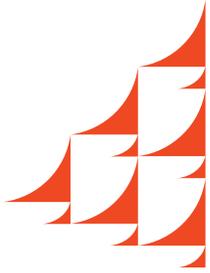


The Arab Gulf States
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Unattractive Choices Government Faced
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Executive Summary

In October, Bahrain announced plans to raise its value-added tax from 5% to 10% in January 2022. The tax rise falls under the umbrella of Bahrain's fiscal balance program, which was recently revised after the coronavirus pandemic interrupted its implementation. Bahrain has the smallest demonstrated oil and gas reserves of the Gulf Cooperation Council countries, and that oil prices have for the most part been below \$80 per barrel since 2014 has led to credit downgrades and a demand from investors for fiscal reforms.

The decision to raise taxes was unpopular among the general public, and many citizens called for the government to consider alternatives, including a tax on foreign transfers (remittances) by migrant workers, a progressive wealth tax, and a tax on company profits. These proposals sought to minimize the tax burden borne by low- and middle-income Bahrainis, at the expense of expatriates or the wealthy.

However, Bahrain's status as a small open economy that is deeply integrated with the economies of neighboring GCC states would undermine the effectiveness of these proposed alternatives. Rather than leading to the wealthy paying their fair share, they would most likely lead to capital flight, exacerbating the government's fiscal problems. This is because the wealthy are particularly adept at evading taxes by rapidly moving their money out of small open economies. In the case of taxes on remittances, although focused at the lower end of capital accumulation, they would threaten Bahrain's reputation as a financial hub that imposes no controls over capital flows, which is a central element of Bahrain's strategy for attracting foreign direct investment.

Even though an increase in the VAT seems the most viable option, higher levels of public buy-in could be secured through greater transparency in fiscal policy. In particular, Bahrain's successful coronavirus strategy has been built on transparent deliberations and proactive engagement with the public, and emulating these aspects in the fiscal domain would help Bahrain implement its needed reforms more smoothly.

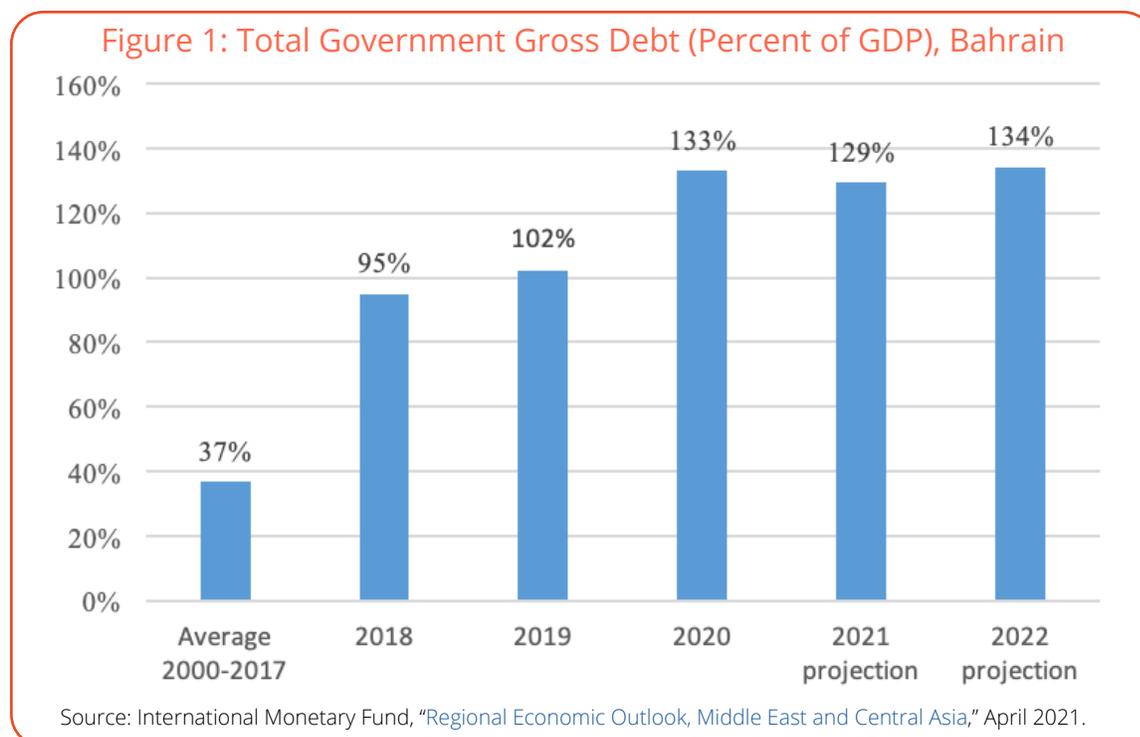
Introduction

In October, Bahrain's government announced plans to increase the value-added tax from its current level of 5% to 10% beginning in January 2022.¹ The move was predictably unpopular among the kingdom's residents. Though, in comparison to available alternative tax policies, Bahraini policymakers assessed a VAT increase, with measures aiming to make the tax more progressive, would balance the fiscal concerns of lower- and middle-class Bahrainis and the government need to secure foreign direct investment. However, in the future, a more transparent approach to the deliberative process would help mitigate public dissatisfaction regarding tax increases.

¹ Babu Das Augustine, "Bahrain's VAT Hike to Reduce Budget Deficit, Improve Chances of Continued GCC Support," *Gulf News*, October 2, 2021.

Bahrain's Fiscal Balance Program

In 2018, Bahrain's national debt rose above 87% of gross domestic product and the budget deficit equaled 6.3% of GDP.² The sustained upward trajectories of both figures, caused in part by the 2014 collapse of oil prices, had made international investors jittery. This was reflected in declining credit ratings on Bahrain's sovereign debt, rising interest rates demanded by creditors, and pressure on the Bahraini dinar's 4 decade-old peg to the U.S. dollar. Figure 1 shows the International Monetary Fund's April estimates and projections for Bahrain's public debt as a percentage of GDP, demonstrating the precarious path.



Unsustainable public finances and sovereign defaults have a long history of ravaging economies, with Argentina and Greece two of the more recent examples. Accordingly, Bahrain's government took decisive action by launching a fiscal balance program in cooperation with its regional partners – Saudi Arabia, the United Arab Emirates, and Kuwait. The plan was to use a combination of \$10 billion in financial assistance from its three neighbors and deep reforms to public finances to restabilize the budget by 2022.

The Fiscal Balance Program involved six primary initiatives.³ Some were continuations of previous reforms, notably cutting subsidies – Bahrain had already reduced the generous subventions it used to provide to gasoline, electricity, water, and several other basic commodities. Rationalizing government expenditure and streamlining private sector regulation also fell under this category.

² Government of Bahrain, "Update of the Fiscal Balance Program," accessed December 7, 2021.

³ Ibid.

Other reforms, however, were completely new. A voluntary retirement scheme attempted to decrease recurring government expenditures on public sector salaries, and it resulted in over 8,000 retirements, representing 18% of the civil service, and saving almost \$350 million annually.⁴ Perhaps the most salient new initiative was the introduction of a VAT, which functions as an indirect tax on select goods and services – often referred to as a consumption tax – that is imposed wherever value is added along the supply chain.⁵ During its first year of implementation, it generated \$660 million in revenue.⁶

By early 2020, the fiscal balance program's initial milestones had been hit.

By early 2020, the fiscal balance program's initial milestones had been hit: The 2019 target for the primary deficit (which is the deficit not including interest payments on government debt) was \$125 million, whereas the actual primary deficit was \$106 million.⁷ The painful belt-tightening seemed to be paying off.

Pandemic Disruptions

Unfortunately, the coronavirus pandemic proved to be hugely disruptive to Bahrain's fiscal balance program through multiple channels: the steep decline in economic activity, including tourism (particularly from Saudi Arabia) that has been an important part of the local economy for decades; the sharp increase in expenditure on health interventions and fiscal stimulus; and the sharp drop in global oil prices caused by the pandemic, as oil profits still comprise over 50% of government revenue.

Though Bahrain has managed the crisis comparatively well, especially on the health side, where it recorded 15 total deaths related to the coronavirus since the middle of July,⁸ the pandemic nonetheless severely impacted the Bahraini economy. In 2020, the budget deficit rose to 12.8% of GDP, while the public debt jumped to 115% of GDP.⁹ International credit rating agency Fitch downgraded Bahrain's sovereign debt from BB-/stable to B+/stable, while both Moody's and S&P changed Bahrain's outlook from stable to negative.¹⁰

Due to its preoccupation with managing the pandemic, and because of the lack of certainty regarding the future of the global economy, the government did not enact any major fiscal reforms, choosing instead to wait for a vaccine rollout to help the kingdom fully reopen its economy. By late September 2021, Bahrain was in a position to focus its efforts on fiscal restructuring having achieved some measure of control over the pandemic, culminating in the October announcement of a rise in the VAT, and the subsequent launch of a recalibrated fiscal balance plan.

⁴ Government of Bahrain, "Update of the Fiscal Balance Program," accessed December 7, 2021.

⁵ Robert Mogielnicki, "Value-Added Tax in Gulf Arab States: Balancing Domestic, Regional, and International Interests," *Arab Gulf States Institute in Washington*, August 26, 2019.

⁶ "VAT Generates BD250m Revenue," *Gulf Daily News*, February 15, 2020.

⁷ Government of Bahrain, "Update of the Fiscal Balance Program," accessed December 7, 2021.

⁸ "Coronavirus: Bahrain," *Worldometer*, accessed December 7, 2021.

⁹ Government of Bahrain, "Update of the Fiscal Balance Program," accessed December 7, 2021.

¹⁰ "Bahrain – Credit Rating," *Trading Economics*, accessed December 7, 2021.

An Unpopular Decision

The Bahraini public expressed concerns over the VAT increase across traditional and social media. One member of parliament even chastised her colleagues on the Financial and Economic Affairs committee upon hearing of the decision, stating: “You did nothing and you are responsible for the VAT spike ... Where are the preventive solutions you drew up when joining the committee as you were aware of the economic situation?”¹¹ Civil society organizations that were skeptical about the need for the tax rise organized forums to discuss the decision and brainstorm about alternative options.

For the most part, though, it seemed as though people were aware of the need to restructure the government’s finances to settle the considerable debt that had been accumulating: In January, the first deputy of Bahrain’s Council of Representatives, Abdulnabi Salman, openly called for more taxes to increase non-oil government revenue,¹² and he continued to express similar sentiments after the VAT increase announcement, albeit while expressing a strong preference for alternatives to a VAT hike. The coronavirus pandemic had made people alert to the unsustainable nature of many aspects of their personal lives,¹³ and that awareness had apparently spread to macrosocietal issues such as the environment and public debt.

However, while Bahrainis for the most part expressed a willingness to entertain an increase in taxes, the majority believed it should be targeted toward either foreigners or wealthy Bahraini citizens. Raising the VAT, they argued, was unfair because it meant that too much of the tax burden would fall on the shoulders of low- or middle-income Bahraini households via their daily purchases of food, clothing, internet services, and so on.¹⁴

Many of the VAT decision’s critics proposed two specific alternatives.¹⁵ First, they suggested a tax on foreign transfers, in an attempt to make the expatriates who comprise approximately half of Bahrain’s population bear the tax burden. Every day, thousands of migrant workers living in Bahrain transfer money they have earned working to their families back home through remittances, while only incurring a small commission charged by the financial intermediary. Many have argued that the government should levy a tax, too. Second, critics have also proffered a wealth tax to be imposed on only the wealthiest segment of Bahrain’s population.

While Bahrainis for the most part expressed a willingness to entertain an increase in taxes, the majority believed it should be targeted toward either foreigners or wealthy Bahraini citizens.

¹¹ “Parliament Panel Criticized,” *Gulf Daily News*, October 2, 2021.

¹² “Taxes Vital to Raise Revenues,” *Gulf Daily News*, January 4, 2021.

¹³ Ghada Abdulla, Abdulaziz Al-Doseri, Deema Almoayyed, and Omar Al-Ubaydli, “The Impact of Covid-19 on the Environment in Bahrain,” *Derasat*, August 15, 2021.

¹⁴ “Eight Government Initiatives for Fiscal Balance ... and We Have Proposed a Package of Economic Solutions,” *Akhbar Al Khaleej*, October 5, 2021.

¹⁵ “Taxes Vital to Raise Revenues,” *Gulf Daily News*, January 4, 2021.

In its response to these calls, the government made two distinct points. First, it reaffirmed the existence of dozens of VAT exemptions¹⁶ on basic goods and services that would – by the estimates of government models – ensure that the impact on the purchasing power of a typical Bahraini household would be a decrease of only 1%. According to the Ministry of Finance and National Economy's calculations, the biggest generators of tax revenue would be high-end car purchases, expensive restaurant meals, and other goods and services generally purchased by the wealthiest portion of the population. In other words, the government argued that the tax was already highly progressive, meaning that those with more means pay a disproportionately higher share than those with less means.

Second, the government indicated that the alternatives to an increase in the VAT, such as ignoring the problem and waiting until Bahrain defaults on its debt, or a cut in public sector salaries, would cause greater harm to the livelihoods of the majority of Bahrainis. However, the official statements did not include an assessment of a foreign transfer or progressive wealth tax, so many Bahrainis continue to believe these would be better options.

Would the Alternatives Work?

Governments can deploy a wide variety of tax instruments as they seek to generate revenue, including income taxes, sales taxes, property taxes, inheritance taxes, wealth taxes, capital gains taxes, payroll taxes, corporation taxes, and, in economies with large numbers of migrant workers, foreign transfer taxes. In the specific case of Bahrain, compared to the VAT, each of these has a key flaw.

In Western countries, income taxes are among the largest sources of government revenue. However, such taxes have been considered politically unacceptable in the Gulf countries for decades, though Oman recently announced that it would be levying an income tax in 2022.¹⁷ While all the other Gulf countries will surely be closely watching Oman's experience, none of them – including Bahrain – wish to take the plunge prior to the sultanate as the historic absence of taxes has made some citizens regard taxation as a breach of the social contract.¹⁸ It is likely that even lower- and middle-class Bahrainis would reject a progressive income tax over fears that it would eventually lead to a higher tax burden for average households.

Neither inheritance taxes nor capital gains taxes are viable in a Muslim country such as Bahrain, as they would violate Islamic principles. For example, there are very specific rules on how inheritances should be distributed, and they are unambiguously described in the Quran. So, there would be a lot of pushback were an inheritance tax to be levied. Moreover, inheritance taxes make only trivial contributions to gross tax revenue in developed economies (less than 1% of federal revenue in the case of the United States¹⁹).

¹⁶ "Basic Food Products Not Subject to VAT," National Bureau for Revenue, accessed December 7, 2021.

¹⁷ "Oman Income Tax Expected in 2022 in Fiscal Shake-Up," *Reuters*, November 2, 2020.

¹⁸ I-Tsung Tsai, "Political Economy of Energy Policy Reforms in the Gulf Cooperation Council: Implications of Paradigm Change in the Rentier Social Contract," *Energy Research & Social Science* 41 (April 2018): 89-96.

¹⁹ "Sources of Revenue for the Federal Government," Datalab, accessed December 7, 2021.

Payroll taxes are commonly viewed as damaging to job creation. So, this would have been a concern to the Bahraini government at a time when it has prioritized creating private sector jobs for citizens. Sales taxes are generally inferior to a VAT (they are easier to evade by disguising final sales as intermediate ones), and so that leaves corporate taxes, property taxes, wealth taxes, and taxes on foreign transfers. The key disadvantage associated with all four stems from Bahrain's status as a small open economy.

Attracting foreign direct investment plays a pivotal role in the country's economic strategy, and foreign capital has been a major driver of rapid growth in the financial and real estate sectors over the last two decades. In particular, Bahrain attracts considerable amounts of Saudi, Emirati, and Kuwait capital, helping to create thousands of jobs in the financial and real estate sectors.

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The success of this strategy depends critically on two pillars. First, it relies upon the fixed exchange rate with the U.S. dollar, which assuages investors' fears about the possibility of a currency crash wiping their investments out. Second, it depends upon the absence of capital controls, which assures investors that there are no obstacles to liquidating their investments at any time of their choosing. The Central Bank of Bahrain's website proudly affirms the kingdom's commitment to freedom of capital.²⁰

With this in mind, a tax on foreign transfers violates the principle of the freedom of capital because it constitutes an impediment to moving money out of Bahrain; it therefore threatens Bahrain's hard-earned reputation as an attractive investment location. Financiers will wonder if a foreign transfer tax nominally targeting migrant workers will soon metamorphose into the sort of restrictive capital controls present in many emerging economies, which can cause major losses to foreign investors. The Bahrain Economists Society surveyed over 40 local experts, and while there was no consensus, the balance of opinion was firmly toward the view that foreign capital – and the jobs that depend upon it – are at serious risk if Bahrain levies a tax on foreign transfers.²¹

Regarding imposing corporation, property, or wealth taxes, decision makers fear they would cause capital flight, as investors – both Bahraini and foreign – would likely exploit the openness of Bahrain's economy to instantly move their investments abroad, compromising the kingdom's economic strategy without yielding considerable revenue. The Gulf Cooperation Council single market, which allows seamless capital flows within the GCC, is a double-edged sword in this regard: It is the reason that Bahrain has been able to attract so much Kuwaiti and Saudi capital, but it is also the reason that such capital could exit almost instantly if threatened by a wealth tax.

While many countries do impose these taxes, countries with small open economies like those of Luxembourg and the UAE tend to shy away from them as they are highly vulnerable to capital flight, compared to countries with large economies such as the United States or France.

²⁰ "Monetary Policy," Central Bank of Bahrain, accessed December 7, 2021.

²¹ "Bahrain Economy Experts' Survey," Bahrain Economists Society, accessed December 7, 2021.

In addition to these macroeconomic disadvantages, wealth taxes are incredibly difficult to administer because the wealthy are highly adept at concealing their wealth and moving it across political boundaries to legally (and illegally) evade taxes.

These considerations are among the reasons the Bahraini government's fiscal experts opted to introduce the VAT in 2019 as opposed to the alternatives. And such considerations further influenced the Bahraini government's decision to increase the VAT rate at this stage rather than introducing a new tax. Similar arguments explain Saudi Arabia's and the UAE's decisions to launch a VAT in 2018 and Riyadh's move to raise the VAT from 5% to 15% in May. All three countries need foreign capital, so they have designed their tax policies to avoid serving as a deterrent to foreign direct investment.

The International Monetary Fund ... had long urged Bahrain to impose a progressive version of a VAT and has since been regularly advising Bahrain to raise its VAT as part of its fiscal reforms.

Notably, while a VAT is not traditionally a progressive tax, Bahrain has tried to make it as progressive as possible by granting the aforementioned exemptions to basic goods and services, such as water, milk, meat, eggs, rice, educational services, health services, and so on. The International Monetary Fund – during its annual advisory visits to Bahrain, known as Article IV visits – had long urged Bahrain to impose a progressive version of a VAT and has since been regularly advising Bahrain to raise its VAT as part of its fiscal reforms.²²

Finally, an additional virtue of the VAT is that it is up and running and likely to yield predictable increases in revenue, which is important for signaling to creditors and investors that Bahrain's fiscal balance program is realistic and effective. With the public debt well over 100% of GDP, it was likely seen as the wrong time to experiment with new or exotic taxes that would require massive new systems before the first dinar of tax revenue even enters the government's coffers.

The Bahraini Public as a Partner

While Bahraini decision makers saw the benefits of turning to a VAT increase to generate greater government revenue, they have not yet secured widespread public buy-in. To garner public support, the government can turn to its experience managing the coronavirus pandemic. Like tackling a large public debt, the steps required to contain the pandemic were perceived as unpleasant and at times heavy-handed, but the rationale and long-term benefits were made clear.

Research has shown that transparency helps in gaining public support for policy measures.²³ If fiscal policies are opaque, citizens don't feel as if they are active partners in the fiscal reform process. For example, many details of Bahrain's annual budget are not publicly available or are only made available after decisions have been made. The government has not published the models it used to estimate the impact of the rise in the VAT on household purchasing

²² "Kingdom of Bahrain," International Monetary Fund, accessed December 7, 2021.

²³ Laurence Ferry and Peter Murphy, "What About Financial Sustainability of Local Government!—A Critical Review of Accountability, Transparency, and Public Assurance Arrangements in England During Austerity," *International Journal of Public Administration* 41, no. 8 (2018): 619-29.

power, and it did not release the research it commissioned or conducted internally to assess the different fiscal options available. If the general public feels left in the dark, it is more likely to feel antipathy toward a final decision.

In contrast, the difficult measures the government has taken in its management of the coronavirus pandemic have found much higher levels of acceptance among Bahrainis, largely due to the transparency of the process. Every day at midnight, the Bahraini government has published data on the number of coronavirus cases, related deaths, and vaccinations, even when the mortality figures were alarmingly high during the second quarter of 2021.

The National Medical Taskforce for Combating the Coronavirus holds regular press conferences, at least weekly, to answer questions from journalists, and team members field questions directly from the general public on social media. The team has been thorough in explaining the deliberations and factors involved in policy decisions regarding the public health crisis. Furthermore, members of the taskforce have published over 20 peer-reviewed papers on Bahrain's experience, with many relating directly to government decisions, such as the quarantining procedure at the airport, and the relative efficacy of the different vaccines deployed in the kingdom.

Getting people to accept painful policy decisions is also helped by demonstrating that everyone is in the same boat. In the case of the pandemic, Bahrain's Cabinet members have been very careful to adhere to mask-wearing and social distancing regulations as part of an effort to set an example for the public. Cabinet meetings themselves were conducted remotely for several months, and regular pictures confirming this were published in the media to convince people of the pandemic's gravity. When a vaccine became available, to overcome any vaccine hesitancy among the public, ministers were first in line, receiving shots live on television.

Bahraini leaders could drum up greater support for fiscal decisions if they follow these general principles regarding transparency. For example, it has been over two years since the VAT was implemented in Bahrain, yet there are no publicly available government white papers retrospectively evaluating the impact of the tax on people's purchasing power. Such a paper would increase the credibility of claims regarding the effect of the current rise in the VAT. More generally, making data available in real time and being more transparent about the available options and their respective pros and cons would help create buy-in. While the coronavirus crisis is not a precise parallel to an economic crisis, since governments might consider some economic data (and decision making) more sensitive than public health equivalents, nonetheless, more transparency – even if controlled – will help the government make its case for the VAT and build public support.

The Path Forward

The success of Bahrain's fiscal balance program depends on three interconnected elements. First, Bahrain needs to maintain strong ties with its three neighboring Gulf states, Saudi Arabia, the UAE, and Kuwait, which are guarantors of the country's support package. Bahrain's foreign policy seems to be geared heavily toward maintaining these positive relations, and Bahrain has shared interests with all three, suggesting that this element will continue to work in the kingdom's favor.

Second, it is tied to the success of its strategy to deal with the economic fallout from the coronavirus pandemic. As the economic recovery strategy was just launched at the end of October, there is not yet sufficient data to evaluate the strength of the strategy or predict its future prospects. However, Bahrain will surely be looking to benefit from Saudi Arabia's fiscal trailblazing, as it managed to post a fiscal surplus during the third quarter of 2021, continuing the trend of raising greater non-oil government revenue. While all the Gulf countries have been aware of the importance of reducing fiscal dependence on oil for decades, Saudi Arabia has so far been the most successful in realizing this goal, albeit at an early stage in its reforms (it almost doubled its non-oil revenue from 2016-20²⁴).

Bahrain's ability to make necessary investments and rebalance its fiscal revenue depends crucially on oil prices staying high for an extended period.

Third, it is dependent upon the buoyancy of oil prices. Oil prices averaged around \$80 per barrel in October, which is a far cry from the \$20 per barrel that had oil exporters reeling during the first quarter of 2020. Bahrain's ability to make necessary investments and rebalance its fiscal revenue depends crucially on oil prices staying high for an extended period.

While predicting long-term oil prices is notoriously difficult, Bahrain will surely be wary of increasing global enthusiasm for the transition away from hydrocarbons. However, in the near term, oil prices might stay high enough to allow the kingdom to exploit the large oil field it announced in April 2018.²⁵

Conclusion

Globally, there is a perception that the rich are not paying their fair share of taxes, and the Bahraini public's response to the VAT increase – including the call for wealth taxes – indicates that Bahrain is no exception to this. However, the reality is that rich people can credibly threaten to move their money and investments around to avoid taxes. This is why the world's leading economies are trying to harmonize corporate tax rates: They want to corner the wealthy. Yet, they remain a long way from realizing this goal, and in the case of small open economies, the threat posed by capital flight is magnified.

While taxing foreign transfers would seem to be an effective way of ensuring that expatriates pay instead of citizens, again, due to Bahrain's status as a small open economy, such a move could jeopardize foreign direct investment, which is critical to the livelihood of many Bahrainis. Instead, the VAT adjustments, including exemptions on basic goods and services that help make the tax more progressive, should more quickly and efficiently generate revenue while having only a minor impact on the purchasing power of Bahraini households.

Nevertheless, getting the public to buy in to painful measures such as tax increases requires transparency. The details of Bahrain's fiscal reforms remain – for the time being – shielded from public view, diminishing people's readiness to accept belt-tightening. In this regard, Bahrain's

²⁴ "Value of Non-Oil Revenue in Saudi Arabia From 2016 to 2020," Statista, accessed December 7, 2021.

²⁵ Holly Ellyatt, "Bahrain is Betting on 80 Billion Barrels of Oil to Help Clear Its Budget Deficit," *CNBC*, May 8, 2018.

positive experience in managing the coronavirus pandemic should act as an exemplar for how open and candid dialogue between technocrats and the public fosters mutual understanding and partnership.

