demand, supply, institutional, regulatory, and other impediments.

Table 3. Getting Credit in Different Jurisdictions, 2014

Region	Strength of legal rights index (0-12)	Credit registry coverage (% of adults)	Credit bureau coverage (% of adults)
East Asia & Pacific	6.2	11.0	20.4
Europe & Central Asia	6.0	19.3	33.7
Latin America & Caribbean	4.8	12.6	39.3
OECD high income	5.8	12.1	67.0
South Asia	5.0	3.2	11.3
Sub-Saharan Africa	4.7	4.5	5.8
Middle East & North Africa	1.3	8.7	11.6
Bahrain	1.0	0.0	48.3
Kuwait	2.0	0.0	32.0
Oman	1.0	20.6	0.0
Qatar	1.0	23.3	0.0
Saudi Arabia	2.0	0.0	47.0
United Arab Emirates	2.0	6.8	28.3

Source: World Bank Doing Business.

8. Several constraints have been identified for SMEs access to credit and the respective policy actions needed to mitigate them:³

- *Insufficient financial information on SMEs.* The lack of financial information on SMEs exacerbates the problems arising from asymmetry of information, especially the adverse selection problem. As there is no corporation tax, SMEs are not required to keep adequate accounting records, implying a lack of financial information for credit assessment. In addition, the lack of effective credit registry and credit bureau coverage has contributed to unreliable credit histories for SMEs (Table 3). As a result, bank loans to SMEs are usually granted based on payrolls, which are not always accurate. Federal initiatives to address insufficient financial information include establishing a credit bureau and an SME rating agency to improve SME transparency. The central bank, with the support of the bank federation, has established a credit bureau containing positive and negative credit information. The Dubai government has also encouraged SMEs to use SME Financial Reporting Requirements.
- *Limited funding sources.* Alternative funding sources available to SMEs are limited in the UAE. Lending to SMEs is costly and risky, requiring more bank capital to cover high unexpected losses

³ See Abu Dhabi Department of Economic Development (2012), Dubai SME (2013), Khalifa Fund (2013).

than under other business lines, and limiting the supply of bank credit to SMEs. In addition, nonbank financial institutions—such as microfinance institutions, leasing companies, private equity, or venture capital firms—are underdeveloped. As alternative sources of funding, there are 26 finance companies and 25 financial investment companies licensed by the central bank. Their share is less than 1 percent of the total financial system and their activities are mainly concentrated toward leasing and equity trading. In addition, the recently established secondary market for trading in shares of private joint-stock companies—an initiative under the Securities and Commodities Commission—could provide a new funding source for SMEs and a way-out to venture capital and other investors. The lack of alternative funding sources and the high interest rates and fees charged by banks result in SMEs relying on their own funds for working capital and investment.

- *Weak legal framework.* Given the nature of their operations, SMEs lack adequate collateral and cannot restructure delinquent loans under the umbrella of a bankruptcy regime. Some important legal impediments preventing greater levels of collateral include: (i) the requirement that pledged assets be under the control of a lender, discouraging the pledge of movable assets needed for business operations—market practice in Dubai allows for possessory pledge with a delivery of title to the pledged assets and affixation of plates; (ii) the ineligibility of sole establishments or civil partnership companies with no commercial register to take commercial mortgages; (iii) the inability of limited liability companies to pledge quotas in their capital; (iv) the lack of a central security register to ensure pledged assets do not have a lien; and (v) the absence of a trustee law.⁴ A weak bankruptcy regime implies that bankruptcies in the UAE are expensive (20 percent of the estate) and have a low recovery rate (28 cents on the dollar) (Table 4). To reduce the high cost of bankruptcy and the low associated recovery, a new bankruptcy framework is currently under discussion.
- *Lack of a supportive regulatory framework.* The central bank regulations do not have a standard definition of SMEs for reporting purposes. The new SME law is currently awaiting the agreement of a definition at the federal level to enact its regulations. The lack of a regulatory guidance for loan guarantee schemes does not allow banks to benefit from the associated capital relief either. According to regulatory restrictions, only SMEs that are 100 percent owned by nationals have access to public funds and guarantees.
- *Financial literacy.* SMEs have a weak understanding of the requirements in a loan application. Capacity building is needed to make SMEs bankable. Initiatives to mitigate against lack of financial literacy include designing training programs with banks and universities and other official programs. SME compliance costs with bank requirements have also increased as a result of anti-money laundering and financing of terrorism legislation at the domestic and international levels.

⁴ Dubai Economic Council (2013).

Table 4. Resolving Bankruptcy in Different Jurisdictions, 2014

Region	Time (years)	Cost (% of estate)	Recovery rate (cents on the dollar)	Management of debtor's assets index (0-6) 1/	Reorganization proceedings index (0-3) 2/	Strength of insolvency framework index (0-16) 3/
East Asia & Pacific	2.6	21.8	36.8	3.2	0.9	8.1
Europe & Central Asia	2.3	13.3	37.7	3.7	1.4	9.2
Latin America & Caribbean	2.9	16.4	36.0	3.0	0.5	8.2
OECD high income	1.7	8.8	71.9	5.4	1.8	12.2
South Asia	2.6	10.1	36.2	2.0	0.2	5.6
Sub-Saharan Africa	3.1	23.3	24.1	4.0	0.4	7.9
Middle East & North Africa	3.1	13.9	34.0	3.1	0.1	6.6
Bahrain	2.5	9.5	41.6	4.0	0.0	7.0
Kuwait	4.2	10.0	32.1	3.0	0.0	6.0
Oman	4.0	3.5	37.7	3.0	0.0	6.0
Qatar	2.8	22.0	56.0	6.0	0.0	9.0
Saudi Arabia	2.8	22.0	28.7	0.0	0.0	2.0
United Arab Emirates	3.2	20.0	28.6	4.0	0.0	9.0

Source: World Bank Doing Business.

1/ Ranges from 0 to 6, with higher values indicating more advantageous treatment of the debtor's assets.

2/ Ranges from 0 to 3, with higher values indicating greater compliance with internationally accepted practices.

3/ Ranges from 0 to 4, with higher values indicating greater participation and rights of creditors.

9. Authorities have also strived to reduce high transaction and setup costs, which will help SME bankability. According to the World Bank Doing Business Report, the cost of doing business in the UAE is high. For instance, the cost of starting a business is about 6 percent of the per-capita income, which is higher than in other GCC and high income OECD countries (Table 5). High transaction and setup costs are the result of high fees at different government agencies. The federal and local governments have been active in reducing the transaction and setup costs. Initiatives include: (i) the new company law, which has exempted minimum capital requirements for company establishment; (ii) the new SME law, which has reduced fees at a federal level and has triggered similar reduction by the Emirates; and (iii) a new forthcoming bankruptcy law, which will reduce the costs involved in closing companies.

Table 5. Starting a Business in Different Jurisdictions, 2014

Region	Procedures (number)	Time (days)	Cost (% of income per capita)	Paid-in min. capital (% of income per capita)
East Asia & Pacific	7.3	34.4	27.7	256.4
Europe & Central Asia	5.0	12.1	5.3	5.8
Latin America & Caribbean	8.3	30.1	31.1	3.2
OECD high income	4.8	9.2	3.4	8.8
South Asia	7.9	16.0	14.6	14.2
Sub-Saharan Africa	7.8	27.3	56.2	95.6
Middle East & North Africa	8.0	18.9	28.1	45.6
Bahrain	7.0	9.0	0.8	192.2
Kuwait	12.0	31.0	1.9	74.0
Oman	5.0	7.0	2.4	206.3
Qatar	8.0	8.5	5.2	62.6
Saudi Arabia	9.0	20.5	4.0	0.0
United Arab Emirates	6.0	8.0	6.3	0.0

Source: World Bank Doing Business

E. Public Sector Interventions in the UAE

10. Public sector interventions to improve the limited access SMEs have to finance have focused on subsidized lending to eligible SMEs. Independent government agencies from the Abu Dhabi, Dubai, and Sharjah Emirates provide eligible SMEs with several forms of assistance, including funding and credit guarantees, training, infrastructure, and other facilities. However, the eligibility criteria restrict public funding only to nationals. As a result, the reach of public sector intervention is limited and reflected in the number of SMEs benefiting from different programs. In addition, the actions of each government agency are not coordinated at the national level.

Key public funding programs in the UAE include:

- *Mohammed Bin Rashid Fund (MBRF).* Established in 2012 within the Dubai SME government agency, it provides loans and financial guarantees (with 80 percent coverage ratio) to support Dubai SMEs. The MBRF has three programs. The first is a credit guarantee scheme available to eight banks since 2003. The program guarantees loans up to AED 3 million, with a low interest rate, three-year grace period, and five-year settlement period. The second is the Seed Fund for startups created in 2010. Its loans are interest-free and cover up to AED 250,000. Finally, the venture capital program established in 2011 has funded more than 60 projects through the network of eight banks.
- *Khalifah Fund (KF).* It was established in 2007 as an independent agency of the Abu Dhabi government. It supports entrepreneurship among UAE nationals and SME development in the UAE. It provides pre- and post-funding technical assistance, including counseling, training, business development plan, and monitoring. It has capital of AED 2 billion and has financed 317 projects with a total loan value of AED 500 million. Its loan portfolio consists of microfinance loans (up to AED 250,000), startup loans (up to AED 3 million), SME loans (up to 5 million), and small industrial enterprise loans (up to AED 10 million). It also has a credit guarantee scheme available to banks, with a coverage ratio of 15 percent of loan losses. The services and industrial sectors in Abu Dhabi benefit mostly from the programs, which fund mainly startups with loans up to AED 3 million.

Table 6. UAE: Khalifa Fund Performance, 2013

Approved by sector			Approved by gender		
	Percentage	Number		Percentage	Number
Agriculture	7	22	Male	77	244
Industrial	35	111	Female	23	73
Service	58	184			
Approved by location			Approved by funding program		
	Percentage	Number		Percentage	Number
Abu Dhabi	69	219	Bedaya	66	209
Al Ain	26	82	Khutwa	16	51
Al Gharbia	5	16	Zeyada	17	54
			Tasnea	1	3

Source: Khalifa Fund

- *Ruwad Establishment (RE)*. Set up in 2005, it provides technical and financial support for Sharjah-based SMEs compliant with Islamic financial principles. Furthermore, its objective is to coordinate public policy toward promoting SMEs by identifying and eliminating administrative and other impediments, and providing training. RE also cooperates with Islamic banks to increase their financing of SMEs.
- *Al Tomooh Finance Scheme*: The Emirates Bank (an affiliate of UAE Dubai National Companies) has created Tamooh Program to provide funding to nationals for small-scale private projects. The credit facilities provide new and existing projects with loans up to AED 2 million, with a two-year grace period, a three-year exemption of interest payments, and a maximum eight-year term.

11. Public sector interventions in the UAE are consistent with international experience. The G-20 stocktaking exercise listed public support schemes that encourage SME access to finance through funded financing facilities, credit guarantee schemes, and state banks.⁵ Funded financing facilities range from simple structures through intermediation of funds through the banking system, to more complex structures involving risk sharing in co-lending, capacity building, and technical assistance to SME borrowers and lenders. Some countries also offer subsidized lending and grants. Even though these funded financing facilities can be justified under certain conditions, they often lack sound credit analysis and risk management processes and can crowd out banks that do not participate in the SME financing activity. Successful initiatives included close coordination and support from stakeholders and the private sector and efficient structures with good-quality human capital and use of information and technology.

F. Prudential Regulations Associated with Credit Guarantees

12. There are different regulatory and supervisory models of credit guarantees. If classified as credit institutions, credit guarantee schemes can be licensed, regulated, and supervised. However, given high compliance costs, credit guarantee schemes are usually exempted from prudential and other regulations. If not qualified as a credit institution, credit guarantee schemes can be regulated and supervised by a government body. In the UAE, the central bank does not regulate and supervise public sector agencies that provide SMEs with loans and guarantees. As previously described, KF, MBRF, and RE are under the Abu Dhabi, Dubai, and Sharja Emirate governments. Consistent with international best practices and Basel II, the UAE central bank provides banks with regulatory incentives in terms of lower risk weighting and provisioning for loans with public sector guarantees.

13. Consistent with international best practices and Basel II, the UAE central bank provides banks with regulatory incentives in terms of lower risk weighting and provisioning for loans with public sector guarantees. The central bank regulation on loan loss provisions requires that minimum specific provisions consider the value of government guarantees in the definition of net

⁵ See G-20 Financial Inclusion Experts Group/SME Finance Sub-Group (2010).

exposures by assigning no haircuts.⁶ The prudential regulations by the central bank also allow guarantees—for capital adequacy purposes—to be used for credit risk mitigation provided they are direct, explicit, irrevocable, and unconditional, as deemed by the central bank on a case-by-case basis. In this case, capital relief is granted to the bank making use of the guarantee as if the credit guarantee would replace the risk represented by the SME by the one represented by the government, with a zero risk weight assigned to the SME. Only a few UAE public sector institutions are assigned a zero risk weight.

G. SME Credit guarantee Scheme in the Middle East and North Africa (MENA) region

14. SME access to finance seems constrained in many countries of the MENA region.

According to a World Bank survey, 33 percent of SMEs report difficulties in getting finance, compared with an average of 25 percent in other developing and emerging economies.⁷ To a large extent, the lack of SME finance is attributed to asymmetric information due to weaknesses in financial market infrastructures, collateral regimes, and judiciary frameworks.

15. Several MENA countries have established Partial Credit Guarantee Schemes (PCGs) to facilitate SME access to finance. PCGs are a risk-sharing mechanism set up by the public sector aimed at reducing the risks and potential losses of creditors. Compared with other public interventions—such as directed lending programs or state banks—PCGs potentially generate fewer market distortions because they usually entail less interference in credit allocation and use private banks as the main vehicles for loan origination.

16. PCGs seem to have a positive impact on SME finance in the MENA region. Focusing on the number of benefiting SMEs, additional SME access, and financial sustainability of the scheme, it seems credit guarantee schemes have contributed to more SME lending in the region. Larger and more established PCGs, in particular, showed larger shares of SME lending.⁸

17. PSGs have multifaceted objectives and several eligibility criteria. As expected, there is no one-size-fits-all formula for designing effective guarantee schemes in the region. Some schemes have a narrow objective, such as compensating for the lack of collateral, while others see their

⁶ For provisions and guarantees, see Clarification and Guidelines Manual for Circular no. 28/2010 (Regulation for Classification of Loans and their Provisions). Specific provisions are calculated by multiplying the provisioning rates by the net exposure amount, which is defined as the outstanding loan balance less the net realizable value of the collateral held. In the case of federal and local government securities and guarantees, the net realizable value is equivalent to the gross value without haircut.

⁷ See Saadani, Arvai, and Rocha (2011).

⁸ The survey covered the largest credit guarantee schemes in 10 MENA countries. The scheme equity ranges from US\$10 million in Syria, to US\$75 million in Morocco. Half of these guarantee schemes are majority state-owned (Morocco, Tunisia, Jordan, Syria, Saudi Arabia, UAE), while the others are majority owned by banks (Lebanon, Egypt, Iraq) or donors (Palestine).

objectives as to promote economic and social development, such as export promotion, supporting entrepreneurship, and implementing indigenous economic programs. Furthermore, the eligibility criteria were even more diversified. While all schemes cover start-ups, those in Morocco and Tunisia are especially generous regarding the size of SMEs (either in terms of equity or number of employees). By contrast, schemes in Egypt, Lebanon, and Palestine restrict the use of guarantees to smaller firms (respectively 50, 40 and 20 employees). Moreover, there are significant differences regarding the maximum size of loans which could be up to US\$2 million, or the equivalent of 600 times GDP per capita (Morocco and Tunisia) to about 60 times GDP per capita (Lebanon, the Palestine, and Saudi Arabia). In addition, some schemes cover all economic sectors, while others exclude trade and service sectors.

18. PSGs' financial conditions vary widely in MENA and may not be directly linked to the riskiness of the borrowers. The purpose of coverage ratios is to provide sufficient protection against credit risk, while preserving incentives for banks to screen and monitor borrowers. The coverage ratios in the MENA region are generally in line with those of other developing countries, which, on average, is between 60 percent and 75 percent, though some offer 90 percent coverage ratios. In several countries, the schemes do not link the coverage ratios to the borrowers' risk profile. For instance, in Morocco, Tunisia, Egypt, and Saudi Arabia the schemes offer higher coverage ratios for riskier types of borrowers, while in Syria, Jordan, Iraq, and Palestine, the coverage ratio is not linked to credit risk exposure. Furthermore, the fees which should be related to risk exposure and contribute to the financial soundness of the scheme are mainly in line with other countries, which average 1.5 percent of the loan value per annum.

19. The absence of financial obligations on the part of borrowers may increase the moral hazard by attracting riskier borrowers. Many schemes require borrowers to provide partial collateral and initial payments in order to mitigate against the risk of attracting riskier borrowers. In some countries, the schemes require a personal guarantee which is limited to a percentage of the loan value. In the MENA region, some banks require high levels of collateral even when using guarantees offered by the schemes, which may contradict the purpose of setting up such a scheme. As down payment, the majority of the schemes require the borrowers to pay around 25 percent of the loan value in addition to the collateral value.

H. Conclusion and Policy Recommendations

20. Access to finance remains a key constraint for SMEs in the UAE. A comprehensive strategy is emerging that would allow them to play a crucial role in the economy, although this policy is restricted to Emirati nationals. Authorities should strive to develop a comprehensive SME policy that includes all SMEs, as the UAE, as a whole, would benefit from higher inclusion and growth. Several important measures aimed at reducing borrowing costs and enhancing the borrower/lender relationship have already been identified, including a new credit registry and a new bankruptcy law. A collateral registry would allow SMEs to pledge movable collateral, broaden access to finance, and provide transparency to pledged assets with associated liens and priorities. Authorities may also provide the SME council with a strong mandate to monitor progress made by

different initiatives and identify specific measures to bridge the SME finance gap throughout the Emirates.

21. In addition to public guarantees and other subsidies, equity finance could be strengthened as a complementary financial product with support from government related agencies. Diversifying funding sources for SMEs would include developing venture capital and business angel financing networks. In this context, the Islamic banking model may play a greater role to provide equity financing. It is, however, crucial that such initiatives are introduced while taking into account financial stability, and transparent and accountable policy objectives.

22. Other best practices and recommendations related to credit guarantee schemes would also include:

- Best accounting practices in the public sector would consider public sector guarantees as contingent liabilities that should be properly accounted for in the government's balance sheet as memorandum items. In addition, if banks and borrowers are exempted from the payment of guarantee fees to the credit guarantee schemes—as a result of government policy to encourage SME access to finance—the guarantee fees should be explicitly accounted for in the government budget as a subsidy to the private sector and transferred to the credit guarantee schemes.
- The schemes should have well defined objectives in terms of types of SMEs to be reached, size, activities, etc.
- The banking sector, rather than public agencies, should make the credit assessments and lending decisions.
- The scheme should have a transparent and accountable corporate governance structure.
- The eligibility criteria should be defined to enhance additionality, reaching financially neglected SMEs. It is important that these criteria do not encourage banks to use the guarantee for large firms and loans, weakening the schemes' purpose to reach new SMEs.
- Coverage ratios, fees, payments, and collateral trade-offs should be linked to the risk exposure in order to reduce moral hazard and contribute to the financial soundness of the scheme, including its financial sustainability and risk minimization.
- Payouts of the scheme should be delayed until recovery actions are taken by the lenders so as to reduce moral hazard.
- The guarantees should be on pari passu basis in which recovery proceeds collected from the borrowers are shared between the bank and the guarantor.

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