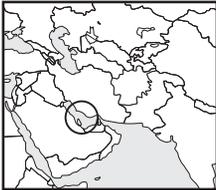


## ■ BAHRAIN

# Oil dependency: short-term benefits but a long-term impossibility



As a country that draws most of its income from oil, Bahrain has benefited from the recent rise in world oil prices, which have helped spur growth in every sector of the economy. However, this tiny island nation's oil reserves could be depleted within a decade, which means that other sources of revenue must be pursued to prevent economic collapse and ensure that the population's needs continue to be met.

Bahrain Economic Society  
Jaffar Mohammed

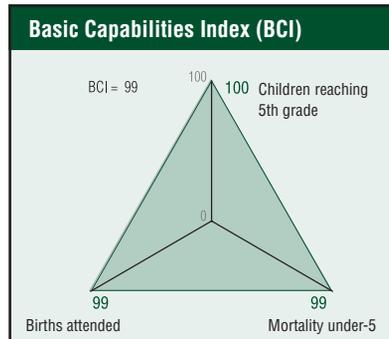
Bahrain is a very small island within an archipelago of 33 islands. The total area of Bahrain is approximately 703.63 square kilometres. However, total area figures continue to change due to extensive and frequent land reclamation schemes. In 1986, Bahrain became linked to Saudi Arabia by a 25-kilometre causeway. Most of the island is flat, the altitude being on average not more than 60 metres above sea level. The northern coast of the island, which is just under five kilometres wide, is cultivated, while the rest of the country is a desert, surfaced with hard limestone rock. In terms of climate, since Bahrain is an island it is humid and extremely hot in summer, while winter temperatures are below 20°C. There is little rainfall.

The country's total population, which was estimated at 70,000 in 1863, has grown rapidly as a consequence of Bahrain's economic development and improved living conditions. It had increased to 182,203 by 1965, then more than doubled in the next 26 years to a total of 508,037 in 1991, reaching 707,160 in 2004. Much of Bahrain's population growth can be attributed to the rise in the number of non-Bahraini nationals living and working in the country, as illustrated in Table 1.

Despite the Government's commitment to increasing the number of Bahraini nationals employed in the private sector, foreign workers, primarily from South and Southeast Asia, still held around 65% of private sector jobs in 2004, because of wage differentials with nationals. Women account for 18% of the purely Bahraini workforce. In 2004, the total workforce was estimated at above 284,969, of whom 99,767 were native Bahrainis (Ministry of Labour).

### An economy fuelled by oil

Hydrocarbons remain the only natural resource in Bahrain. The domestic economy is still largely dependent on the production and export of oil to maintain its very existence and meet the basic requirements of the population. However, since 1970, the oil sector in Bahrain has been declining at an average rate of 6% annually, and according to forecasts, its oil supply will be depleted in nine years time. Bahrain's proven oil reserves are relatively small and



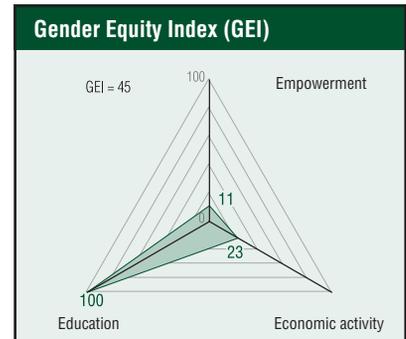
the number of productive oil wells is limited. Since yields from the remaining wells are low, any attempt to increase production would mean higher production costs. Therefore, unless other sectors are developed to replace the oil sector, the economy is threatened with collapse.

Bahrain also has relatively substantial reserves of natural gas. Based on current extraction rates, Bahrain's gas reserves are expected to last for 25 years. Total reserves were estimated at 255 billion cubic metres in 1979 and were reduced to 201 billion cubic meters in recent years. The country depends on two sources for its gas production: associated gas (found in association with crude oil) and dry gas (found in natural gas fields). As rapid industrial development emerged and the need for more energy increased, Bahrain endeavoured simultaneously to utilize the associated gas and reduce the amount of gas that is flared (burned off) as "waste" from oil wells.

Given the declining production yields of Bahrain's onshore oil fields, the country has become increasingly dependent on the oil produced in the Abu Saafa offshore field, which it shares with Saudi Arabia. The Abu Saafa field currently accounts for the bulk of Bahraini oil production, as Table 2 illustrates.

### Towards diversification

In recent decades, the Bahraini government has made concerted efforts to transform the economy from one that is dependent on the primary sector for output and employment into a modern industrial economy and services centre. The government's economic strategy is currently under review, and the liberalization of inward investment has been



stated as a key issue. The government's main goals are geared towards:

- diversifying the economy and national income, which will be pursued through developing small- and medium-scale industries
- encouraging the services sector, notably commercial services
- developing off-shore banking and tourism by removing obstacles to foreign investment
- encouraging the contribution of the private sector to economic development.

In many countries, government revenue is largely derived from the different components of taxes. In Bahrain, as in other Gulf countries, the government's revenues are determined primarily by oil revenues. However, as oil revenues gradually decline alongside decreased production, a possible expansion of the role of taxation in the future is a distinct possibility. There has already been a marked trend in the increase of indirect taxes.

In Bahrain, the Government's budget consists of two income transfers – oil and non-oil revenues – and current and capital expenditures. Oil revenues are collected from two sources, the Bahraini onshore oil fields and the Abu-Saafa offshore field shared with Saudi Arabia, while non-oil revenues include grants, indirect taxes, and income from investment. Meanwhile, expenditures mainly comprise the Government's purchases of goods and services to meet the country's administrative, military and social services needs. Oil revenues are allocated by the Government to the construction and development of all other non-oil sectors in the country, such

as transportation, manufacturing, agriculture, public services, commerce and others.

Public expenditure is most often determined by government revenues. Thus a rise in oil revenue is normally translated into higher public spending, leading to an overall improvement in economic growth conditions. It is important to emphasize that as non-oil revenue is proportionately smaller, current expenditure has been largely financed from oil revenue until now. Bahrain has benefited from the current rise in world oil prices, which has directly and positively affected all of the country's economic sectors, spurring economic growth and generating more job opportunities in both the private and public sectors. Nevertheless, no matter how high oil prices may be, as Bahrain's reserves dwindle, oil revenues will obviously decrease accordingly.

It would be difficult to decrease current expenditure, which comprises mainly wages, salaries and maintenance expenditure (62% of the total expenditure), without causing a great disturbance throughout society as a whole. The problem with this expenditure is that once it has reached a certain level or maintained a certain rate of growth, it not only becomes fundamental to the standard of living, but its growth will also influence growth in other sectors. Since reducing the growth or the volume of this expenditure is difficult, one can predict that it will remain high.

Capital expenditure is of two types, fixed capital assets and capital transfer, of which electricity and water constitute the largest part. This expenditure is partly financed from oil revenue and grants (mainly from Saudi Arabia and Kuwait) and partly from domestic borrowing. Any decline in capital expenditure would reflect a government policy of fiscal restraint as a measure to cope with lower oil income.

Grants and loans emerge as important elements in the state budget. In addition to providing financial aid, other Gulf States have also been involved in implementing social and development projects in Bahrain. Kuwait, for example, has paid for 18 primary, secondary and technical schools on the island. Saudi Arabia and the United Arab Emirates (UAE) have contributed to social services, and payment for part of the cost of the Bahraini distillation programme was promised by both of these countries. Grants, however, are determined by economic and political conditions in the region. The political instability in the Gulf since 1980 suggests that financial aid will become less readily available to Bahrain. Since 1980, the Gulf States have been more concerned with regional political development, while military expenditure has been increasing rapidly in almost all of the region's countries.

The level of government expenditure, rather than the level of oil prices or oil revenues, determines the level of surplus or deficit in the state

**TABLE 1**

Population by nationality			
Year	Nationality		Total
	Bahraini	Non Bahraini	
1941	74,040	15,930	89,970
1950	91,179	18,471	109,650
1959	118,734	24,401	143,135
1965	143,814	38,389	182,203
1971	178,193	37,885	216,078
1981	238,420	112,378	350,798
1991	323,305	184,732	508,037
2001	398,221	239,361	637,582
2004	438,209	268,951	707,160

Source: Central Statistical Organisation, 2001, and Ministry of Finance

**TABLE 2**

Production of crude oil (in 1,000 barrels) for the years 1981-2004			
Year	Production of crude oil		Total production
	Bahrain onshore fields	Abu Saafa production	
1981	16,862	19,502	36,364
1983	15,273	19,206	34,479
1985	15,301	23,819	39,120
1987	15,216	22,491	37,707
1989	15,583	25,136	40,721
1991	15,373	26,351	41,724
1993	14,875	38,385	53,260
1995	14,459	38,585	53,044
1997	14,159	45,194	45,208
1999	13,677	61,746	77,422
2001	13,656	71,723	87,380
2004	13,647	62,690	76,338

Source: Ministry of Oil and Industry, Bahrain Oil and Gas Statistics.

budget. For example, in 1977 and 1983, with expenditure undergoing explosive growth, the state budget experienced a deficit of BHD 14.7 million and BHD 46.9 million respectively (USD 40.12 million and USD 128 million). The usual government reaction to the appearance of a fiscal deficit is to choose the easiest option by leaving some of the unimportant current expenditure intact, but cutting capital expenditures simply by postponing a few investment projects.<sup>1</sup>

### Improvement in the standard of living

Bahrain has adopted an action plan to improve the standard of living of the average Bahraini. The plan includes improvements in healthcare (particularly preventive medicine), education and training programmes, an expansion in the existing infrastructure, and more housing projects. Bahrain is already one of the top-ranking Arab countries on

the Human Development Index (HDI) compiled by the United Nations Development Programme (UNDP). With an HDI score of 0.846 in 2005, it was narrowly surpassed only by Qatar and the United Arab Emirates, which both scored 0.849. It also ranked number one on the UNDP's first Arab Human Development Index.

Bahrain has set a target of annual gross domestic product growth of 5%-6% over the next four years, a significant increase from the 4.5% average annual growth rate over the previous four years. Instrumental to achieving this objective is the attraction of an annual BHD 650 million to BHD 700 million (USD 1.77 billion to USD 1.91 billion). ■

<sup>1</sup> Jaffar Alsayegh, Bahrain: A case study of Diversifying oil exporting Economy- 1971-1989.