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KINGDOM OF BAHRAIN

SELECTED ISSUES

May 19, 2017

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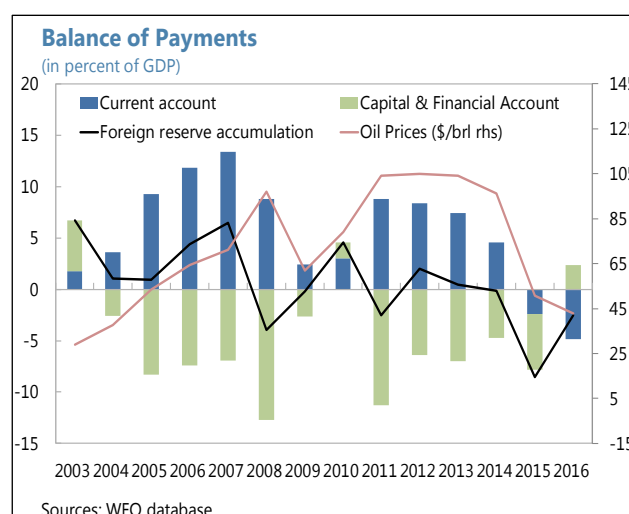
TRENDS AND DRIVERS OF PRIVATE CAPITAL OUTFLOWS IN BAHRAIN¹

Bahrain's external environment is challenging as the fall in oil prices has led to shift in its current account (CA) from a surplus to a deficit in 2015. The country is also experiencing significantly higher private capital outflows than comparator countries, while also offering lower interest rates and returns, and a higher sovereign credit spread. Policy makers can address these issues by reducing fiscal vulnerabilities and implementing structural reforms that improve private sector growth and investment opportunities.

A. Introduction

1. Bahrain's capital and financial account has recorded a large deficit in several years since the early 2000s.

There are two periods during which oil prices and current account surpluses (CA) rose significantly, between 2003–08 and 2009–11. Oil prices remained elevated until 2014H1. The CA surplus widened significantly over those periods to about 13 percent of GDP in 2007 and to almost 9 percent of GDP in 2011. During these periods, the capital and financial account (KA) recorded a large deficit in most years, even in 2003–08 when growth was strong. In 2011, this deficit increased to about 11 percent of GDP in part reflecting the increase in domestic political tensions.²



2. During the periods of high oil prices, Bahrain's international reserves were rising.

There was a difference in the pattern of foreign reserve accumulation between the two periods. In 2004–07, reserves increased by an average of 3 percent of GDP per year, while in 2010–13, they increased by an average of 1 percent of GDP. Reserve adequacy was above 3 months of imports, but consistently below other standard measures (such as the IMF's reserve adequacy metric). Foreign reserves declined significantly in 2015 and 2016.

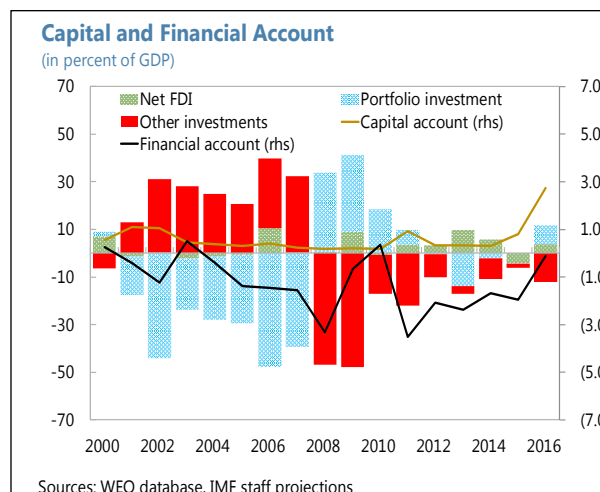
¹ Prepared by Phil de Imus.

² During the global financial crisis years of 2008 and 2009, the CA surplus narrowed considerably and the KA deficit at first widened and then narrowed as well. There appeared to be a significant reduction in other investment liabilities that may have been associated with tighter global bank funding conditions.

3. There was a change in the pattern of financial flows after the global financial crisis.

The overall magnitude of flows shrunk markedly in 2010 compared to the period 2003–07.

Additionally, there was a change in the composition of flows, wherein the large inflows of other investments and portfolio outflows turned into more consistent other investment outflows and some portfolio inflows. Overall, the deficits in the financial account from 2004–07 were driven mostly by portfolio investments and the deficits from 2011–15 mostly by other investments, both reflecting the changing activities of the private sector.



B. Estimating Private Capital Outflows and International Comparison

4. Bahrain has been experiencing significant negative private capital flows (PCFs) during the period of elevated oil prices and strong economic growth. Private capital flows are estimated by subtracting net issuance of government debt from the sum of net FDI, portfolio investments, other investments, and errors and omissions.^{3,4} Positive PCFs indicate inflows and negative PCFs outflows. Figure 1 shows two averages, one for the period of high oil prices (2010–13, period 1) and another for the period of falling oil prices (2014–16, period 2). Private capital flows averaged over -10 percent of GDP in period 1 and -9 percent in period 2.

5. The magnitude of Bahrain's PCFs is compared to three sets of countries. The first set represents other Gulf Cooperation Council (GCC) countries, which share regional ties and similar economic structure. A second set of comparators are countries that currently have a similar sovereign credit rating (within 1 or 2 notches) and are likely to have high macroeconomic vulnerabilities. These include Jordan, the Dominican Republic, Turkey, Brazil, etc. A final comparator is a set of countries whose exports and fiscal revenues are dominated by the energy sector. These include some MENA countries like Algeria, Iran, and Iraq, as well as countries in South America, Africa, and the Caucasus. Some of the comparator countries in groups 2 and 3 differ from Bahrain, particularly in regards to their exchange rate regime or the importance of hydrocarbons in the economy.

6. Bahrain's PCFs are more negative compared to most comparator countries. Bahrain stands out particularly when compared to other GCC countries and other oil exporters. In the GCC,

³ There are other methods of estimating PCFs used for analyzing capital flight, etc. For example, see Mlachila et al. (forthcoming).

⁴ Bahrain's SWF is mostly invested in domestic assets. While time series data on foreign investments by SWFs are unavailable, for countries where the SWF invests in foreign assets, this methodology overstates their private capital outflows.

on average only Bahrain and Saudi Arabia experienced negative PCFs in periods 1 (2010–13) and 2 (2014–16). Oman and Bahrain experienced the largest negative PCFs in period 2. Countries with similar sovereign credit ratings to Bahrain (Group 2) all show negative PCFs of considerable size relative to GDP. Bahrain experienced the third largest average negative capital flows in 2010–13 and the largest in 2014–16. Among non-GCC oil exporters (Group 3), Bahrain stands out as having one of the largest negative PCFs for both periods. Colombia and Ecuador also have negative PCFs, but to a lesser degree.

7. Bahrain is also compared against its peers in terms of risk and return. Deposit interest rates, stock market returns, and credit spreads relative to the comparator countries are shown in Figure 1. These measures of risk (i.e. credit spread) and return are typically used to gauge the attractiveness of domestic investment opportunities. Only a subset of countries from groups 1, 2, and 3 are shown based on data availability.

8. Bahrain continues to stand out with relatively low returns. Deposit rates, the mostly widely available rate for the sample of countries, are used to make the comparison. Bahrain maintains the second lowest nominal deposit rate in the sample of 14 countries. The disparity in interest rates is particularly high with countries like Turkey, the Dominican Republic, Azerbaijan, and Brazil, etc. Some of these have experienced significant currency fluctuation, which likely accounts for some of this difference. However, deposit rates are orders of magnitude higher in Ecuador as well, which is fully dollarized. While the differences are much narrower, Bahrain has lower deposit rates than other GCC countries, except for the UAE.

9. Bahrain's stock market returns are also among the lowest of a set of 11 countries and CDS spreads are high. For most of the countries we use MSCI dollar indices to account for any differences in exchange rates. Only Brazil has lower average returns in both periods 1 and 2. At the same time, Bahrain's sovereign credit spread (5 year CDS spread) is among the widest, suggesting financial markets perceive a high level of sovereign credit risk relative to comparator countries. These comparators either are members of the GCC or have similar credit ratings to Bahrain.

C. Empirical Analysis

10. Univariate regression analysis is first used to empirically examine the drivers of PCFs in Bahrain. Empirical analysis of Bahrain's capital flows should be treated with caution given the limited data (annual from 1990 to 2015) and concerns about data quality. We draw from the literature on the drivers of capital flows to emerging market (EM) countries and EM asset prices to identify the independent variables.^{5,6} PCFs as a share of GDP are regressed on various push and pull factors shown in the table below. Pull factors indicate developments in the domestic economy or in the recipient of capital flows, while push factors are developments in the countries that are sources

⁵ For example, see IMF April 2016 and Koepke 2015.

⁶ An augmented Dickey-Fuller test was applied to each variable. The dependent variable and most of the independent variables rejected the null hypothesis of having a unit root. However, tests for variables in levels like oil prices and the US 10-year yields could not reject the null, so transformations to those variables were also used.

of capital flows. The variables represent some of the most commonly used in capital flow analysis. Positive PCFs indicate inflows and negative PCFs outflows, so a positive regression coefficient is associated with higher inflows (or lower outflows).

Category of Independent Variables		
	Variable	Category
Pull	Bahrain GDP growth	Domestic output
	Bahrain GDP growth - world GDP growth	Domestic output
	Overall fiscal balance	Country risk indicator
	Overall fiscal balance chg	Country risk indicator
	Bahrain T-bill rate chg	Asset return
	Bahrain - US short-term interest rates	Asset return
	Bahrain stock market return	Asset return
	Bahrain - World stock market return	Asset return
Push	Log of oil prices	Commodity exporters
	VIX	Global risk aversion
	Log change in the VIX	Global risk aversion
	US 10-year yield	Advanced country interest rates, global liquidity
	US 10-year yield chg	Advanced country interest rates, global liquidity
	EMBIG spread chg 3/	EM credit risk, risk aversion

Note: The categories are sourced from Koepke 2015.

11. The results suggest that when Bahrain's economy grows faster than the rest of the world, PCFs to the country increase. This could be interpreted as indicating better investment prospects in the country compared to other parts of the world. On the other hand, higher oil prices are associated with less private capital flows. Higher oil prices are likely to put more foreign exchange and wealth in the hands of domestic investors to invest abroad; especially as domestic investment opportunities might be limited.

12. Measures of international risk and returns help explain PCFs in Bahrain, while other independent variables were not significant. The US 10-year yield is significant at the 1 percent level and has a higher R-squared than several other variables.⁷ This variable has been used in the literature to represent global liquidity conditions and US monetary policy (especially during the period of US quantitative easing), where a higher US 10-year yield meant tighter global liquidity and US monetary policy conditions. Tighter conditions are then associated with expectations of a reduction in global asset prices. The positive coefficient in relation to Bahrain's PCFs could be interpreted as a greater incentive to repatriate foreign investments by domestic investors. An additional incentive would be the increase in interest rates in Bahrain given the fixed exchange rate. The change in emerging market spreads (EMBIG spread chg) is also significant and has the highest R-squared. One interpretation of the negative coefficient is that when risk premia in EMs rise, foreign investors pull back from their investments in emerging markets including Bahrain. The other variables were not significant in a univariate setting, although Bahraini interest rate differentials vs. the US were significant at a less stringent 15 percent level, and with the correct anticipated sign. The level of significance for this variable might be affected by the shorter sample of T-bill interest rate data. The variables were also tested in a multivariate setting below.

⁷ 10-year yields were normalized and changes in 10-year yields were also tested.

Coefficients from Univariate Regressions

Dependent variable: Private Capital Flows (percent of GDP)

(Annual data 1991 to 2015)		Coefficient	R-squared
Pull	Bahrain GDP growth	1.71	0.10
	Bahrain GDP growth - world GDP growth	1.61 **	0.12
	Overall fiscal balance	-0.21	0.01
	Overall fiscal balance chg 1/	1.12	0.14
	Bahrain T-bill rate chg	0.34	0.01
	Bahrain - US T-bill rate 2/ 3/	-1.43	0.12
	Bahrain stock market return 3/	0.89	0.01
	Bahrain - World stock market return 3/	-5.88	0.13
	Log of oil prices	-7.07 ***	0.23
Push	VIX	-0.07	0.00
	Log change in the VIX	-4.48	0.02
	US 10-year yield	3.46 ***	0.37
	US 10-year yield chg	3.45	0.05
	EMBIG spread chg 3/	-0.02 *	0.40

* 10% significance, ** 5% significance, *** 1% significance

Source: IMF staff calculations

Note: The regressions were tested against the contemporaneous term and the contemporaneous and first lag of the independent variables.

1/ The contemporaneous and first lag of the fiscal balance were significant at 20% and 15% levels, respectively.

2/ The interest rate differential with the US was weakly significant at the 15% level when nominal private capital flows are used as the dependent variable.

3/ Data for BHR T-bill rates start in 2003, stock market returns in 2005, and the EMBIG spreads in 2000.

13. A multivariate regression suggests that Bahrain's relative growth, changes in oil prices, US 10-year yields, and short-term interest rate differentials with the US drive PCFs to the country. Various specifications were tested using the variables in the univariate regressions. For most of the regressions, Bahrain's growth relative to the world and US-10 year yields are significant. When Bahrain's growth is greater than the world growth rate and US-10 year yields are higher, PCFs to Bahrain tend to increase. In some specifications, increases in oil prices are significantly associated with lower PCFs, and higher short-term interest rates in Bahrain relative to the US are significantly associated with higher PCFs, with both coefficients significant. The R-squares of these models range from 0.4 to 0.5. Changes in EMBIG spreads, the VIX, and the fiscal balance in Bahrain were not significant. These results suggest that domestic and global risk factors and returns play a role in determining PCFs to Bahrain.

Bahrain: Coefficients from Multivariate Regressions

Dependent variable: Private Capital Flows (percent of GDP)

(Annual data 1992 to 2015)	Coefficient	Coefficient	Coefficient	Coefficient	Coefficient	Coefficient	Coefficient
Bahrain GDP growth - world GDP growth	1.39 *	2.09 ***	1.67 **	1.83 **	1.65 **	0.88 *	2.16 ***
US 10yr yield (normalized)	0.10 ***	0.08 ***	0.18 ***	0.12 ***	0.07 **	0.04	
US 10yr yield change							3.47
Log change in oil prices		-0.11 *					-0.11
Bahrain ST interest rate - US ST interest rate			2.41 *				
Change in EMBIG spread 1/						-0.01	
Log change in the VIX index					-3.19		
Change in the fiscal balance				-0.13			
Constant	-3.38 *	-4.99 ***	-20.4 ***	-18.48 ***	-17.93 ***	-11.99 **	-5.71 ***
R-squared	0.39	0.48	0.52	0.44	0.45	0.49	0.34

* 10% significance, ** 5% significance, *** 1% significance

Source: IMF staff calculations

1/ EMBIG spread data only from 2001 - 2015

D. Conclusion

14. Private capital outflows have been large and sustained in Bahrain. Private capital outflows from Bahrain have averaged near 10 percent of GDP in recent years. The current account surplus has financed private capital outflows in the past, but given the change in outlook to current account deficits, continued capital outflows could lead to lower international reserves.

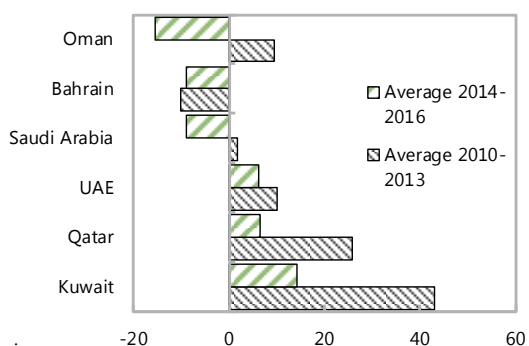
15. Bahrain has been experiencing larger private capital outflows than comparator countries. This paper compares the private capital flows of Bahrain to 3 groups of countries. The first group are other countries from the GCC, and share to some extent common economic structures, particularly the dependence on hydrocarbons and reliance on foreign workers, and exposure to shocks to the region. A second set of countries are those that have similar sovereign credit ratings and level of macroeconomic vulnerabilities as Bahrain, and a third are commodity exporters located in other regions. Bahrain's private capital outflows are the most similar in magnitude to countries with similar credit ratings, although even among this group Bahrain exhibits the largest negative capital flows in recent years. In comparison with other countries, indicators suggest that risks are relatively high and returns to investors are relatively low in Bahrain.

16. Empirical analysis suggests that capital flows to Bahrain are driven by both push and pull factors, and return differentials play a strong role. Push factors representing global liquidity conditions such as US 10-year yields are associated with higher capital flows to Bahrain, while changes in oil prices and world stock market returns are negatively associated with capital flows to Bahrain. The pull factors of Bahrain's economic growth relative to world growth and Bahraini interest rates relative to the US are associated with higher capital flows.

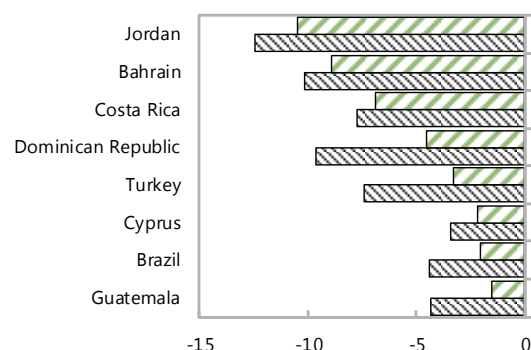
17. Mitigating private capital outflows will require structural reforms to improve investment opportunities and raise real returns. Bahrain has had lower interest rates and equity returns than most of its comparators, while at the same time a relatively higher perception of sovereign risk (i.e., high spreads and large fiscal deficits). It should be considered whether the current level of interest rates is appropriate given the interest rates in neighboring countries. Lower macroeconomic vulnerabilities and improved domestic investment opportunities for investors can help reduce capital outflows. Fiscal structural reforms and efforts at further fiscal consolidation could help keep the sovereign risk premium from rising further, and structural reforms that promote stronger private sector growth and deepen financial markets could improve confidence, returns, and provide more investment opportunities.

Figure 1. Comparative Data on Private Capital Flows**Privated Capital Flows 1/**

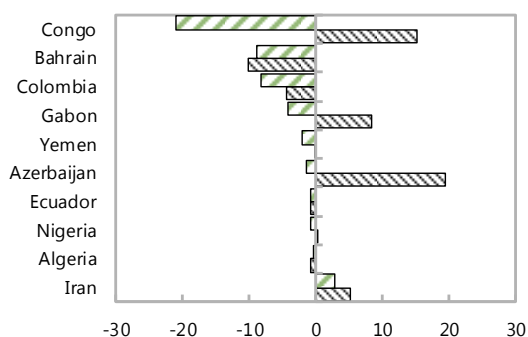
(Bahrain vs. other GCC countries, % of GDP)

**Private Capital Flows 1/**

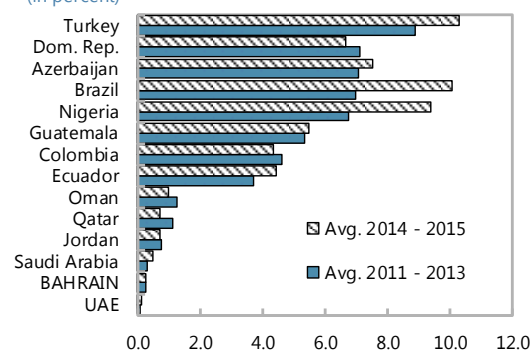
(Bahrain vs. similarly rated countries, % of GDP)

**Private Capital Flows 1/**

(Bahrain vs. some non-GCC oil exporters, % of GDP)

**Deposit Rates**

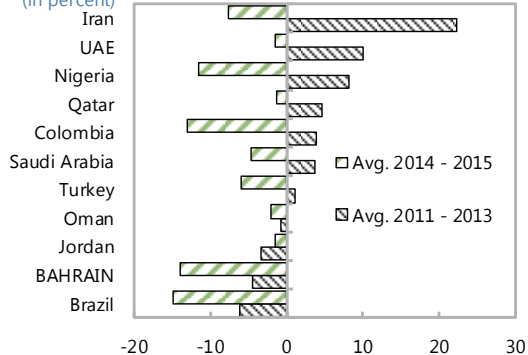
(in percent)



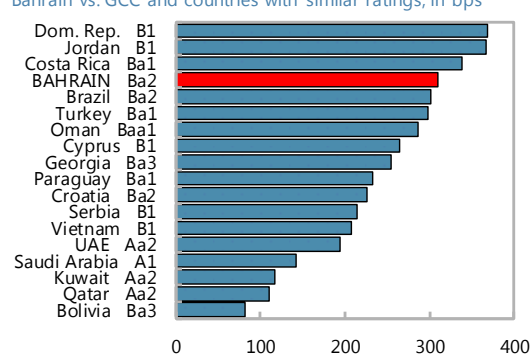
Sources: Haver Analytics

Stock Market Returns 2/

(in percent)

**Sovereign Credit Spreads 3/**

Bahrain vs. GCC and countries with similar ratings, in bps



Source: WEO database, IMF staff calculations, Haver Analytics, Bloomberg

1/Private capital flows = (FDI + Port. inv. + Other inv. + E&O) - net government debt issuance

2/ MSCI dollar indices with net dividends, except local indices.

3/ 5yr CDS spreads or Yield Spread vs. UST 10-yr as of Dec. 14, 2016

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PERFORMANCE AND VULNERABILITIES OF BAHRAIN'S NONFINANCIAL CORPORATE SECTOR¹

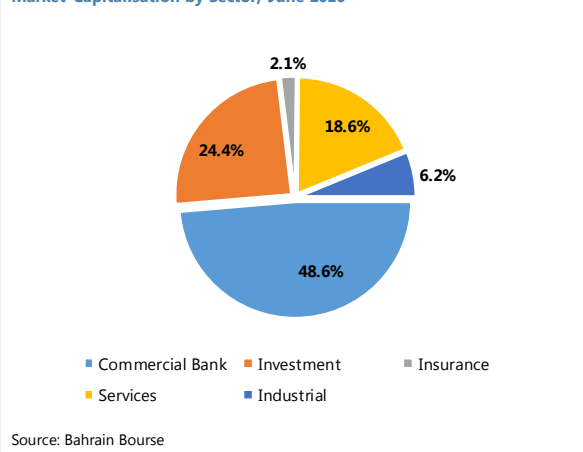
Bahrain's non-financial corporate sector balance sheets have remained healthy as of end-2015, though some deterioration in profitability and debt servicing ratios took place during the year. While overall debt servicing capacity remains strong, stress tests indicate a higher vulnerability to changes in the cost of funding for the industry sector companies relative to other sectors.

A. Introduction

1. Bahrain's non-financial corporate sector is relatively small compared to other sectors, with respect to GDP and is highly concentrated.²

Assets of the listed and non-listed non-financial corporate (NFC) sector firms in our sample were 28 percent of GDP at end-2015, up from 26 percent of GDP at end-2014. The listed NFC sector holds less than a quarter of market capitalization and is dominated by two majority state-owned enterprises (SOEs) that together account for 66 percent of total assets. The first one, BATELCO (30 percent of NFC sector assets; 52 percent of the service sector assets), dominates the service sector and has expanded its assets since 2012 mainly through debt financing. The second one, ALBA (Aluminum Bahrain), dominates the industrial sector and has recently increased its debt substantially through external loans. ALBA's assets represent 36 percent of NFC sector assets and 88 percent of industry sector assets. The construction sector is represented by one firm which has close to 10 percent of total NFC sector assets. The remaining activity in the service sector is primarily concentrated in trade (6 percent of total assets), real estate (7 percent), and to a lesser extent in tourism.

Market Capitalisation by Sector, June 2016



Nonfinancial Corporate Sector: Selected Indicators

	2012	2013	2014	2015
(Billions of U.S. dollars)				
Total assets	7.8	9.8	8.5	8.8
Cash	0.8	1.0	0.8	1.1
Total liabilities	1.1	1.6	1.3	1.3
Net profits	0.6	0.5	0.6	0.4
(Percent)				
Assets to GDP	25.4	30.1	25.5	28.2
Assets to Non Oil GDP	33.8	40.4	33.3	32.6
Debt to Equity	20.1	25.4	20.8	21.1
ICR ¹	37.8	27.7	27.8	14.5
Return on Assets	7.3	5.2	6.7	4.5
Return on Equity	10.3	7.9	9.3	6.3

Sources: IMF Corporate vulnerability utility (CVU); Orbis; and IMF staff calculations.

¹ Interest coverage ratios are calculated based on data from Orbis.

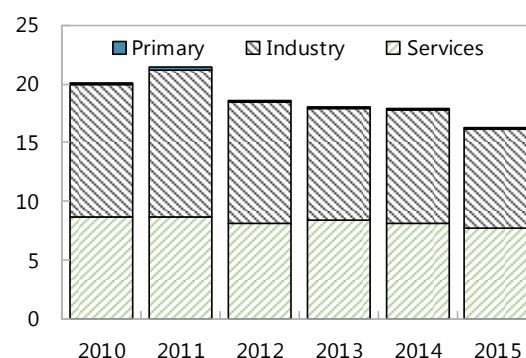
¹ Prepared by Vahram Stepanyan and Brian Hiland.

² Financial indicators used in our analysis are primarily based on data from Orbis and cover 27 nonfinancial firms (including 18 non-financial firms listed on Bahrain Bourse) over the period of 2012–2015. Data for end-2016 are unavailable.

B. Nonfinancial Corporate Sector Performance

2. Non-financial corporate sector sales declined in 2015. Operating revenue as a percent of non-hydrocarbon GDP has been shrinking since 2011, largely explained by a substantial drop in metal prices during this period which has affected the Aluminum Bahrain sales. This trend highlights the risks related to concentration in one non-hydrocarbon sector (metals) and the need for a more diversified Bahraini economy.

Operating Revenue: Share of Nonhydrocarbon GDP (Percent)



Sources: Orbis; and IMF staff estimates.

3. Returns on assets and returns on equity have both declined from their 2014 levels.

Companies in Bahrain's nonfinancial corporate sector continue to remain profitable, but less so than in previous years. While decreases in profitability occurred in some GCC countries, on average, profitability among Bahrain's non-financial companies has experienced the sharpest decline, particularly with respect to return on equity.

Non-Financial Corporate Sector: Return on Assets, 2012–15 (Percent)

	2012	2013	2014	2015	Average 2012-2015
Bahrain	7.3	5.2	6.7	4.5	5.9
Kuwait	3.9	4.7	4.2	4.7	4.4
Oman	5.7	5.5	6.9	6.7	6.2
Qatar	8.4	8.3	8.7	7.2	8.1
Saudi Arabia	8.1	8.0	7.8	7.2	7.8
UAE	4.0	4.3	5.1	5.3	4.7

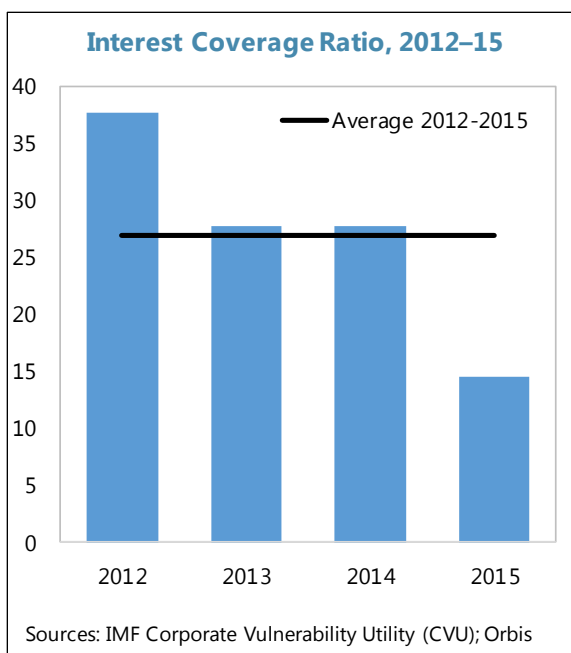
Source: IMF Corporate Vulnerability Utility (CVU); Orbis

Non-Financial Corporate Sector: Return on Equity, 2012–15 (Percent)

	2012	2013	2014	2015	Average 2012-2015
Bahrain	10.3	7.9	9.3	6.3	8.5
Kuwait	1.8	2.9	7.0	6.1	4.4
Oman	8.1	12.5	12.0	8.3	10.2
Qatar	16.0	12.6	13.3	11.3	13.3
Saudi Arabia	11.1	11.1	11.8	10.1	11.0
UAE	5.4	4.4	4.9	8.1	5.7

Source: IMF Corporate Vulnerability Utility (CVU); Orbis

4. Debt servicing capacity, as assessed by the Interest Coverage Ratio (ICR)³, remains at comfortable, albeit decreased levels. Even as the aggregate level of non-financial companies debt is low, the average ICR for 2015 has declined, possibly highlighting vulnerability to regional and global shocks, albeit with a caveat that the sample of Bahraini firms used for this indicator is small.⁴ Meanwhile, more recent data indicate that external debt of non-financial corporations has increased to above USD 9 billion at end-2016, primarily driven by SOEs (aluminum, steel, and airport companies) debt issuance.



C. Sensitivity analysis

5. Stress tests are used to assess the resilience of the NFC sector to a combination of interest rate and earning shocks. The sensitivity analysis explores three scenarios which impose shocks to both profitability and funding costs. For the stress tests, the interest coverage ratio (ICR) threshold for determining debt-at-risk is set at 1.5.

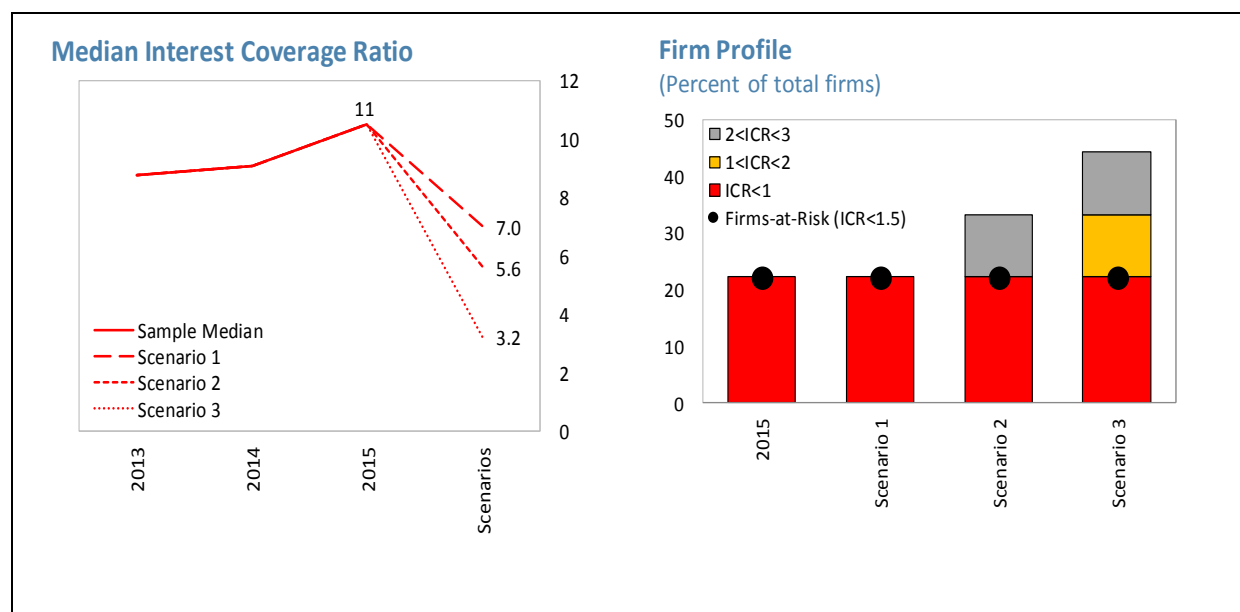
- The first scenario assumes an increase in the cost of funding by 200 basis points, and no change to aggregate earnings.
- The second scenario assumes the same increase in the cost of funding (200 basis points), combined with a 20 percent decline in aggregate earnings.
- The third, and most severe, scenario assumes a further increase of the cost of funding, this time by 500 basis points, combined with a 30 percent decline in aggregate earnings.

6. Sensitivity analysis results show that Bahrain's nonfinancial corporate sector is relatively well protected from interest rate and earnings shocks. In all three scenarios, while the ICR declines it remains above the debt-at-risk threshold and the share of firms-at-risk remains stable at 22 percent. This is explained by very high starting ICRs for all but two firms in our sample. A 200-basis point increase in the interest rate (scenario 1) causes a decrease in the median ICR from eleven to seven. Adding a 20 percent decrease in earnings to this (scenario 2), causes the ICR to fall to 5.6. Finally, under the most severe scenario (scenario 3), the median ICR falls to 3.2 and puts

³ The ICR is calculated as earnings before interest and taxes divided by annual interest expense and does not give a full picture on capacity to service the debt payments which also include principal payments.

⁴ The sample for the ICRs includes nine firms which account for 84 percent of total assets of the total nonfinancial corporate sector. A negative ICR of a smaller firm notably affected the average for 2015. Still, ICRs declined across all major firms in the sample.

33 percent and 44 percent of the firms in our sample into ICR range of below 2 and below 3, respectively.



D. Concluding Remarks

7. Bahrain's nonfinancial corporate sector is small and concentrated. The analysis in this paper is based on 27 listed and non-listed firms whose assets amount to less than 30 percent of GDP and are dominated by two majority state owned enterprises.

8. The NFC sector in Bahrain has remained resilient as of end-2015, although some deterioration in profitability and debt servicing ratios took place during the year. Overall debt is low and debt servicing capacity of NFC sector remained adequate. Stress tests indicate that, except for two firms with low interest coverage ratios, the remaining firms remain robust to interest rate and earnings shocks.

POLICY OPTIONS FOR FISCAL ADJUSTMENT IN BAHRAIN¹

As oil prices rose in the early 2000s, the increase in oil revenues was used to finance a large increase in current spending in Bahrain, building in expenditure rigidities. With the decline in oil prices since mid-2014, there is a need for large fiscal adjustment to restore fiscal sustainability. A combination of non-oil revenue and expenditure measures will be required to underpin the adjustment. This paper outlines some considerations that could inform the choice of non-oil revenue and expenditure measures.

A. Introduction

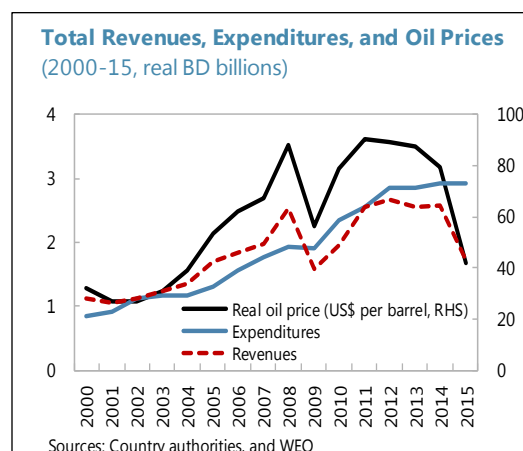
1. Bahrain's fiscal revenues are highly oil-dependent and have been affected by the oil price decline. Oil revenues accounted for about 80 percent of total revenues during 2000 to 2015, which exposes Bahrain to fluctuations in oil prices. The substantial decline in oil revenues on the back of the sharp drop in oil price since mid-2014 has resulted in a large deficit, close to 18 percent of GDP in 2015 and 2016.

2. The government has launched fiscal consolidation measures, in particular, to reduce energy subsidies. In early 2016, the retail price of gasoline was raised by nearly 60 percent. Price increases for diesel, kerosene, LPG, and electricity and water tariffs are being phased in through 2019, albeit with exemptions. Natural gas prices are being increased through 2021. The government has implemented increases in tobacco and alcohol taxes and in government fees and charges. The government has also tightened spending on subsidies and transfers. Even with these measures, the fiscal deficit is expected to remain high. The public debt reached 82 percent of GDP at end-2016 and is expected to continue to increase rapidly over the medium-term.

3. The deterioration in Bahrain's fiscal position calls for a sustained and sizable fiscal adjustment over the medium-term. Measures to raise non-oil revenues, contain current expenditure, and prioritize capital spending are urgently needed.

B. Trends in Revenue and Expenditure

4. Total revenues and expenditures have increased substantially since 2000. Driven by the increase in the real oil price, real revenue grew by 3.5 percent per year on average during 2000–15. Between 2000 and 2008, it grew by 11 percent, and declined sharply by 38 percent in 2009 before rebounding again in 2010. During 2011–14, real revenue continued to grow by 7.8 percent annually on average, before dropping by one-third in 2015. Growth in



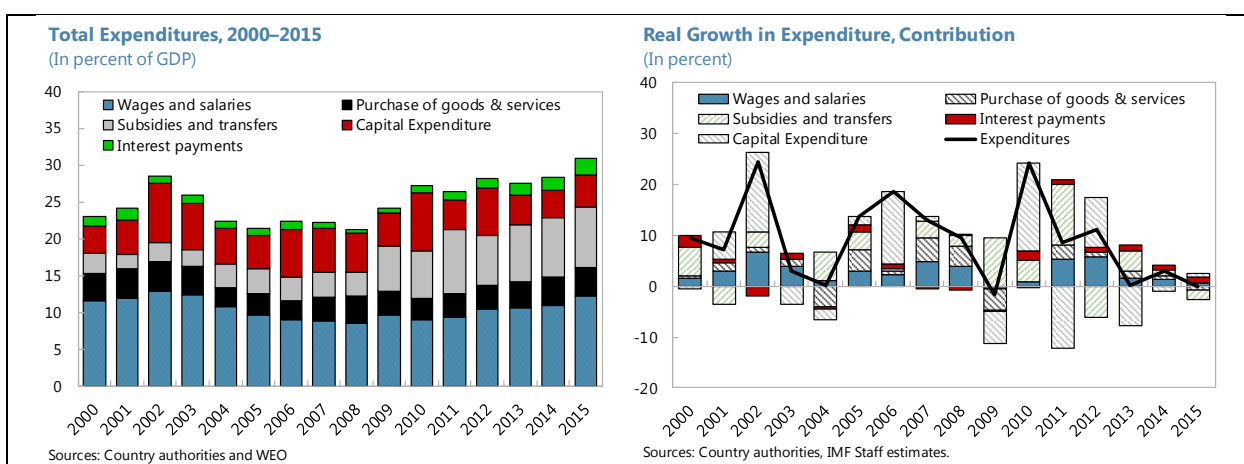
¹ Prepared by Ali Alreshan.

revenue was outpaced significantly by growth in total real expenditure, over 8 percent on average over the entire period. The correlation of government revenue with oil prices introduced volatility based on oil prices. On the other hand, real expenditure grew at a relatively steady pace.

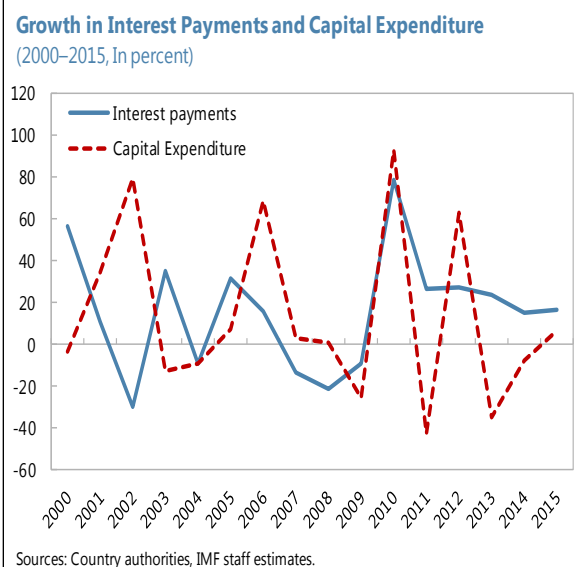
5. Government revenue has been declining as a share of GDP. Oil revenue was about 14 percent of GDP in 2015, down from 22 percent of GDP in 2000. On average, oil revenue has been hovering around 21 percent of GDP during 2000–14. However, the large decline in oil price in 2015 reduced oil revenue by 7 percent of GDP. Non-oil revenue declined to 4 percent of GDP in 2015 compared with about 8 percent in 2000.

6. Non-oil revenue is dominated by administrative fees and charges. Non-tax revenue, which contains administrative fees and charges and other non-tax revenues, accounted for 83 percent of total non-oil revenue in 2015. The other 17 percent was tax revenue, mainly customs and other import duties. The decline in non-oil revenue over the past decade has occurred primarily in administrative fees and charges—these stood at 5.7 percent of GDP in 2000, but reached only 1.3 percent of GDP in 2015 owing to reductions between 2007 and 2009 to protect vulnerable groups from higher inflation.

7. Expenditure has risen to 31 percent of GDP in 2015 from 23 percent in 2000, with the bulk of the increase concentrated on current spending. Current expenditure as share of GDP increased from about 20 percent in 2000 to about 27 percent in 2015, while capital expenditure increased from 3.6 percent in 2000 to 4.4 percent of GDP in 2015. Within current spending, real wages and salaries increased by 6.8 percent annually over the period 2000–15, and declined as a share of total expenditures. Subsidies and transfers, on the other hand, increased as a share of total spending from 12 percent in 2000 to 26 percent in 2015, recording an annualized real growth rate of 14 percent. Subsidies and transfers as share of GDP stood around 2.8 percent in 2000 and continued hovering around this rate until 2009 when they doubled to reach 6.2 percent of GDP. They continued to expand strongly in 2011 and 2013 and amounted to 8.2 percent of GDP in 2015.

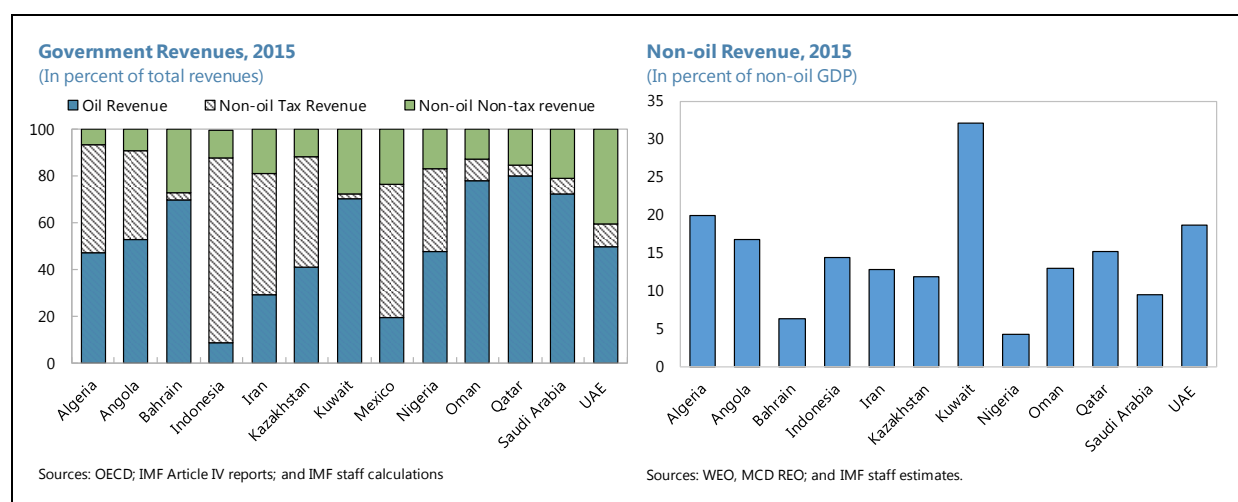


8. The share of interest payments has been on a positive trajectory in recent years driven by a rising debt level. Public debt started to increase since 2009 to reach about 66 percent of GDP in 2015 compared with 13 percent in 2008. This large increase in debt has resulted in higher interest payments to reach 2.3 percent of GDP compared with 0.6 percent in 2008 and 2009. Between 2000 and 2015, the average annual growth rate of interest payments reached about 10 percent, outstripping the average growth rate of capital expenditure of 8 percent. The share of capital expenditure in total spending has seen significant variation from year to year, including large declines in 2011 and 2013.



C. International Comparison

9. Bahrain's non-oil tax revenue, at 0.8 percent of non-oil GDP and 3.8 percent of total revenue, is lower than most other oil exporters. As a share of non-oil GDP, among the GCC, Bahrain has the lowest non-oil tax revenue, while Kuwait and the UAE have the highest. However, as a share of total revenue, all GCC countries have low non-oil tax revenue compared with other oil exporting countries.



10. Wages are relatively high and contribute to expenditure rigidity. In 2015, Bahrain's wage bill as a share of total expenditure was estimated at nearly 40 percent, which places Bahrain close to Saudi Arabia and higher than other oil exporting countries. As a share of GDP as well, wages and salaries in Bahrain are higher than in most other oil exporting countries. The high share of spending on wages and salaries contributes to expenditure rigidity in Bahrain.

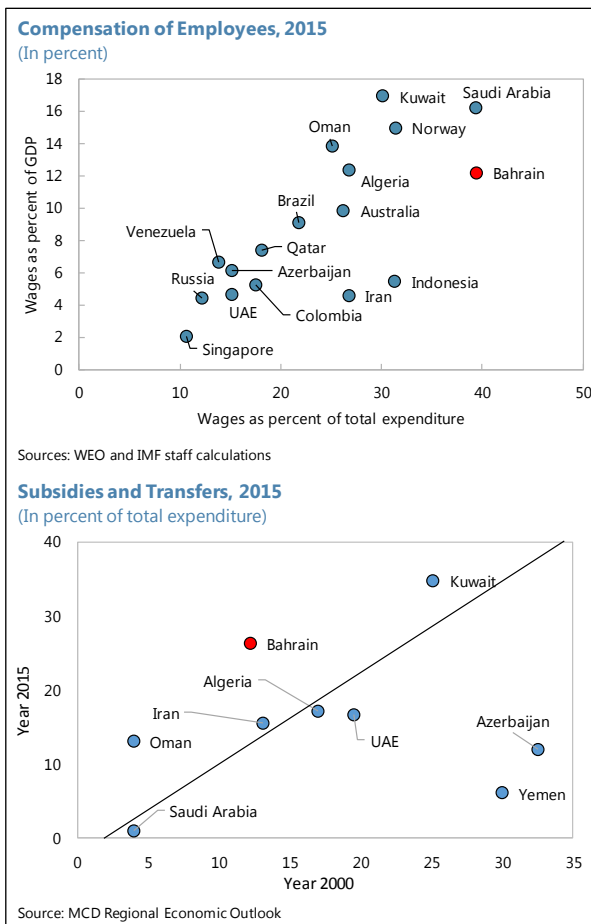
11. Bahrain had the largest increase in subsidies and transfers over the period 200-15. Subsidies and transfers as a share of total expenditure increased from 12 percent in 2000 to 26 percent in 2015. In Kuwait and Oman, subsidies and transfers increased much less than in Bahrain, and even decreased in most other oil exporters.

D. Fiscal Adjustment Strategy²

12. The government should develop a fiscal adjustment strategy that focuses both on revenue and expenditure measures. Increasing non-oil revenue will help finance future provision of government services and lower the vulnerability of the budget to volatility in oil prices. Increasing non-oil revenue through a well-designed tax system will require adapting legislation, developing an effective tax administration, and communication strategy. On the revenue side, the government should consider direct and indirect taxes along with increasing government fees and privatization.

Value Added Taxes (VAT)

13. Bahrain, along with other GCC countries, has announced its intention to introduce a VAT in 2018. Like other GCC countries, it is considering implementing a single tax rate of 5 percent on a harmonized base. However, the harmonized base excludes six sectors: education, health, financial services, real estate, domestic transportation, and oil and gas, where every country has the liberty to decide on the tax treatment. While some implementation issues are still to be agreed, the proposed VAT rate is low with significant exemptions and should have a modest incremental impact on inflation in Bahrain, estimated at about 2 percentage points.



² This section is based on "Diversifying Government Revenue in the GCC" IMF (2016).

14. The estimated VAT revenue ranges from 1.9 to 2.2 percent of GDP (IMF, 2016).³

Broadening the base to include exempt sectors would help generate higher revenues. For instance, a VAT can be imposed on financial fee-based services such as safe deposit boxes, fees for bank advice, subscription fees credit cards, premium against general insurance and other services, as long as it is easy to determine the charges for these services.⁴ In addition, Bahrain should start building the necessary capacity to administer the VAT.

Business Profit Tax

15. Other than taxes on oil companies, Bahrain does not tax income for incorporated and unincorporated businesses. The Business Profit Tax (BPT) is a substantial source of revenue for many countries.⁵ Under this tax, corporations and individuals are subject to tax on corporate income and personal income that includes profit from unincorporated businesses.

16. Bahrain is the only country in the GCC that does not apply a BPT. Yields from a Corporate Income Tax range from 3 percent of non-oil GDP in Oman to 0.5 percent in Kuwait. Given the larger nonoil sector in Bahrain, it is reasonable to start imposing business profit taxes. Imposing a tax of 15 percent on non-oil business (both incorporated and unincorporated) could generate sizeable revenues, up to 3.3 percent of GDP.⁶ However, the net revenue yield might be smaller if there are exemptions and deductions.

Revenues Estimates for a Proposed Business Profit Tax								
(In millions BD, unless otherwise noted)								
	GVA non-hydrocarbon economy	Gross operating surplus in non-hydrocarbon economy 1/	Depreciation 2/	Business profit tax potential base	Hypothetical tax rate, percent	Potential revenue yield	Expected revenue yield at 60 percent tax effort	Expected revenue yield, in percent of 2015 GDP
	(1)	(2) = (1)*0.55	(3) = (1)*0.12	(4) = (2)-(3)	(5)	(6) = (4)*(5)/100	(7) = (6)*0.6	(8)
Bahrain	10,032	5,518	1,204	4,314	15	647	388	3.3

Source: Haver; IMF WEO database; OECD; authorities; and Fund staff estimates.

1/ The assumption is that in the GCC countries on average gross operating surplus is 55 percent of the non-hydrocarbon GVA. As a comparison, the indicator was 2/ Assumed at 12 percent of the non-hydrocarbon GVA. The fixed capital consumption (used as a proxy for depreciation) is estimated at 10.5 percent for UAE and at

Property Tax

17. Property tax is another potential source of revenue for Bahrain. The property tax is an annual tax imposed on the value of immovable properties. It typically falls on wealthier individuals

³ These revenue estimates are based on two different methods. The first yield estimate is based on the C-efficiency ratio of 0.58 percent for a selected sample of countries, while the second estimate is based on assumption that 90 percent of private consumption is the base for the VAT.

⁴ For more details, see Jenkins and Khadka (1998).

⁵ There is an overlap between PIT and BPT, especially for unincorporated businesses. Therefore, the yield from implementing the two measures is likely to be less than the sum of the yields from each measure individually.

⁶ Average tax effort is assumed to be 60 percent.

as property ownership is a good proxy for (and significant component of) personal wealth. By taxing accumulated wealth, it does not affect future economic behavior and is also difficult to evade. For these reasons, the property tax is considered an efficient and equitable means of raising revenue. Due to the lack of data on property in Bahrain, it is difficult to estimate the tax revenue. However, based on international experience, the property tax yield could be around 1 percent of GDP.⁷ To implement this, the government would need to develop a comprehensive property valuation and registration system.

Taxation of Deposit Interest Income

18. The government may want to consider taxation of deposit interest income as another source of revenue. Such tax—applied in many countries, is progressive and, in the absence of a personal income tax, provide a useful way for wealthier individuals to share the tax burden. In addition, these should be relatively easy to administer, with limited scope for avoidance, if implemented through a final withholding approach. Staff estimates suggest that imposing a 15 percent tax rate on interest income might generate around 0.2 percent of GDP.⁸

Excises

19. The GCC countries have also agreed to impose excises on tobacco, alcohol and sugar-sweetened beverages (SSBs). Bahrain has already implemented taxes on tobacco and alcohol in 2016, while excises on SSBs should start in 2017. Estimates of incremental revenue from taxing SSBs are unavailable. However, for these excises to be successful, they should be accompanied by strong enforcement to reduce smuggling, especially for tobacco. For SSBs, the excises should cover all beverages with added sugar and sweeteners to avoid revenue losses from substitution to other alternatives.⁹

Government Fees

20. Authorities are raising government fees on public services. The government used to generate between 5–7 percent of GDP from administrative fees and charges during 2000–05. However, this declined to reach only 1.3 percent in 2015. Fees that were increased or introduced in 2016 are estimated to yield about 0.2 percent of non-oil GDP. While the government could increase the fees to cost recovery levels or even higher to generate revenues, these efforts should focus on select services (e.g. education, healthcare) where the revenue potential is sizable (see Box 1 for the Dubai experience). The increase in fees should avoid an adverse impact on business activity and be accompanied by an improvement in the efficiency of services. In addition, the government could outsource some services to the private sector to cut costs.

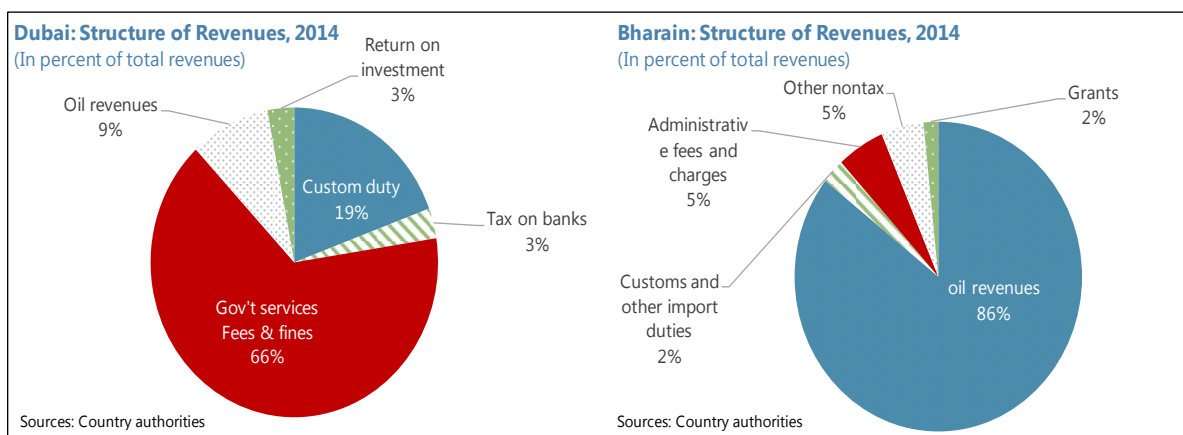
⁷ This yield estimate is based on the average of 65 countries at different development stages. For more details, see Norregaard (2013).

⁸ This calculation is based on the total private sector deposits (excluding demand deposits) and average interest rate on deposits as of end-2015.

⁹ For more details, see “Diversifying Government Revenue in the GCC” IMF (2016).

Box 1. Fees of Government Services as a Source of Income: Dubai Experience

Dubai's revenues originate from two sources: tax and non-tax revenues. Tax revenues consist of custom duties and taxes on foreign banks, and account for 22.5 percent of total revenues, while non-tax revenues include government services fees and fines, oil revenue, and return on investments. Revenues generated from government services fees have been on upward trajectory since 2002, dominating other sources of revenues. They accounted for 84.5 percent of non-tax revenues and 65.5 percent of total revenues in 2014. The continuous increase in government services and fee revenues is driven by the variety of services offered and the pricing mechanism of these services.



Dubai offers four different categories of services and each category has a different pricing mechanism as follows:

First category: Public goods and services such as security, justice, legal system, and infrastructure. This category is financed through taxes.

Second category: Administrative and organizational services such as civil services, visas, and permits. This category is financed by fees that are determined by cost recovery and benefits of services (return on government services for beneficiary). In addition, the government has developed policies to increase or reduce services fees as needed, especially to regulate demand.

Third category: Competitive economic services, which are provided by government and private sector, are priced at market (e.g. education and health services).

Fourth category: Non-competitive economic services such as electricity, water, sanitation. These services are financed by tariffs based on economic cost (accounting cost plus required return on capital). Tariffs increase with consumption to safeguard low-income groups.

Personal Income Taxes

21. Bahrain does not impose personal income taxes. Direct taxation of capital and labor income can raise non-oil revenue in an efficient, equitable and simple way.¹⁰ Taxing household income through the Personal Income Tax (PIT) represents a potential source of non-oil revenue.

¹⁰ Tax efficiency means that capital allocation and investment choices should not be distorted by tax considerations, while tax equity means that the tax should be fair, with two main dimensions: horizontal equity (the treatment of taxpayers with the same level of income) and vertical equity (the treatment of taxpayers with different levels of income).

Given the likely constraints on Bahrain's tax administration capacity, policymakers should adopt a simple taxation system to begin with until capacity constraints are removed.

22. A flat rate PIT system seems the most appropriate given its simplicity and efficiency.

There are different types of PIT systems (Box 2), but most of them are complex, which may reduce tax efficiency and increase administrative costs. The use of a flat rate on capital and non-capital income (with appropriate deductions and thresholds) reduces distortions. Capital income includes capital income from all sources such as interest, dividends, capital gains from financial assets, and profits from personal business. Non-capital income includes labor income from employment and self-employment, transfers from the government, and public pensions. Taxation of capital income can be facilitated by using financial institutions as vehicles for withholding tax at the source to reduce compliance costs.

23. The PIT could yield non-oil revenue up to 3½ percent of GDP. Household income (from 2006 household expenditure and income survey) accounts for 40 percent of GDP. Imposing a 15 percent flat tax rate without allowances on household income would generate about 3.6 percent of GDP or BD 400 million assuming a tax effort of 60 percent (Table 1).¹¹ This estimate may be on the high side given that it does not account for thresholds, compliance and efficiency issues. The flat tax rate of 15 percent is also relatively low compared to that in other countries and is likely to have only a limited adverse impact on Bahrain's competitiveness.

Revenues estimates from Personal Income Tax 1/						
	Nominal GDP, 2015 (in billion, NC)	Total household income (share of GDP)	Flat income tax rate 2/	Estimated tax revenue (in billion, NC)	Estimated tax revenue at 60 percent tax effort	Estimated tax revenue (percent of GDP)
Bahrain	11.7	40.2	15%	0.7	0.4	3.6

Sources: Country authorities and staff calculation.

1/ The estimate of household income is based on published "household expenditure and income survey" 2006.

2/ This tax rate is for illustrative purposes.

24. Regional coordination would facilitate the eventual introduction of a PIT. None of the other GCC impose a PIT currently. If all GCC countries introduce PIT as a part of their reform agenda, and coordinate the implementation, this could increase public acceptance.

¹¹ Average tax effort for non-oil countries is 60 percent based on Fenochoietto and Pessino (2013).

Box 2. Types of Income Tax Systems

Many countries impose income tax, and the choice of income taxation system depends on each individual country's economic characteristics. The different types of income tax systems are discussed below.

Flat tax system: it levies a proportional (flat) tax rate on net income. This system can take different forms, such as flat rate with no basic allowance, flat rate with basic allowance, and flat rate on all positive payments to employees above a basic allowance coupled with the same flat rate on all incorporated and unincorporated business income. A flat tax system is simpler than a progressive system. Furthermore, it could remove the incentives for income shifting if the same flat rate is introduced for both personal and corporate income, which increases efficiency and reduces administrative costs. This system can be made progressive by using basic allowances. However, tax allowances and incentives may distort the household's labor and saving decisions, especially when effective tax rates are different between saving vehicles.

Comprehensive income tax system: this system taxes all or most income (less deductions) at the same rate, which is usually progressive with the income level. It is based on the principle of horizontal equity in the sense that individuals with the same level of income are taxed equally. It also fulfills the vertical equity principle requirements, and avoids income shifting possibilities, reducing administrative costs. This system is mainly based on realized (cash) income in practice. However, the progressivity of this system discriminates against variable income which may discourage seasonal work and reduce investment in human capital and demand for risky assets. This system does not take into account the high mobility of capital across borders.

Dual income tax system: it levies a proportional tax rate on all net income combined with progressive rates on gross labor and pension income. It imposes a flat, symmetrical tax rate on income from capital and business profits, which ensures a symmetrical treatment of all capital income with no double taxation of dividends and capital gains on shares. A dual income tax system achieves horizontal equity by lowering the tax rate on capital and implementing a neutral and progressive tax rate on labor income, which enhances efficiency and ensures income redistribution. However, the lower proportional tax rate on capital income might undermine vertical equity as income from capital tends to be in the upper income brackets. In addition, this system gives taxpayers the incentive to shift income from labor to capital income to avoid higher tax rates.

Semi-dual income tax: it uses different nominal tax rates on different types of income. It taxes some forms of capital income at low and flat rates and remaining forms of income at higher and progressive rates. This system could be hybrid between comprehensive and dual income tax system. It is difficult to distinguish between semi-dual and semi-comprehensive personal income tax system and it is a matter of interpretation. Usually, semi-dual income tax system taxes capital income at low flat rates, labor income at progressive rates, while the semi-comprehensive system taxes both capital and labor income at high progressive rates.

Reducing Expenditure

25. Lower fiscal multipliers for current spending suggest that expenditure cuts should fall to the extent possible on current spending. The fiscal multipliers for both capital and current spending are only 0.4 and 0.3, respectively, in the short-term. While capital spending multiplier is increasing in the medium-term to reach 1.6, current spending multiplier remains constant.¹² To mitigate the impact of expenditure cuts on economic activities, the government should start with

¹² The multipliers estimates are for the whole GCC region. For more details, see "More Bang for the Buck in the GCC" IMF (2016).

current expenditures which have the lowest fiscal multipliers. Raising the efficiency of investment spending can also help maximize its impact on growth.

26. Fiscal consolidation may weigh negatively on inequality in the short-term, emphasizing the need to put in place targeted social safety nets for the poor and vulnerable.

Over the longer term, as fiscal adjustment helps correct macroeconomic imbalances, this will support growth and create more jobs (IMF, 2014).

27. GCC funds afford an opportunity to reduce public investment spending financed by own funds. The GCC funds are expected to disburse \$7.5 billion over the medium-term for construction of schools, roads, hospitals, and the airport expansion. This is likely to support growth and provides an opportunity to reduce government-financed public investment.

28. PPPs have the potential to alleviate spending pressure on government and increase private sector engagement. The public sector has a large role in the Bahraini economy. Shifting some infrastructure projects to the private sector through Public-Private Partnerships (PPPs) can help reduce spending pressures and increase the role of the private sector in the economy. Previously, Bahrain has encouraged private sector involvement in the utilities and housing sectors. A broader use of PPPs would require establishing the accompanying institutional and regulatory frameworks, as well as strong project appraisal and prioritization processes.¹³ When regulated effectively, PPPs allow for flexible risk sharing between the public and private sectors, encourage the private sector to take long term investment decisions, and mitigate potential fiscal risks. Risk sharing with the private sector should enable the government to stop or suspend a PPP project if needed to limit moral hazard and adverse selection.¹⁴ Government guarantees often create contingent liabilities and are the main fiscal risk associated with PPPs. Therefore, they must be well designed and limited in scope and duration.

29. Reducing current spending will require addressing wages and salaries and subsidies and transfers. The two largest items accounting for over 75 percent of current spending in 2015 are wages and salaries (46 percent) and subsidies and transfers (31 percent) which impart considerable rigidity to the government budget. Given the 30 percent average wage gap between nationals employed in the public and private sectors, a streamlining of allowances and a nominal wage freeze can help lower the wage bill without affecting the attractiveness of public employment or service delivery. Moreover, with government employment at 12 percent of the working age population, compared with 8.3 percent in emerging markets, there is scope for reducing public employment through attrition targeted at overstaffed areas.¹⁵

30. The recent efforts to reduce energy subsidies are steps in the right direction but more is needed. In early 2016, the retail price of gasoline was raised by nearly 60 percent. Price increases

¹³ For more details, see Akitoby, Hemming and Schwartz (2007).

¹⁴ For more details, see IMF (2004).

¹⁵ For more details and discussion, see IMF (2016).

for diesel, kerosene, LPG, and electricity and water tariffs are being phased in. A majority of Bahraini households (on their first property) and small businesses (whose consumption is below a certain threshold) are exempt from higher electricity and water tariffs. Natural gas prices are being increased gradually through 2021 in line with Henry Hub prices. Broad exemptions should be replaced with targeted transfers to the low-income and vulnerable groups. Setting natural gas reference prices using prices in Europe and Asia and eliminating exemptions would generate revenues of about 3.9 percent of GDP, while meeting social goals and improving economic efficiency. An automatic pass-through mechanism could be introduced for gasoline and diesel and would protect the fiscal position from volatility. Implementing the spending measures in a phased manner will allow the private sector time to adjust and avert a deterioration in balance sheets.

31. A comprehensive evaluation and review of expenditures, including the government size and functions, can help achieve efficiency gains. This evaluation could examine the role of the government and the cost effectiveness of different policy interventions. The government departments' functions can be reviewed to identify areas of duplication and overlap and addressed through structural reforms, including the elimination of some functions and merging of ministries.

E. Conclusion and Recommendations

32. Large fiscal deficits and the rising level of public debt call for fiscal consolidation in Bahrain. The fiscal adjustment strategy will need to rely on a combination of measures to reduce expenditure, increase non-oil revenue, safeguard economic activity, and protect vulnerable groups. In addition, the government should strengthen the fiscal framework by adopting medium-term fiscal and budget frameworks. A comprehensive communication campaign can help explain the fiscal strategy to the public, increasing buy-in and predictability for taxpayers and investors.

33. Bahrain has the lowest non-oil revenues among the GCC countries, providing scope to raise them further. While there may be scope to raise fees and charges, these efforts should focus in select areas where the revenue yield is sizable. Caution is warranted as a complicated system of fees and charges may prove difficult to administer, weaken the business environment, and distract from other more effective efforts to generate non-oil revenue. Other options to generate non-oil revenue include a Business Profits Tax (BPT), excises, property taxes, and eventually a Personal Income Tax (PIT). Developing the capacity to administer these taxes will require time.

34. Spending has increased rapidly over the past decade and should be reduced. Rapid growth in wages and salaries and subsidies and transfers has contributed to a high level of current spending and expenditure rigidity. Reductions of the wage bill can be achieved through streamlining allowances and freezing wages in nominal terms. Hiring freezes and attrition targeted towards overstaffed areas can help reduce public sector employment. Generalized subsidies and transfers should be replaced with targeted cash transfer programs to protect low-income groups. The opportunity presented by the GCC funds to streamline public investment should be availed. Shifting some infrastructure projects to PPPs can help increase the role of the private sector and safeguard growth. Finally, developing the capacity to better manage expenditure and increase efficiency is crucial for the success of fiscal adjustment strategy.

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