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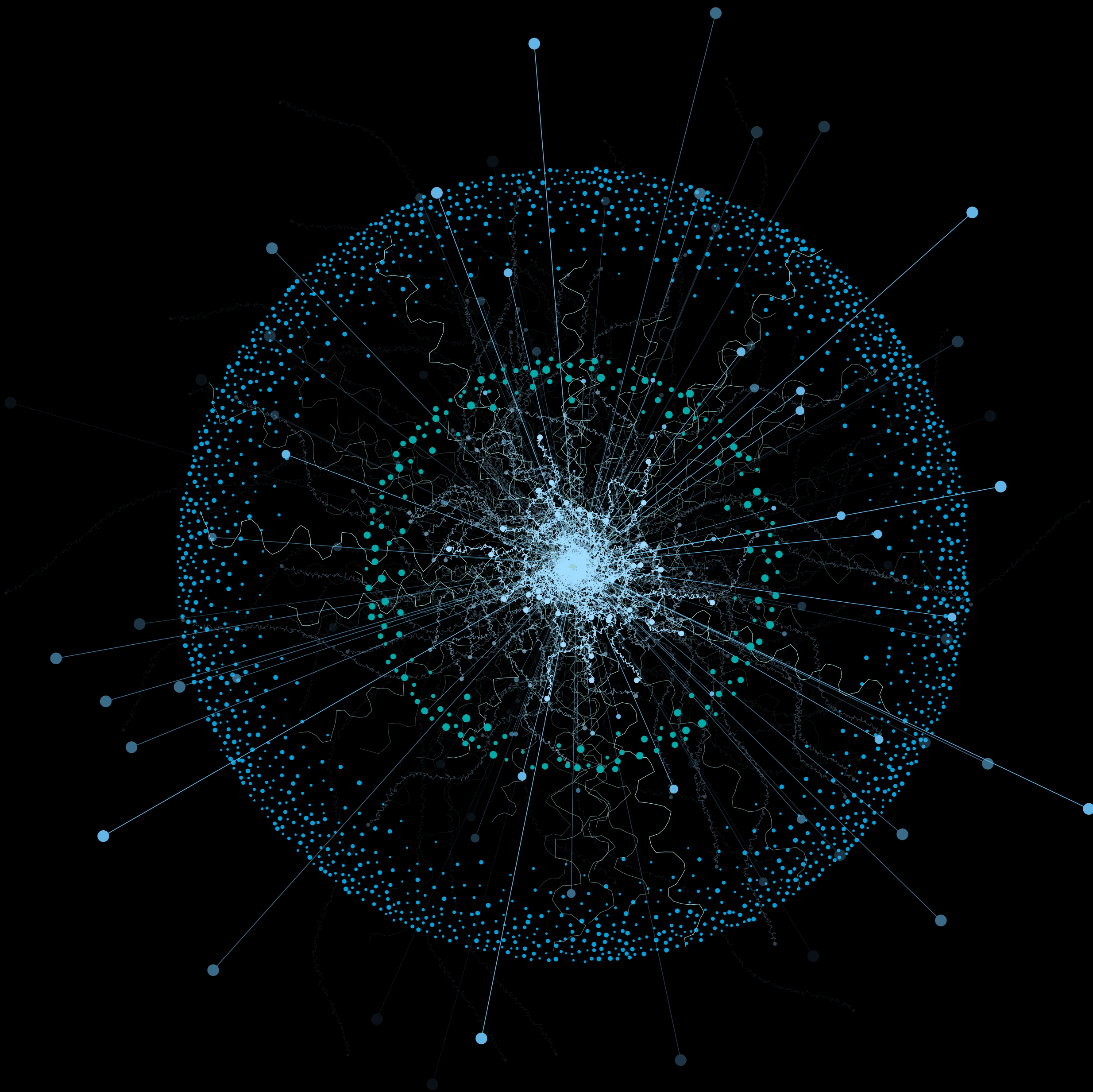

Carbon taxes and incentives from a Middle East perspective

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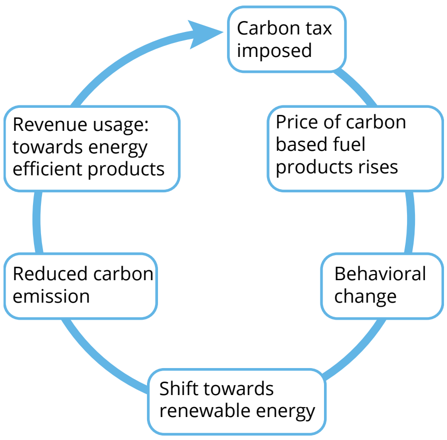
Introduction
The impact of global warming is an escalating concern with far-reaching consequences, and the Gulf Cooperation Council (GCC) countries–Bahrain, Kuwait, Oman, Qatar, Kingdom of Saudi Arabia, and the United Arab Emirates (UAE) are no exception to the effects of climate change.[1]

Several global initiatives and agreements are shaping government policies to address climate change. Notable examples include the 2015 Paris Agreement and the Organization for Economic Co-operation and Development's (OECD) Inclusive Framework on Base Erosion and Profit Shifting (BEPS), which is responsible for developing and implementing the Pillar Two Model Rules.

The 2015 Paris Agreement is a landmark international agreement signed by 197 countries which are legally bound to limit the Global warming to well below 2 degrees Celsius as compared to pre-industrial levels.[2] While the agreement does not specify particular taxes or incentives, it requires countries to follow best practices for emissions reduction. All GCC countries are part of the Paris Agreement.

The OECD is an inter-governmental organization committed to promoting policies that enhance global economic and social wellbeing. Most GCC countries have committed to the OECD's inclusive framework, which advocates for carbon pricing as a tool to reduce greenhouse gas (GHG) emissions. The OECD has also found that carbon pricing can take various forms, and the design of such policies is crucial for their effectiveness.

What is Carbon tax?
A carbon tax is imposed to reduce harmful emissions by levying a fee on carbon-based fossil fuels, such as coal, oil, and natural gas, making them more expensive to discourage their use. This tax aims to reduce GHG emissions and combat climate change by promoting cleaner energy sources and energy efficiency.
The diagram below illustrates how carbon taxes can incentivize a behavioral shift towards cleaner energy.



What are some of the types of carbon taxes?
- **Carbon taxes:** These are taxes on the carbon content of fuels.
- **Carbon Border Adjustment Mechanism (CBAM):** A recent regulatory development in the EU which takes the EU ETS and allowance mechanism a step further – to encourage carbon emission reduction. CBAM puts a price on carbon emissions from imported goods.
- **Emissions Trading System (ETS):** This is a market-based system allowing the trade of emission allowances, creating permits that can be sold. This encourages emission reduction and establishes a carbon price.

ETS systems include:
- **Cap-and-trade arrangements:** The total number of permits in circulation places a cap on the total amount of emissions allowed.
- **Baseline-and-credit arrangements:** The government dictates a baseline amount of permitted emissions, and grants credits to companies that emit less than their baseline allowance. The credits can be sold to companies that exceed their baseline allowance.

Below are some of the types of incentives the countries can opt to provide:
- **Energy efficiency standards:** Countries can implement strict standards for energy-consuming products.
- **Renewable energy subsidies:** Countries can make renewable energy more affordable by providing subsidies.
- **Green investment funds:** Countries can invest in low-carbon projects and make renewable energy competitive with fossil fuels.
- **Carbon capture credit/storage:** Countries can provide monetary credits for capturing and geologically storing carbon oxide emissions permanently.

The impact of government grants, tax credits and incentives on OECD's Pillar Two rules
OECD's Pillar Two aims to ensure that multinational enterprises with substantial annual turnover pay a minimum effective tax rate of 15%. Certain tax incentives, including grants, incentives and credits for low carbon or green energy, may affect the effective tax rate calculation and reduce potential tax liabilities. Jurisdictions that have committed to Pillar Two rules are expected to implement from 2024/2025.

Government grants are generally recognized as income and should be included in the Globe Income to determine the ETR. Tax credits referred to as Qualified Refundable Tax Credits (QRTCs) include environmental tax credits. If these tax credits meet QRTC conditions, they should be treated as income, potentially increasing a company's ETR and reducing tax liability. Hence, government tax credits and incentives need to align with Pillar Two rules, to enable businesses to reduce their carbon foot print and efficiently transition to low carbon economies.

Are carbon taxes implemented internationally?
As per the International Monetary Fund and World Bank report[3], currently, there

are 73 countries and regions that have implemented carbon pricing initiatives, including carbon taxes, ETS and hybrid systems which cover up 23% of the GHG emissions.

The top five carbon-emitting countries are China, the United States of America (USA), India, Russia, and Japan. Some countries with carbon taxes include Argentina, Canada, Chile, China, Colombia, Denmark, the European Union, and Japan, amongst others. While the USA is debating a carbon tax, several states, including California, Oregon, and Washington, have implemented their own.

EU has implemented CBAM gradually since 1 October 2023, imposing tariffs based on carbon emissions on products imported into the EU from non-EU countries. CBAM is part of the EU Green Deal, aiming to reduce GHG emissions by 55% by 2030. The following table sets out the Carbon Tax policy summary of a few countries:

EU carbon tax policy:

- Type of tax: Cap, trade system, and CBAM
- Sectors covered: Power generation, manufacturing, and aviation
- Target: Reduce GHG emissions EU by 55% by 2030
- Applicability: All EU countries

Canada carbon tax policy:

- Type of tax: Direct carbon tax
- Sectors covered: Transportation, electricity generation, other sectors.
- Target: Reduce GHG emissions 40-45% by 2030
- Applicability: Mixed approach but applicable to all states in Canada

USA carbon tax policy:

- Type of tax: Carbon tax and Cap & Trade system
- Sectors covered: Power generation, transportation, industrial facilities
- Applicability: Reduce GHG emissions 40% by 2030
- There is no federal level carbon tax. Only a few states have implemented.

What is the impact of global carbon tax developments on GCC countries?

The impact may depend on the GCC countries extent of global operation. For example, CBAM will likely affect GCC economies since they are major exporters of CBAM-covered goods[4] to Europe. GCC exporters will need CBAM certificates starting from 2026, linked to the EU ETS, adding costs for exporting to EU markets. Hence, the GCC export of CBAM-covered products to the EU may become costlier.

Establishing a similar mechanism to ETS in GCC countries could provide credits or exemptions from carbon taxes, reducing costs compared to other jurisdictions. Additionally, some GCC countries are also investing in Hydrogen, a low-GHG-emission alternative in manufacturing processes.

Have the GCC countries implemented carbon taxes?

While GCC countries have not yet implemented carbon taxes or incentives, they are increasingly focused on addressing climate change. The Riyadh Agreement, signed in 2021, commits these nations to reduce GHG emissions by 28% by 2030 and promotes the development of a regional carbon market. GCC countries have recently revised their 2030 nationally determined contributions, adopting various decarbonization measures.

The following section sets out what some of the GCC countries are doing in this area.

United Arab Emirates (UAE):

- The UAE was the first GCC country to commit to an economy-wide reduction in emissions, and the first to announce a Net Zero by 2050 strategic initiative. The UAE Energy Strategy 2050 was launched to promote clean energy and sustainable development. To achieve the target of Net Zero, the UAE government may consider introducing a carbon tax.
- The UAE will host COP28, the United Nations' next round of climate change talks, providing a comprehensive assessment of global progress since the Paris Agreement.
- The UAE is planning to establish a carbon trading market through the creation of credits from the company's emission-reduction projects. The credits would be available to offset potential carbon taxes levied on exported products that contribute to emissions.
- In the UAE, Abu Dhabi Global Market (ADGM) announced the formation of a voluntary carbon credit trading exchange and clearinghouse. In 2022, Mubadala Investment Company, UAE, acquired a strategic stake in AirCarbon Exchange (ACX).

The Kingdom of Saudi Arabia (KSA):

- The Vision 2030 plan includes renewable energy goals and mentions exploring options for reducing carbon emissions.
- KSA's sovereign wealth fund Public Investment Fund (PIF) plans to launch a carbon credit exchange by early 2024 and will also offer advisory services to companies looking to decarbonize their operations.
- The NEOM project in KSA aims to be carbon-free, producing carbon-free hydrogen using solar energy by the end of 2026.
- KSA conducted the Middle East's first carbon offset auction and sold over 1.4 million tonnes of carbon credits.
- PIF and the Saudi Stock Exchange, Tadāwul, announced a joint plan to establish a voluntary carbon exchange in Riyadh by 2023 for the trading of verified, approved, and high-quality carbon credit certificates.
- The Zakat, Tax, and Customs Authority (ZATCA) has recently introduced a draft Income Tax Law for public consultation wherein they have proposed tax incentives for green investments by entities. Further details are awaited in the form of regulations.

Qatar, Kuwait, Bahrain, and Oman:

These countries have also expressed interest in addressing climate change and reducing emissions, however, the specifics of carbon pricing measures are yet to be announced.

The below table provides a summary of the GCC countries' targets to address climate change:

UAE:

- GHG emission reduction targets: 40% by 2030
- Renewable energy targets: Clean energy, 50% by 2050
- Net-zero target: Yes, by 2050

Saudi Arabia:

- GHG emission reduction targets: 27% by 2030
- Renewable energy targets: Clean energy by 2030
- Net-zero target: Yes, by 2060

Other GCC countries

- GHG emission reduction targets: Oman, 7% by 2030 and Qatar, 25% by 2030
- Renewable energy targets: 5% to 10% by 2035
- Net-zero target: Bahrain by 2060

The GCC countries are some of the highest emitters of GHGs per capita in the world. The introduction of carbon pricing would be a significant step towards reducing emissions in the region. The Riyadh Agreement is a positive step towards addressing climate change in the GCC, but it is important to note that the agreement is voluntary and there is no enforcement mechanism.

What are the challenges for implementing carbon taxes and incentives in GCC?

Challenges to implementing carbon taxes in the GCC include its status as a major oil producer relying on low cost fossil fuels, potential high costs of producing low carbon/renewable energy, restrictive fiscal provisions in the existing production sharing or other agreements and absence of a regional carbon trade market. Nevertheless, international commitments like the Paris Agreement and the implications of Pillar Two suggest that GCC countries will eventually introduce carbon taxes and incentives.

How should GCC businesses prepare for carbon taxes?

Companies should consider the following points:

- Integrating climate change into financial and commercial decision-making
- Educating stakeholders about potential operating cost increases due to carbon taxes
- Staying informed about evolving energy ecosystems
- Assessing wider fiscal and regulatory policy changes
- Addressing reputational risks
- Considering future compliance requirements

The way forward

To move forward, GCC countries should collaborate to introduce tax credits and incentives in line with Pillar Two to enable businesses to efficiently transition to low carbon economies, to establish new fiscal and regulatory polices for carbon market trading and develop infrastructure for affordable renewable energy. Investment in R&D for energy-efficient technology is crucial. The regulatory carbon market will provide confidence in investors for making informed decisions.

As momentum builds, it is likely that carbon taxes and incentives will be implemented in the coming years. Businesses worldwide need to prepare for this transition later this month. COP28 in the UAE later this year will provide an opportunity for leaders to discuss the role of carbon taxation and incentives in reducing GHG emissions and accelerate related initiatives.

As global fiscal and regulatory policies evolve to deal with climate change, business must consider carbon taxes and incentives and start building internal capabilities and strategies, to reduce carbon foot print and increase efficient energy transition

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Endnotes

[1] According to the NASA's Goddard Institute for Space Studies (GISS) - Global warming is the long-term heating of Earth's climate system due to human activities, primarily fossil fuel burning, which increases heat-trapping greenhouse gas levels. Earth's global average temperature has gone up by 1 degree Celsius primarily due to human activities.

[2] United Nations report on Climate change 2023. https://www.ipcc.ch/report/ar6/syr/

[3] Report from World Bank - https://carbonpricingdashboard.worldbank.org/

[4] CBAM covered goods – From 1st October 2023, CBAM applies to EU imports of iron & steel, aluminium, electricity, certain fertilisers, cement and hydrogen, as well as certain precursors and a limited number of downstream products. Inclusion of polymers and organic chemicals will be decided by 2026 and by 2030, it is expected to extend to all product groups covered by EU ETS or to the list of products with a risk of carbon leakage. Organic chemicals will be decided by 2026 and by 2030, it is expected to extend to all product groups covered by EU ETS or to the list of products with a risk of carbon leakage.

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