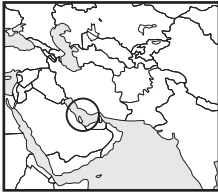


BAHRAIN

Economic reforms and uncertainty



In spite of remarkable achievements in economic and social development due to the unprecedented level of oil prices, mismanagement of economic and human resources has led to social marginalization and poverty. The projected economic reforms intended to make the kingdom less dependent on oil revenues may also be generating uncertainty among many residents.

Social Watch Bahrain¹

Since he succeeded his father Sheikh Isa in 1999, Emir Sheikh Hamad Bin Isa Bin Salman Alkhalifa has introduced a series of political and economic reforms in response to popular discontent with the prior order. These efforts have ended the era of social unrest that erupted in 1994, sparked by a deep economic crisis that left thousands of Bahrainis either unemployed or without hope.

In January 2001, the new ruler granted amnesty to all political detainees and exiles. In February 2001, a National Charter was passed and approved in a referendum by 98.4% of the population. Municipal and parliamentary elections were held in May and October 2002, respectively, a time of widespread hope that the reconciliation process would lead to improved economic and social life.

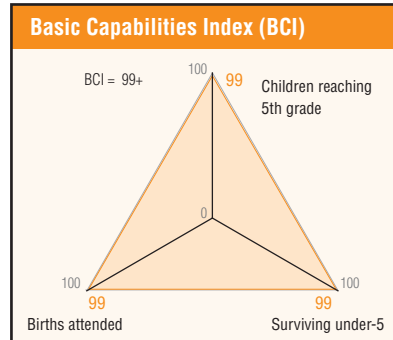
Along with political reforms, the new regime introduced initiatives aiming at restructuring the state-controlled economic model that had been in place since the declaration of independence in 1971. Under that model, the Government had taken over all economic and social aspects of development. Whatever its limitations, this system had maintained a minimum level of economic and social stability, enabling a middle class to emerge.

As part of the reform process, the Government asked the American consultant company McKinsey & Co. to present a new model for Bahrain's economy. Based on its research, McKinsey proposed a series of economic, educational and labour market reforms. According to projections, around 10,000 nationals would be entering the labour market each year, starting in 2003; this meant that a total of 100,000 nationals would be seeking jobs during the next decade.

The proposed reform

Since the public sector, the largest employer of nationals in the past, has almost reached its growth potential, the private sector – traditionally the employer of low-productivity/low wage foreign workers – will have to absorb a majority of the Bahrainis entering the labour force. Nevertheless, nationals are not attracted to most of the jobs in this sector due to their poor remuneration (low pay, low benefits) and highly stressful physical demands.

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Foreign workers constituted 70% of the private sector workforce in 2002 and now make up 80%.² Their percentage is likely to increase even further in the future as the country's projected economic growth requires more foreign workers to fill low skilled jobs in sectors such as construction and manufacturing.

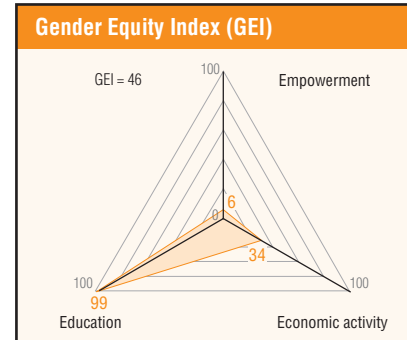
To ensure that Bahrainis became the best hiring option and the private sector the engine for the economy's growth, McKinsey outlined a comprehensive approach, proposing the introduction of six reform policies simultaneously. Four were aimed at reducing the attractiveness of foreign workers to employers.

First, the McKinsey experts proposed imposing a levy on each foreign worker hired and a ceiling restricting the total number of foreigners permitted to work in the country. The goal was to eliminate the cost differential between national and foreign workers and reduce the private sector's dependence on cheap labour while maintaining a stable rate of economic growth.

Second, they recommended establishing a labour fund, outside governmental control, to be utilized in various employment support programmes such as subsidizing the wages of nationals, providing educational and training programmes and training of the unemployed and support for businesses that could contribute significantly to the overall growth of the economy.

Third, they proposed elimination of the "sponsorship" law that tied foreign workers to their sponsor. This made them more attractive to many employers than Bahrainis, who could switch jobs more freely.

² Bahraini Economic Development Board.



Fourth, they proposed imposing regulations that conformed to ILO standards. This would eliminate harsh labour conditions that foreign workers tolerated but Bahrainis would never accept.

McKinsey proposed two policies that it predicted would spur adaptation to changing market conditions and give the private sector the flexibility to grow and create jobs: 1) elimination of "Bahrainization" targets that legally require economic entities to employ a fixed percentage of Bahrainis, who therefore have no incentive to be productive, and 2) elimination of all minimum wage rules.

Finally, the McKinsey consultants recommended the introduction of clear and predictable termination processes for all employees. This was suggested to help the employees understand their rights and duties and increase their productivity while liberalizing the market and creating a competitive environment.

The path to uncertainty

These looming reforms will lead Bahrain into a disruptive period. Applying labour levies in every part of the economy regardless of its ability to absorb these extra costs may have devastating repercussions. Sectors highly dependent on cheap, low-skilled labour, such as construction and manufacturing, will not be able to reduce the impact of the levies through higher productivity and will pass the extra costs to the consumer. The changes will not help to increase the employment of Bahrainis either, since they are not interested in low-category jobs.

Small and medium enterprises will be the most affected by these levies. Most of them have limited resources to improve productivity, and will have to pass the extra costs to consumers. No longer able to compete against other companies based in countries

in the region that do not impose such fees, many will go out of business. The price increases posted by the remaining companies will push up the rate of inflation, which was approximately 3.5% at the time McKinsey was conducting its study. Imposing a ceiling on the inflow of foreign workers will increase the cost of labour, sending the inflation rate even higher.

Nationals do not possess many of the requisite labour skills. Restricting the supply of labour is not going to solve that problem. Rather, it would be more efficient and less costly to invest in innovation and technology in certain sectors and making it possible for nationals to learn the skills that any new jobs generated will require.

Diversification

Crown Prince Shaikh Salman Bin Hamad Bin Isa Alkhalifa established the Economic Development Board in April 2000 with a mandate to end the Government's role as the major force in the economy and employer of the vast majority of nationals. The board has been gradually assuming authority; its main aim has been to make the private sector the engine of growth. The economy is to be diversified. Rather than remain a country relying heavily on exports of oil and its derivatives, the goal is to create an economy capable of attracting investments from abroad, primarily in the following industries:

- Manufacturing
- Tourism
- Telecommunications
- Finance
- Trade and Services

This second aspect of the reform programme, economic restructuring, is based on selective initiatives with uncertain outcomes. They require a combination of reorganization and privatization. We will elaborate on this process in next year's report.

Social network institutions

Since independence, and continuing to date, one of the hallmarks of Bahraini social development has been the social support provided by a variety of bodies, involving several governmental and civil institutions. The largest outlays have come from the Ministry of Social Development, which gives financial aid to thousands of Bahraini families and some non-governmental charity societies. In addition, dozens of non-governmental charity funds provide support to local communities. Their activities, however, are religiously driven; their aid plays a very negative role, creating social divisions among the Bahrainis.

Among the social reforms introduced by the King was the recent establishment of the Royal Charity Association (RCA), headed by one of his younger sons. Through financing diverse projects, the RCA has played a positive role in ameliorating the living conditions of numerous Bahraini families.

Wealth and mismanagement

There is no doubt that Bahrain has achieved remarkable successes in economic and social development over the past five years, due in large part to oil prices that have reached levels unprecedented since the second oil shock in 1979. Public spending has increased by 54.8% in five years (2001-2005) from BHD 832.8 million (USD 2,214.9 million) to BHD 1,289.2 million (USD 3,428.7 million), thanks to the efforts of governmental and non-governmental institutions.

Nevertheless, the level of poverty and social marginalization does not reflect the wealth accumulated in the last four years. This disparity can only be attributed to mismanagement of economic and human resources. ■