Report of the UN-DESA Mission to Bhutan[1]

6-16 July 2011

At the invitation of the Gross National Happiness Commission (GNHC - the National Planning Commission), the Royal Government of Bhutan, Hamid Rashid, Senior Adviser for Macroeconomic Policy, undertook a scoping mission to Bhutan on 6-16 July 2011. Margit Molnar, Regional Adviser of UN-ESCAP, joined the mission from Bangkok. The mission held discussions with the Prime Minister, the Minister for Economic Affairs, the Minister of Labour and Human Resources, the Minister of Housing and Urban Development, the Governor of the Royal Monetary Authority (RMA), the Finance Secretary and the Secretary for Labour and Human Resources. It also met with private sector representatives, including the Secretary General of the Bhutan Chamber of Commerce, Chairman of the Bank of Bhutan, CEOs of the Bhutan National Bank, Bhutan Development Bank, Druk Holdings and Investment and Druk Green Power Corporation. The mission also met the World Bank and IFC Country Representatives as well as the representatives of UNDP, UNICEF and other UN agencies.

GNHC – as it embarks to prepare the 11th Five Year Plan for 2013-2018 – invited UN-DESA to review the macroeconomic policy framework of Bhutan. GNHC also requested the mission to identify the capacity development needs of GNHC and that of other economic entities of the Government of Bhutan. The scoping mission explored the linkages between the country's development plan and the macroeconomic policy instruments that are available to the Government. In the process, it explored sector specific issues to address concerns for employment generation, inclusive growth and sustainable development. The hydropower and financial sector policies received particular attention. In preparation for the mission and finalizing the report, the mission reviewed a large number of policy documents[2] and in particular, the following:

a. Annual Report 2009/2010, Royal Monetary Authority of Bhutan
b. 10th Five Year Plan Mid-term Review Report;
c. Bhutan 2020: A Vision for Peace, Prosperity and Happiness
d. Economic Development Policy 2009
e. Foreign Direct Investment Policy 2010
f. National Human Resource Development Policy 2010
g. Labour Force Survey Report, 2010
h. Bhutan: 2011 Article IV Consultation—Staff Report
i. Bhutan Investment Climate Assessment Report, 2009

The observations and recommendations of this report are based on the review of relevant policy documents as well as consultations held during the mission. The mission makes a number of general observations throughout the report and makes specific recommendations on capacity development in the concluding section.

The recent IMF Article IV consultation expressed concerns about rising inflation and increasing external debt and advised the Government to tighten fiscal spending and raise interest rates. The key policy challenge for Bhutan, at least at this stage, is not inflation or rising external debts. The mission believes that country is facing a more significant challenge

1 The report represents the views of Hamid Rashid and not the official position or views of the United Nations or its Member States. For questions or comments, please write to rashid12@un.org

2 The report uses data from additional sources, including from the World Bank's World Development Indicators (WDI) database and the central banks of Bangladesh, India and Sri Lanka

of ensuring coordination, consistency and alignment among existing policies and developing national capacities for their effective implementation. One example of poor policy coordination is manifested in high borrowing costs and inadequate access to finance. While the Economic Development Policy (EDP) seeks to promote private sector development as the 'engine of growth', the monetary policy is misaligned to realize this objective. The contractionary monetary policy of RMA is narrowly focused on taming inflation, and not on reducing the exorbitantly high borrowing costs, which continue to impede private sector development.

While EDP recognizes low labour productivity as a constraint, both EDP and the National Human Resource Development (NHRD) Policy fall short in prioritizing, sequencing and coordinating investments for productivity growth. These policies are likely to have greater development impacts should they take into account the spill-over effects of the productivity growth of one sector on the growth of other priority sectors. Both EDP and FDI Policy focus narrowly on fiscal incentives to attract investments but generally ignore the role of labour cost and productivity in investment decisions. EDP recommends adoption of a number of new policy documents to improve the policy and regulatory environment. The mission feels that the Government of Bhutan may avoid the proliferation of new policy documents as their preparation will consume considerable amount of staff time, further compartmentalize development activities and make policy coordination even more difficult. It is the view of the mission that the Government may concentrate efforts to:

a. Improve coordination among fiscal, monetary and planning authorities to ensure that policy objectives, instruments and decisions are aligned to achieve targeted development outcomes;
b. Strengthen analytical capacities of planning and finance authorities to forecast and assess the impacts of policies on growth, fiscal positions, employment and income distribution and evaluate various policy options ;
c. Assess comprehensively the impact of the hydropower revenue on economic diversification and employment generation, development of non-hydropower sectors and long-term development of the economy;
d. Estimate the financing costs of EDP with appropriate sequencing of priorities and implement a set of monetary and fiscal policies, including tax reforms, that will facilitate the implementation of EDP within the framework of the 11th Five Year Plan and beyond;
e. Pursue productivity growth as the key policy priority for EDP, FDI and NHRD policies and the 11th Five Year Plan and develop benchmarks for tracking and improving labour productivity;

Macroeconomic Performance

Bhutan registered impressive growth in recent years. The economy grew at an average of 9.6% against the target of 8.2% that was envisaged in the 9th five-year plan (2003-2007) and reached 17.9% at the completion of the Tala hydroelectric power project in 2007. In 2008, the growth rate dropped to 4.7% as the global crisis adversely affected export and tourism sector of the economy (Chart I). GDP growth accelerated to an estimated 7.5 percent in 2009-10, again fuelled by hydro-power construction. While the growth performance of Bhutan has been robust, it remains highly volatile and overly dependent on hydropower revenue. Currently, growth in hydropower generation and related construction accounts for about one third of its GDP growth. While the demand for hydropower is strong and persistent, the revenue performance of the sector often depends on rainfall and exhibits high seasonal variability.

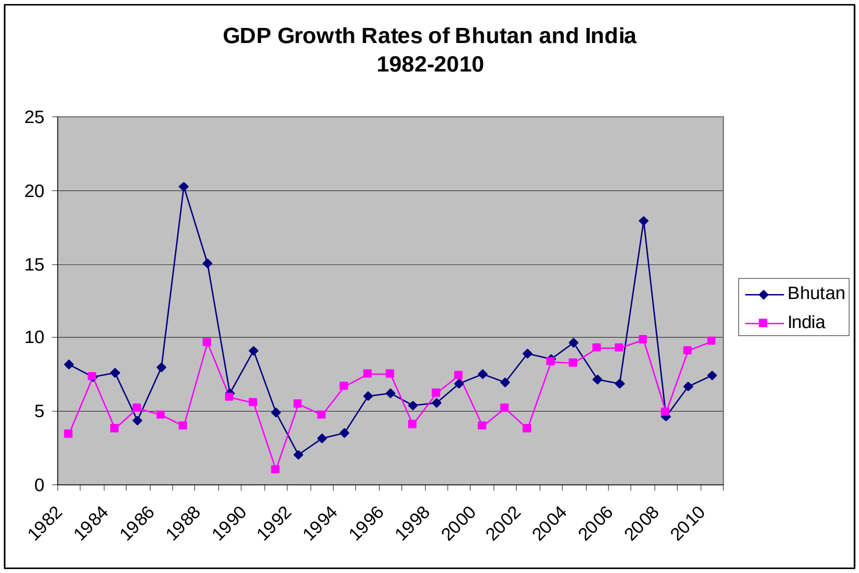

Chart I: GDP Growth Rates of Bhutan and India

Hydro-power development has largely produced jobless growth, posing the risks of making Bhutan a "rentier state[3]" with uneven distribution of the benefits of growth and rising income inequality. The sector accounts for nearly 20% of GDP but its share of employment is only 1.6%. At an installed capacity of 1480 MW, the sector currently employs only 5,200 people. While the Bhutanese economy shifted its dependence from subsistence agriculture to hydropower, growth in the latter has not created a sufficient number of new jobs to absorb under-employed workers from the agricultural sector and the increasing number of educated youth who are seeking employment opportunities in the urban sector. Although hydropower generation is projected to increase nearly eight-fold from 1,480 MW to 11,626 MW by 2020, additional capacity will add only 5,815 new jobs[4] and over 80% of these new jobs will be in low and medium skill categories.

Inflation and fiscal policy

Bhutan has had moderate inflation during most of the last decade, approaching a double-digit number only in 2008. Its inflation is highly correlated to India's, largely because over 75% of its imports – mostly consumer goods – come from India. Between 1990 and 2006, the correlation was 0.84. However, since 2006 there has been a significant decoupling of the two inflation rates, suggesting that Bhutan's CPI is also influenced by imports from third countries as well as prices of its non-tradable goods and services. In recent years, a lower electricity price also helped Bhutan keep its CPI below the Indian inflation rate. The correlation between the inflation rates of Bhutan and India fell to -0.069 during 2007-2011 (Chart-II).

3 A rentier state typically relies on a substantial external rent, usually from a single source, and therefore does not require a strong domestic productive sector and only a small proportion of the working population is typically involved in the generation of the rent.
4 Estimates obtained from the WAPCOS projection.

Bhutan has managed its fiscal policy relatively well and kept the budget deficit within tolerable limit. The fiscal balance stood at 1.88% and 1.66% of GDP in 2008/2009 and 2009/2010. Itis projected to be negative 4.82% of GDP in the current fiscal year, with 49% increase in capital expenditure explaining the projected fiscal deficit.

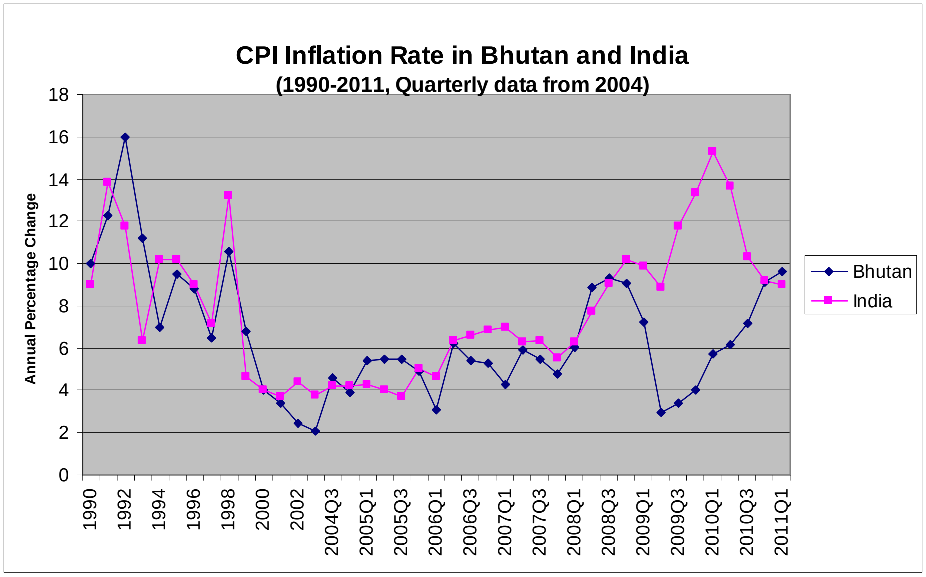

Chart II: CPI Inflation Rates of Bhutan and India

During the most recent Article IV consultations, IMF staff advised the Government to tighten the fiscal belt "by cutting non-priority current spending and saving any revenue over-performance. A fiscal tightening of about 2 percent of GDP (combined) in 2011 and 2012 would be desirable to help cool growth in aggregate demand." While there is scope for improving budgetary efficiency and broadening the tax base, the Government does not need to embrace fiscal tightening to contain inflation as it would dampen growth, especially in non-hydropower sectors. For a fast growing economy, moderate inflation is inevitable. When the demand for public services is largely unmet and there is continued need for public investments in infrastructure, a fiscal tightening policy will compromise Bhutan's commitment to inclusive growth and sustainable development.

While high food and fuel prices continue to exert upward pressures on Bhutan's CPI, the main driver of its inflation is the booming construction sector. The construction boom is triggering an asset price bubble in the housing sector and inducing a wealth effect. The demand-pull inflation, largely caused by the wealth effect, is unlikely to be moderated through cutbacks in public sector spending. The Government may consider targeted interventions, such as an imposition of luxury taxes to curb conspicuous consumption or property taxes on new construction, to moderate demand growth and dampen the wealth effect. Instead of adopting a nominal ceiling on current spending, as proposed by the IMF, the Government may adopt investment targets for priority sectors, seeking to diversify the sources of economic growth and improve productivity. While a sudden increase in current expenditure can trigger inflation, an increase in capital expenditures, especially for infrastructure development, can have the opposite effect. Stable and predictable public investments, can contribute to reduce the cost of production and distribution, which may, in turn, lower PPI and CPI. To improve accountability in public expenditures and generate support for non-inflationary fiscal expansion programmes, the Government may make a clear distinction between the capital expenditures on infrastructure and its consumption of durable goods - including purchase of vehicles, office equipment etc. – which is also classified as capital expenditures. It may introduce a separate budgetary line for government consumption to reduce non-productive and inflation-inducing government consumption of durable goods and safeguard 'true' public sector investments in infrastructure, health and education sectors. In addition, a more effective management of the demand for Indian Rupees, as discussed in a latter section of the report, is also likely to reduce the inflationary pressure.

Tax Policy

Currently, the tax revenue is under-exploited as the Government is able to finance deficits with foreign aid inflows and non-tax revenue, mainly with dividends and royalties from the hydropower sector. Tax revenue as percentage of GDP is very low, even by developing country standards. Corporate income taxes, mainly from hydropower projects, are the largest source of tax revenue for the Government, in contrast with other developing countries in the region that rely on different forms of indirect taxes, including customs duty and sales tax (Chart III and IV). Revenue from sales tax was only 1.5% of GDP in 2008/09, less than half in the average of the Asian LDCs. While indirect taxes are generally regressive, they tend to be less distortive than direct taxes. It is likely that the very high Average Effective Tax Rates on Corporate Profits – currently at 40.6% – is discouraging private sector development. While the EDP and FDI Policies offer tax exemptions to foreign investors and exporters, these policies offer no incentives to encourage import-substituting domestic private investments. To ensure that EDP does not disadvantage non-exporting firms, it could offer tax benefits to new firms, taking into account the level of local value addition, the number of jobs created in different skill categories and their investment in human resource development.

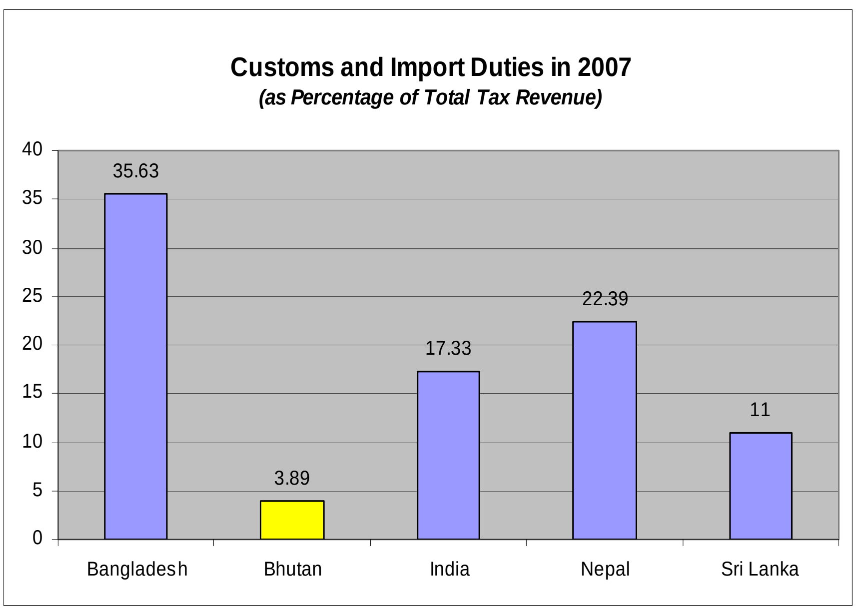

Chart III: Share of Customs and Import Duties in Bhutan and other South Asian Countries

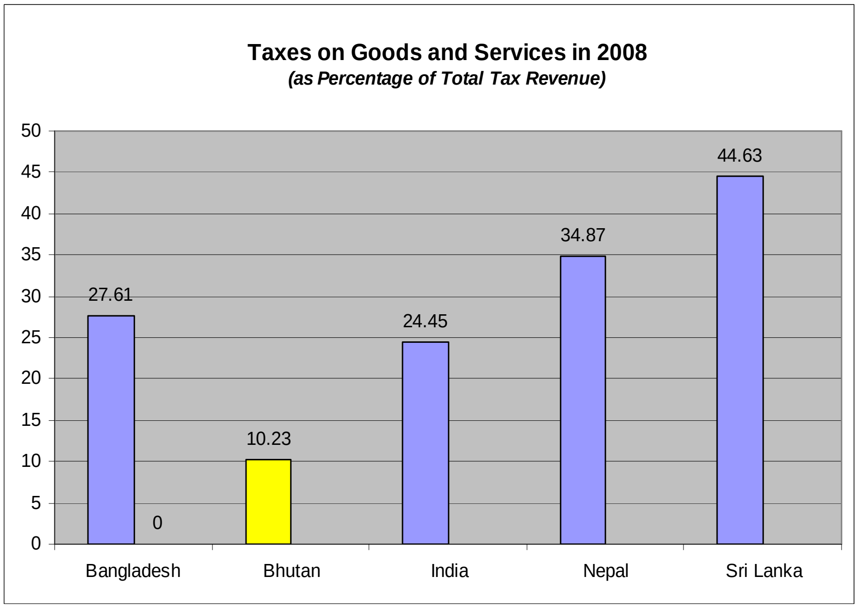

Chart IV: Share of Taxes on Goods and Services in Bhutan and other South Asian Countries

With the gradual phasing out of grants, Bhutan needs to revamp its tax policy to generate more taxes to avoid an excessive reliance on hydropower revenue. The mission feels that the Government should not introduce VAT, as suggested by the IMF staff. VAT is generally regressive and complex to set up and administer. The procedural complexity of VAT may encourage tax evasion and promote an underground economy. The Government may also explore and offer specific incentives to bring the informal economy under the tax net. This will help broaden the tax base.

To encourage the growth of existing firms, the Government may waive taxes on retained earnings if they are re-invested, while taxing dividend payouts. Higher dividend taxes will encourage re-investment and private sector development. Government may also raise the sales tax especially on luxury goods, which is currently very low, in the urban areas to introduce some elements of progressiveness in the sales tax. In addition to introducing property taxes, the Government may also introduce surcharges on construction materials to generate more revenue and contain the housing boom in urban centres.

Monetary Policy

The Royal Monetary Authority (RMA) is primarily concerned with price stability as well as with external and financial sector stability. Guided by these objectives, RMA policies narrowly focus on liquidity and systemic risk management and manifest a persistent deflationary bias. With the peg in place and relatively unrestricted current and capital account transactions with India, RMA has very few policy instruments at its disposal. It frequently adjusts the Cash Reserve Requirement (CRR) and Statutory Liquidity Ratio (SLR) to address concerns for inflation and systemic risks. Currently, commercial banks are required to maintain 37.5% of their deposits in CRR and SLR. The very high CRR and SLR minimize systemic risks but severely restrict the ability of commercial banks to lend to the real sector. Banks with excess liquidity and few lending opportunities seldom use the RMA borrowing window, which restricts the ability of RMA to directly influence interest rates. The inter-bank market is also virtually non-existent.

The recent IMF Article IV consultation advised the Government to tighten monetary conditions to lower excess liquidity and credit growth. It further advised that RMA should raise interest rates in the near term to help cool down aggregate demand, when the lending rate is already as high as 14%. The mission does not feel that RMA should tighten its monetary policy. On the contrary, it is felt that RMA policies need to be better aligned with the development priorities of Bhutan, requiring it to pursue a more pro-active and development oriented monetary policy. Without policy guidance from RMA, banks are now lending to sectors that are considered least risky – e.g. construction, trade and consumer loans – and are shying away from lending to productive sectors that are likely to generate employment and improve factor productivity. The monetary authority may relax CSR and SLR requirements to encourage banks to lend to priority sectors. Following the good practices of the Reserve Bank of India, RMA may set specific targets for priority sector lending. In order to address concerns for liquidity, RMA may increase the use of treasury bills and require commercial banks to hold a certain portion of their deposits in government securities[5]. In the absence of a well-functioning Treasury bill market, SLR is currently maintained largely in cash and cash-equivalents. RMA may, for example, introduce T-bills with longer maturities to facilitate long-term public investments. This will help reduce commercial bank lending to non-productive sectors and secure a line of credit for the Government to make necessary public sector investments.

Managing the Peg and International Reserves

Maintaining a one-to-one peg between the Ngultrum and Indian Rupee is, in fact, the main thrust of Bhutan's monetary policy. The mission feels that Bhutan must maintain the peg with Indian Rupee to:

- Keep the cost of imports low;
- Lower its financing costs and the cost of repaying its Rupee denominated debts;
- Increase and retain the value of its equity investments in the hydro-power sector.

In order to maintain the peg, the Monetary Authority is required, in theory, to hold 100% reserve of Rupee for all Ngultrum it issues. In practice, RMA uses a standby credit facility with the Government of India, with access up to 3.0 billion Rupees. The State Bank of India (SBI) over-draft facility meet the additional Rupee requirement at 9.25% interest. The share of Rupees in RMA's international reserves fell from 26.17% in 2000-01 to -6.88% in April 2011 (Chart V).

The Rupee shortfall reached 2.66 billion in April 2011, while the convertible currency reserves reached a staggering USD 932.1 million (over 70% of Bhutan's GDP in 2010). In 2010, RMA incurred interest expenses of Nu 189 million to borrow Rupees from SBI, which increased by 88 percent since 2009. The interest expense on Rupee borrowing is expected to exceed Nu 300 million in 2011. While RMA paid over 9% interest on Rupee borrowings, it earned an average interest of 1.73 percent on convertible currency reserves. Furthermore, the devaluation of USD is eroding the purchasing power of the convertible currency reserves held by RMA (Chart VI). The USD depreciated vis-à-vis the Ngultrum by nearly 15% between May 2009 and August 2011, making it less attractive for RMA to hold its reserves in US dollars.

5 For example, RBI requires commercial banks in India to hold 24% of their assets in government securities

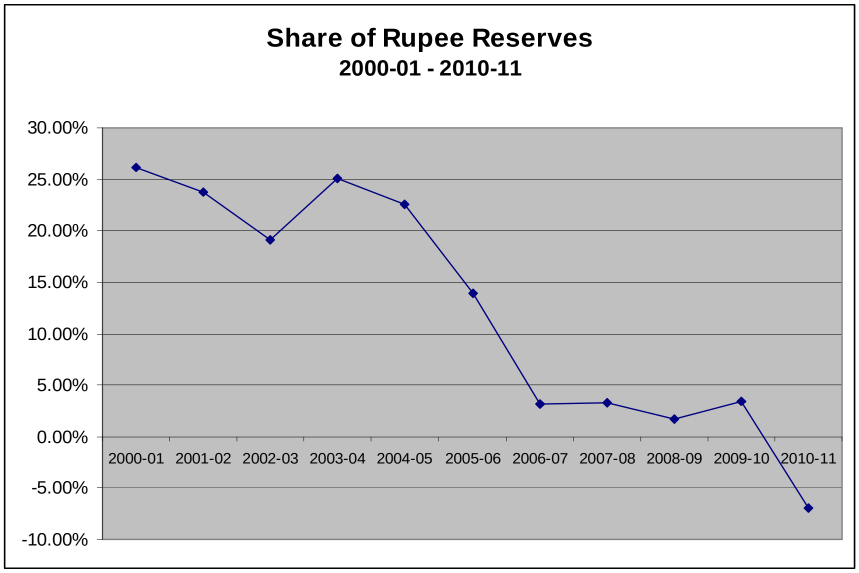

Chart V: Share of Rupees in the International Reserves Held by RMA

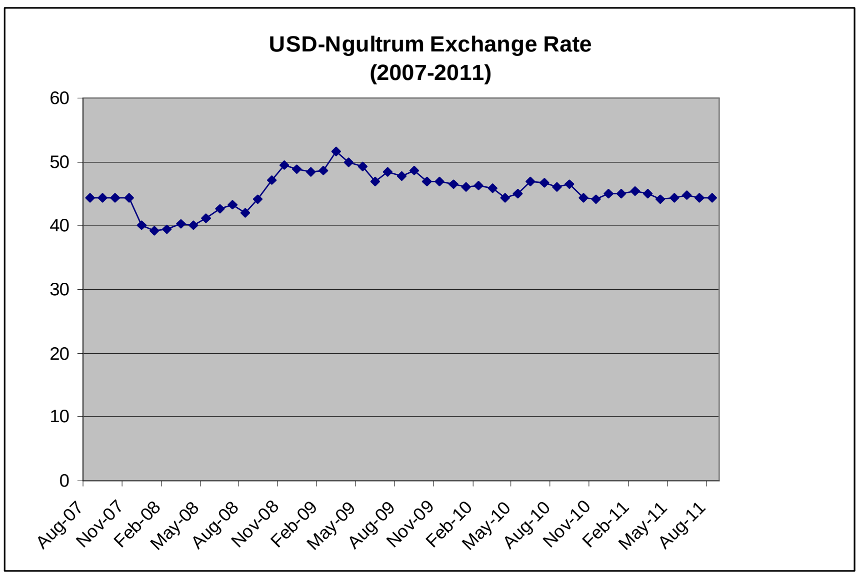

Chart VI: USD-Ngultrum Exchange Rate

In the 2009-10, Bhutan's export increased by 35.7 %, while its exports grew by only 3.0 %. The strong surge in import demand largely explains the growth in the demand for Rupee, which is likely to grow stronger in the coming years. The excess demand for Rupees, because of growing current account deficits without offsetting capital inflows, is putting pressure on the peg. Even if the current account deficits with India moderate and the price levels in Bhutan remain lower than in India, the demand for Rupee will continue to grow on speculation as well. Ngultrum has been historically over-valued although it is not the case now. The Bhutanese private sector is likely to expect that it will eventually lose value and that the relative value of Rupee denominated debts will increase. If RMA allows the private sector to borrow in Rupees from India, the demand for Rupees will increase further, mainly because the Bhutanese borrowers would want to retain their ability to repay the Rupee denominated debts. Given the high interest rate differential between convertible currencies and the Rupee and the appreciation of the Ngultrum vis-à-vis US dollars, it may not be the optimal policy for RMA to hold all its reserves in convertible currencies, especially when nearly 80% of Bhutan's international trade and 60% of its external debt are in Rupees.

Given the excess demand for Rupee, a policy option for RMA could involve converting a part of its convertible currency reserve to Rupees and maintaining it as a buffer stock to manage the demand for Rupees. The Rupee reserve should be sufficiently large, around 20% of total reserves, and stable. By re-building the Rupee reserve, RMA may effectively manage the real as well as speculative demand for Rupees. By lowering the cost of borrowing Rupees from SBI, RMA will also manage to partly reduce the inflationary pressure.

To offset the risk of losing access to convertible currencies, RMA may buy long-term Currency Futures (or Currency Options if the future demand for convertible currency is less than certain) to meet its hard currency requirements. The cost of Dollar or Euro Futures would be significantly lower than the 9.25% interest that RMA pays to borrow Rupees from the State Bank of India. RMA may also allow the Bhutanese private sector to hold and trade Currency Swaps to reduce the demand for Rupee.

Managing Hydropower Revenue and Real Exchange Rate Appreciation

The surge in hydropower revenue is expected to put upward pressure on the value of the Ngultrum. In the immediate term, there is no visible pressure on the real exchange rate as the revenue from the hydro-power sector is used up to meet the costs of imports and also to service Rupee denominated debts. Although the PPP conversion factors for Bhutan and India suggest that that the Ngultrum is currently slightly under-valued and that its purchasing power was 4.1% higher than that of the Indian Rupee in 2010 (Chart VII), this is likely to be a short-term phenomenon. The Ngultrum has been historically over-valued vis-à-vis the Indian Rupee and it is likely to appreciate significantly once the pipeline hydropower projects become operational and debt service requirements fall relative to total revenue generated by these new projects.

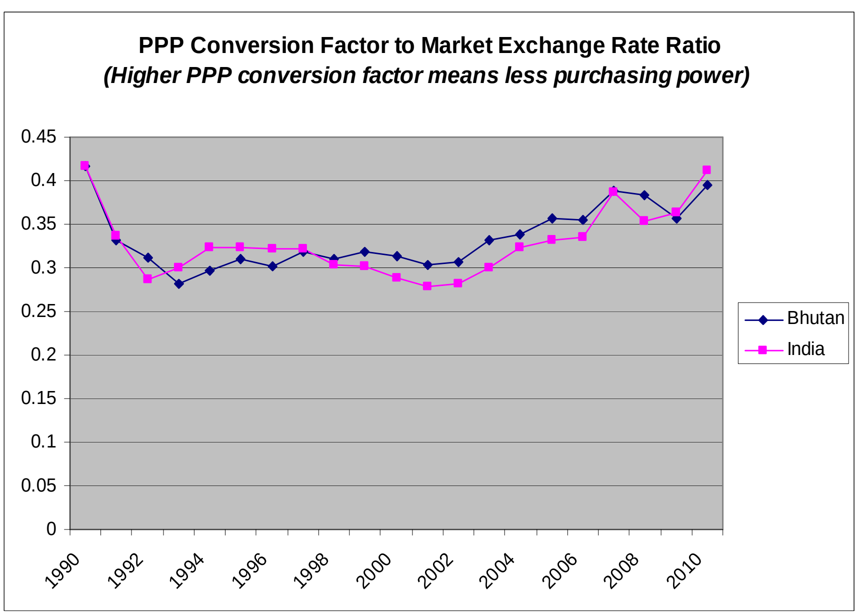

Chart VII: PPP Conversion Factors of Bhutan and India

Bhutan's economic development plans must take into account the effects of hydropower on its real exchange rate to avoid the pitfall of the 'resource curse'. The country will minimize the risks of a 'resource curse' if it considers hydropower revenue as a finite, time bound natural resource. Such a perspective will allow Bhutan to adopt a development strategy that is not entirely dependent on and fuelled by hydro-power. This will encourage the Government to actively pursue diversification of the economy, with strong emphasis on improving labour productivity. If Bhutan wants to build a competitive economy, then it must invest its hydro-power revenue to improve its factor productivity. Higher labour productivity will counteract the pressure on real exchange rates, allow it to diversify its production and enhance its export competitiveness.

In the coming years, Bhutan will increasingly rely on hydropower revenue to finance public investments. But hydropower revenue exhibits large seasonal variation with more than 50 percent of the annual revenue generated in the third quarter. This makes fiscal planning and management somewhat difficult. In order to make budgetary outlays more predictable and less volatile, the Government may create a Stabilization Fund, setting aside a portion of hydropower revenue to meet seasonal or unanticipated short-falls in current expenditures. The Stabilization Fund could make investments and the return on these investments could be used to finance counter-cyclical policies and targeted poverty reduction programmes. The decoupling of current expenditures from hydropower revenues would make the budgetary process more stable and predictable and the economy more resilient to shocks. Furthermore, hydropower revenue should be used effectively for human resource development to ensure inter-generational equity. The Government may create a Productivity Fund to finance investment in skills development and productivity growth and to facilitate transition from low-skilled, low value added production to high-skill, high-value added production. Establishment of the Stabilization Fund and the Productivity Fund, with a strong institutional and oversight framework, will limit the scope for discretionary and inefficient use of this finite national resource.

Reducing the cost of borrowing and enhancing access to credit

The agricultural sector still employs 59.4% of the labour force, yet it received only 1.65% of all commercial bank credit in 2010 (Chart VIII). The share of credit to the agricultural sector dropped from 4.43% in 2001 (Chart IX). In neighbouring countries, the share of agricultural credit is significantly higher. For example in India, 52% of the workforce is employed in the agricultural sector, which received nearly 14% of all commercial bank credits. The lack of credit and inadequate policy support to boost productivity partly explains why Bhutan's agricultural sector registered below 2% growth rates in recent years.

The two other productive sectors of the economy – transport and manufacturing – also received inadequate bank credit. Credit to the manufacturing sector hovered around 17% of all credit during the past decade. The share of bank credit to the transport sector fell from 14.9% in 2001 to 7.7% in 2010. Both these sectors are critical to stimulate productivity growth of the economy.

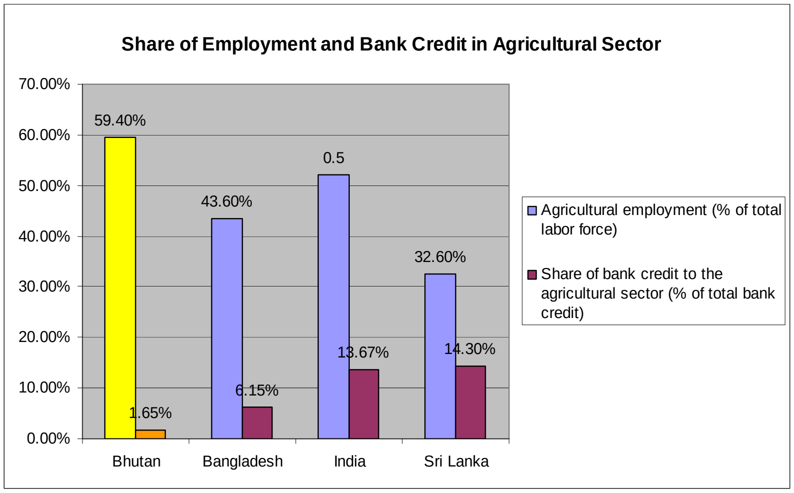

Chart VIII: Share of Employment and Agricultural Credit

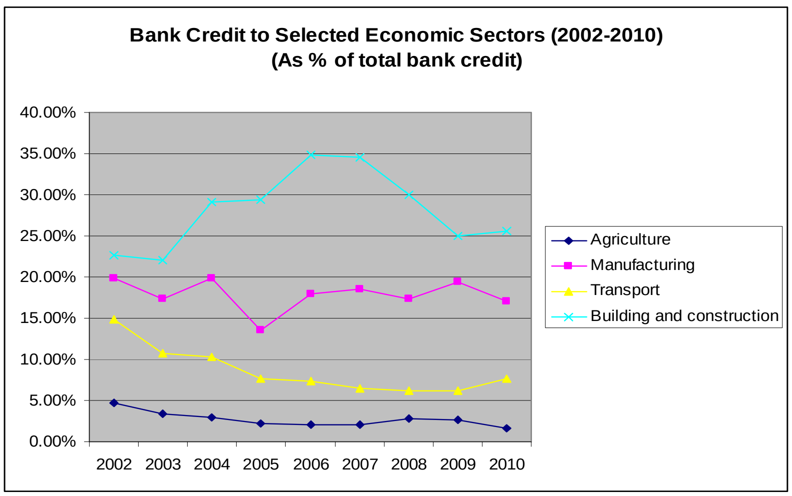

Chart IX: Bank Credit to Selected Economic Sectors in Bhutan

While the financial sector is stable and registered healthy profit, it should be a concern for the Government of Bhutan, and particularly for RMA, that banks are not adequately lending to the productive sector. While construction and trade are the two fastest growing sectors to receive bank credit, they do not contribute to productivity growth. In order to boost agricultural productivity and achieve structural transformation - facilitating the absorption of surplus labour in higher skill, higher value-added sectors – RMA should issue policy guidelines and set incentives to encourage commercial bank lending to the agricultural and higher value-added sectors.

RMA should also encourage banks to provide credit-score based lending. Banks in Bhutan are typically constrained by a system of collateral based lending, offering the same rate to all prospective borrowers. Development of a credit registry and the use of credit scores to offer differentiated rates to creditworthy borrowers will increase availability of credit to the private sector. Furthermore, introduction of a deposit insurance scheme should encourage banks to undertake more risks in lending to the real sector. The government may subsidize the insurance premium on deposits that are used for lending to the productive sector.

Instead of limiting credit growth in general, RMA should set specific directives to discourage lending to non-productive sectors.

Economic Development Policy

EDP identifies nine priority sectors – from tourism to poultry, financial services to waste management – for economic development of Bhutan. Given the size and scope of the economy, the list includes the full set of feasible economic opportunities in Bhutan. The priorities identified in EDP need to be based on Bhutan's dynamic comparative advantages in short, medium and long-terms. EDP needs to strategically sequence the sectoral priorities to target and optimize human resource development. For example, tourism sector development can be a short-term focus while ICT sector development can be a medium to long-term priority. Short-term priorities should be based on current factor endowments, including human resources, while long-term priorities should facilitate skills enhancement, productivity growth and structural transformation. It would be important for Bhutan to sequence investments in human resources to ensure that its labour force can transition from low skilled-low value added to high-skill high-value added sectors.

While EDP explicitly intends to "depart from the usual sector/agency based approach", it essentially promotes a sectoral approach and does not take into account the synergies and spillovers between and among various sectors. Furthermore, EDP is likely to lead to a large scale proliferation of policy documents. It suggests that the Government should design and adopt the following 17 (seventeen) new policy documents and 6 (six) new Acts:

- Policy Framework on Private Public Partnership for Infrastructure Development
- Policy on Intellectual Property Rights by 2011
- Captive Power Generation Policy
- National Renewable Energy Policy by 10^{th} plan
- Cottage and Small Industries Policy
- Special Economic Zone Policy by 2011
- Policy framework on Anti-dumping
- Education Policy for Private and Higher education
- Health Sector policy
- ICT sector policy by end of 2010
- Foreign Worker policy
- Mineral Development Policy by 2010
- Strategic Plan for Industrial Development
- Strategic Plan for Capacity building of the Construction Industry by 2010
- Roadmap for Developing Bhutan as a Financial Hub
- Export Promotion Strategy
- Comprehensive Framework for Approval of Projects
- Consumer Protection Act by 2010,
- Competition Act within the 10^{th} Plan
- Industries and Investments Act within the 10^{th} Plan
- Foreign Investment Promotion Act within the 10^{th} Plan
- Trade Development Act shall be enacted within the 10^{th} Plan
- Tourism Act shall be in place by 2011

The drafting of numerous policy documents will require a significant amount of staff time, not only from the Ministry of Economic Affairs, but also from other ministries and agencies. This will considerably impact the ability of the Government to implement, monitor and evaluate existing policies, including EDP. The proliferation of policy documents is also likely to further sectoralize/compartmentalize development activities, making policy coordination and coherence even more difficult. Given the stage of economic development, it may also be prudent for the Government to delay adoption of certain policies, especially those related to IPR, anti-dumping or competition. The mission feels that instead of formulating new policy documents, the Government should concentrate its efforts to improve policy coordination and implementation.

While EDP targets regional and rural development, it is silent on the role that local government authorities must play to facilitate local investment. The current pace and degree of political decentralization in Bhutan will pose considerable coordination challenges to the realization of its regional development goals. The Ministry of Economic Affairs needs to develop an implementation scheme for EDP, with specific roles assigned to local government authorities. The local government bodies should be encouraged to play a pro-active role to attract foreign and domestic investments in their areas. They should be able to leverage public sector spending to attract private sector investments.

EDP identifies ten constraints to the economic development of Bhutan, but identifies no specific measures and sequences on how to overcome those constraints. For example, the Government can mitigate the constraints of inadequate management skills, a shortage of professionals and low labour productivity through focusing on two other constraints, namely increasing access to finance and enhancing policy coordination, for example, between EDP and NHRD. While inadequate access to finance is identified as a key constraint, EDP does not make any recommendation to reduce the cost of borrowing.

To incentivize investments, EDP offers broad exemption on customs duty and sales tax for imports of a large range of capital goods, raw materials, firm machinery, agricultural inputs, hybrid cars and so on. It also exempts corporate income tax on export earnings in convertible currencies. The policy allows business enterprises to report R&D expenditures as tax deductible. Furthermore, it offers 10-year tax holiday for commercial farming as well as for CSIs established in rural areas.

It is important for the Government to recognize that tax is only one among many incentives that can influence investments and that tax incentives work in conjunction with other enabling factors. The tax elasticity of investments – FDI or domestic – is generally low and depends on specific tax burden indicators[6]. A number of studies have shown that the tax elasticity is lower for pure investments in production, plant and equipment. Given that Bhutan needs FDI mostly to develop its physical and social infrastructure, it is unlikely that the tax incentives alone will attract the needed investment from abroad. An OECD Policy Brief on FDI argues, *"it is not always clear that a tax reduction is required (or is able) to attract FDI. Where a higher corporate tax burden is matched by well-developed infrastructure, public services and other host country attributes attractive to business, including market size, tax competition from relatively low-tax countries not offering similar advantages may not seriously affect location choice. Indeed, a number of large OECD countries with relatively high effective tax rates are very successful in attracting FDI. This points to the importance of market size and other host country attributes in attracting FDI and the presence of location-specific profits that governments are able to tax. It is also clear that a low tax burden cannot compensate for a generally weak or unattractive FDI environment. Tax is but one element and cannot compensate for poor infrastructure, limited*

6 Schwarz , P., Estimating Tax-Elasticities of Foreign Direct Investment: The Importance of Tax Havens, Economics Bulletin, Volume 31, Issue 1, January 2011

access to markets, or other weak investment conditions."[7] There are also a number of empirical studies that show that political factors play an insignificant role in firms' decision to invest abroad.[8]

Given the international experiences, Bhutan cannot solely rely on tax incentives, location or political stability factors to attract foreign investment. It cannot leverage its market size either but it can offer a competitive labour market and unrestricted access to the large Indian market to attract FDI. A number of empirical studies have found strong positive correlation between low labour costs and inward FDI in case of China and other developing countries, even when tax rates and the regulatory environment were less favourable in those countries[9]. The low labour cost in nominal terms, however, may not be sufficient to offset low labour productivity and high transaction and transportation costs in many developing countries[10]. In case of Bhutan, it will require consistent policy interventions to keep the nominal labour costs low, while incrementally improving labour productivity. EDP needs to consider and expand non-tax incentives, government-funded skill enhancement programmes, cost-sharing for employee healthcare and pension benefits, accelerated depreciation of capital goods, export credits, a "Buy Bhutan" programme and other incentives to attract domestic and foreign private investments.

It is also important that the Government estimates the implementation cost of EDP. Most of the tax exemptions, as offered in EDP, will become available when the Ministry of Finance will face considerable budgetary crunch between 2011 and 2016. The slow growth in hydropower revenue until 2016 will be inadequate to offset the expected decline in grant and ODA flows. From the fiscal management perspective, implementation of EDP needs to be sequenced and carefully calibrated to the fiscal position of the Government. The Government may develop a multi-year financial plan for implementation of EDP, with adequate focus on generating new tax revenue from non-hydropower sectors. While EDP talks about improving the payment system, allowing external borrowing by the private sector, creating an inter-bank market, allowing inter-corporation borrowing or developing a bond or capital market, the document is silent on the cost of borrowing from commercial banks. The Ministry of Economic Affairs should work closely with the Ministry of Finance and RMA to reduce the cost of borrowing and reduce interest rate spreads for development of the priority sectors identified in EDP11. The Government may explore alternative financing mechanisms such as Global Depository Receipts (GDR)[12] or Foreign Currency Convertible Bonds (FCCB)[13] to reduce the borrowing costs for Bhutan. Given the size of the economy, relative under-development and other structural constraints, equity finance is likely to be costly for Bhutan in the short-term. Rupee denominated Convertible bonds may be more attractive to both domestic and foreign investors as that will reduce upfront investment risks.

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7 OECD Policy Brief, "Tax Effects on Foreign Direct Investment", February 2008

8 Swain & Wang, 1997 Zhang, 2002, Andreosso – O'Callaghan & Wei, 2003

9 See for example: Swain and Wang (1995); Liu et al (1997)

10 Miller (1993)

11 The spread between deposit and lending rates is over 10% - one of the highest in the region.

12 A negotiable certificate held in the commercial bank of one country representing a specific number of shares of a stock traded on an exchange of another country.

13 A foreign currency denominated convertible bond is a mix between a debt and equity instrument. It acts like a bond by making regular coupon and principal payments, but these bonds also give the bondholder the option to convert the bond into stocks.

FDI Policy 2010

Bhutan's FDI Policy 2010 is very liberal by international standards. The minimum threshold for foreign equity to qualify as FDI is relatively low. While Bhutan allows 51% foreign ownership of banks and 74% foreign ownership in other strategic sectors, India caps foreign ownership in banking, insurance and telecommunication at 49%, 26% and 49% respectively. Bhutan's policy extends full national treatment to foreign firms. The FDI policy also provides generous and comprehensive safeguards against nationalisation and expropriation, with provision for prompt payment of compensation at market value.

As the FDI policy extends the tax benefits of EDP, many FDI firms will be exempt from corporate income taxes provided they earn revenue in convertible currencies. In India, foreign firms and their branch offices are subject to a maximum tax of 40% on their net profits while the tax rate for domestic firms is 36.75%. The subsidiaries of foreign firms in India, even with 100% foreign ownership, are considered as domestic firms under the Indian laws and are subject to tax rates applicable to domestic firms. This creates incentives for foreign investors to set up subsidiaries in India, which allows the Government of India to regulate and direct the activities of foreign firms to optimize their development impacts. Instead of offering blanket tax exemptions to foreign firms, the Government of Bhutan should encourage FDI firms to setup local subsidiaries and encourage them to invest in Bhutan's human resources development.

The FDI policy, regardless of the size of investment, provides guaranteed access to convertible currency - up to $ 5 million per annum – for repatriation of dividends during the first 10 years of operation. This provision is likely to put pressure on the current account balance. In comparison, neither the Indian government nor the Reserve Bank of India provides any guarantee against inconvertibility or makes any advance commitment for the conversion of Indian currency into other currencies, except for facilities for forward contracts. Bhutan may offer similar facilities to FDI firms to meet their convertible currency requirements. The FDI policy also allows foreign firms to borrow from domestic banks in Bhutan, which may crowd out domestic investment and defeat the purpose of FDI. The Government may reconsider this provision and may limit domestic borrowing only for working capital, and not for capital investments.

The FDI policy does not contain any lock-in provision for invested capital in Bhutan. It states, "Foreign investors shall have the right to repatriate their invested capital and any capital gains secured, in the currency of investment." Both India and Bangladesh allow repatriation of capital only in the event of liquidation of a FDI firm. Other countries, including China, allow repatriation only after the expiry of the lock-in period. The Government may consider introducing a lock-in period and other quantitative and qualitative restrictions to prevent volatility in capital flows.

While many provisions in the FDI policy are attractive, they are unlikely to bring sufficient amount of FDI to offset the imbalances in the current account. Bhutan must effectively leverage its relatively low labour cost and its free access to the Indian market to attract investments from India and beyond. Foreign investors would be encouraged to invest in Bhutan if they see that the Government has a credible plan, with resources committed, to boost its labour productivity.

National Human Resource Development policy

Human resource development, leading to higher productivity, needs to be the key policy priority of the Government of Bhutan. Its labour force – with 59.4% employed in agriculture – is trapped in low-skill, low value added activities. While the labour force participation rate increased significantly during the last ten years, sectoral composition of employment remained somewhat unchanged. The economic sectors with higher value additions – manufacturing, hydropower, tourism and construction – continue to employ only 7.6% of the labour force, with the share of professional and technical category jobs in these four sectors representing 1.59% of the labour force.

The public sector is still the largest employer in the economy, with employment in government, public corporations and the armed forces accounting for 87.3% of jobs in the wage economy outside the agricultural sector. The Government is still the employer of choice. The high demand for secure public sector jobs makes it harder for the private sector to find sufficient number of qualified candidates. As high as 63.3% of Bhutan's labour force is illiterate while only 3.3% of the workforce has at least a Bachelor's degree. According to the World Bank's "Bhutan Investment Climate Assessment Report, 2009", the average labour cost in Bhutan is higher than the labour costs in Bangladesh and India respectively. The nominal labour cost, however, does not take into account labour productivity. The same study, however, shows that the unit labour cost is lower in Bhutan than those in neighbouring countries. This is largely because of relatively higher labour productivity in Bhutan.

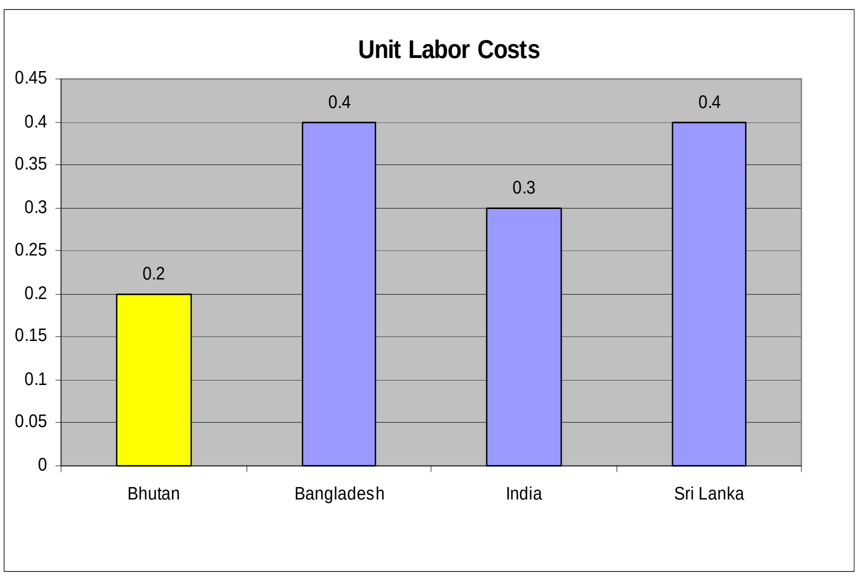

Chart X: Unit labour Costs in Bhutan and Other South Asian Countries (Source: The World Bank)

NHRD rightly recognizes the imperative of developing human capital to make Bhutan a knowledge-based society. The eight objectives of NHRD, however, do not include labour productivity or international competitiveness of the Bhutanese labour, which, at least for Bhutan, can be a key determinant for attracting domestic and foreign investments. The policy recognizes that human resource development activities in Bhutan are fragmented and there is a lack of coordinated efforts at the national level. Different sectors have their separate HRD policies and plans, sometimes leading to a mismatch between the provision of knowledge and skills, and labour market demands. While it underscores, "The Economic Development Policy and the NHRD policy must be mutually reinforcing and should supplement and complement each other", the NHRD policy does not present a framework for developing human resources within the context of EDP. It also does not present a strategy on how to reduce the high demand for jobs in the public sector and make private sector jobs more attractive.

NHRD needs to take into account the projections for labour market demand from various priority sectors identified in EDP. For example, if Bhutan intends to develop its ICT sector, NHRD needs to setup a mechanism to estimate the number of software and hardware engineers that Bhutan must have within a specified timeframe. The policy should also develop specific mechanisms to estimate unit labour costs and productivity in each sector to assess their international competitiveness. It should also have an estimate for the cost of human resource development and how that cost would be shared between the public and private sector. The Government needs to put in place monetary and non-monetary incentives to ensure that human development goals are achieved within a stipulated timeframe.

Capacities for Development Planning and Analyzing Policy Options

The mission came to know that GNHC and other economic entities in Bhutan do not use any macroeconomic or CGE model to make projections on output, growth, inflation or other macroeconomic variables. They also do not use any model to assess various policy options and analyze their trade-offs. Most estimates are made with spread-sheets and use linear extrapolations of past trends to make projections. The UNDP Colombo Regional Centre supported an initiative to develop a macroeconomic model for Bhutan and train GNHC officials to use it for development planning. As the model was fairly advanced and as the concerned GNHC officials were not involved in the development of the model, they were not fully familiar with its objectives and operational methods. Once the UNDP trainer left Bhutan, GNHC officials were unable to change assumptions and run the model on their own. The model was abandoned in 2009 and there was no further attempt to develop modelling capacities in GNHC, the Ministry of Finance and the Ministry of Economic Affairs.

The planning process of Bhutan will benefit greatly from the development and use of a simple and easy to manoeuver structural macroeconomic model to analyze and forecast the effect of public and private investment on fiscal balance, economic growth, real exchange rate and exports. The use of a macro model will strengthen the capacity of the Government of Bhutan to develop the 11th plan and other development plans. The macro model would incorporate the linkages between and among production, consumption and investment, price levels, government revenue, expenditure and fiscal balance, exports, imports and trade balance. It could incorporate information on the tax system, making it possible to assess how a policy change would influence the tax revenue and run simulations into account the:

- Changes in the inflation rate
- Changes in the interest rate
- Changes in the income growth in different sectors (private, government, informal and traditional)
- Changes in employment rates in selected sectors
- Changes in direct and indirect taxes.

The macro model would allow the Government to make fiscal projections, taking into account the changes in hydro-power revenue, ODA and other taxable incomes. It could be used to assess various financing options, including external borrowing, to meet the development and employment targets. The model could be designed to obtain short, medium and long-term cost estimates for implementation of EDP. Using labour force and sectoral output data, the model would also allow the Government to track capital labour ratio in various sectors and make interventions to boost labour productivity. At a later stage, the model could incorporate the linkages between formal and informal sector of the economy and estimate the effects of various policies on the informal sector of the economy. Given the policy focus on poverty reduction and sustainable development, the model could be further developed to measure the effects of various macroeconomic policies on poverty and income distribution.

The use of a macroeconomic model would enable GNHC and the Ministry of Finance to counter the forecasts of short-term models such as the RMSM-X or the Polak model that are typically used by central banks. The Polak model analyzes the short-term effects of macroeconomic policies on country's internal and external balance, with strong focus on price stability. These models are designed to study the effects of changes in exports and bank credit on income and balance of payments. While the Polak model is well suited for quickly evaluating the fiscal and institutional feasibility of a financial plan, they often fall short on evaluating optimal policies for growth and income distribution.

Way Forward

a. Enhancing Policy Coherence and Coordination:

The Royal Government of Bhutan needs to streamline policy objectives, align priorities and coordinate the use of its policy instruments to achieve its development objectives. The interfaces between fiscal and monetary policies need to be strengthened to ensure that policies give the right signal to market participants and encourage private investments, generate employment and promote growth. To improve policy coordination and coherence, the Government may take steps to:

- Strengthen the stature and mandate of the Macroeconomic Framework Coordination Committee (MFCC) to ensure full cooperation and accountability of all stakeholders, including that of RMA;
- Broaden the membership of MFCC to include representation from the Ministry of Labour and Human Resources and also from the Bhutan Chamber of Commerce and commercial banks to ensure that employment generation and access to finance receive adequate priority in fiscal policies;

The Government may also strengthen the capacity and policy-making authority of the Board of Directors of RMA to ensure that employment, economic growth and income distribution considerations receive due consideration in monetary policies, alongside the focus on price and financial sector stability. To ensure that the monetary policy and the EDP objectives are duly aligned and mutually reinforcing, the RMA Board may include representation from the Ministry of Economic Affairs. Furthermore, to align the short-term monetary policy objectives and the long-term development objectives, the RMA Board should include representation from GNHC and the Ministry of Labour and Human Resource.

The Government may form a high-level Economic Development Committee (EDC) to provide necessary guidance and sequence priorities for the implementation of EDP. EDC should have the mandate to recommend necessary changes in fiscal and monetary policies to promote investment and generate growth. The Committee should bridge the gap between fiscal and monetary policy activities to make sure that financial resources and incentives are available for timely and targeted implementation of EDP. The Committee should also include representation from local government bodies to ensure coherence and synergies between national objectives and local development priorities. The local government bodies should be adequately sensitized and trained to perform the role of development facilitators.

UN-DESA stands ready to collaborate with the Government of Bhutan and facilitate a detailed review of EDP, NHRD and FDI policies and other policy documents to enhance their coherence and development impacts.

b. Developing Capacities for Macroeconomic Modelling:

The MFCC Technical Committee should acquire necessary technical capacity to use macroeconomic modelling tools to analyze various policy options, consider trade offs, run simulations, identify risks and make projections on output, employment and income distribution. A dedicated MFCC team – with at least two representatives each from the Ministry of Finance, Ministry of Economic Affairs, Ministry of Labour and Human Resources, RMA, GNHC and the National Statistical Bureau – should be trained extensively to run macroeconomic models to project different scenarios. The officials should be involved in the design phase to ensure that they understand the motivations of the model. The trained officials should be able to run the macroeconomic model individually, using the same dataset but under different assumptions and using different parameter estimates that would suit the concerns and priorities of their respective agencies. This should allow the technical committee to debate different assumptions and outcomes. The deliberations of the technical committee and their model-based policy analysis should feed into the decision making processes of the Coordination Committee of MFCC. UN-DESA stands ready to provide necessary technical assistance to develop the macroeconomic modelling capacity of the Government of Bhutan.

c. Assessing the Impact of the Hydropower Sector:

Although hydropower revenue is yet to put significant upward pressure on the real exchange rate, the situation is likely to change by 2016. The Government should use this time window to create enabling conditions for the development of other productive sectors. A comprehensive study of the risks and volatility in revenues from hydropower will allow the Government to have a longer-term development perspective. It will also facilitate fiscal and development planning and allow the 11^{th} Plan to prioritize the development of sectors that will have the highest productivity dividends. The study would analyze the impact of hydro-power revenue on agriculture, rural development and infrastructure and how the revenue could be used to finance productivity growth and generate employment in other priority sectors. It would also assess how the hydropower revenue could be effectively used to eradicate poverty in Bhutan. The study would also analyze the need for a Stabilization Fund to smooth fiscal spending. UNDP-Bhutan and UN-DESA may collaborate with the Government of Bhutan to conduct the study, which would serve as a key background paper for the 11^{th} Five Year Plan of Bhutan. The study would also serve as an input to the next UNDAF for Bhutan.

d. Estimating the Cost of Implementing EDP and Assessing Financing Options:

The Economic Development Policy needs to develop an implementation scheme with specific targets, timeline and budgetary outlays. This will require EDP to sequence its sectoral and geographic priorities. Based on a multi-year cost projection, EDP could develop a financing strategy to finance investment projects and facilitate access to finance for the private sector. The Government of Bhutan may consider bond financing options and issue Rupee denominated development bonds or “Green bonds” to finance the required public sector investments as envisaged in EDP. For private investments, the Government may allow the private sector to raise capital through GDR, Foreign Currency Convertible Debt or other financing mechanisms. UN-DESA stands ready to work closely with UNDP-Bhutan and UN-ESCAP and assist the Government of Bhutan to develop an implementation scheme for EDP. The implementation scheme, presented in a study, would consider and evaluate different financing options for EDP, including reforms in tax policies and external finance. The scheme would also evaluate the feasibility of bond financing to support public and private sector investments. The study would serve as a backgrounder for the 11th Five Year Plan and the next UNDAF for Bhutan.

e. Tracking and Improving Labour Productivity:

For Bhutan to achieve structural transformation, it must improve the productivity of the agricultural sector. The growth in the sector has been minimal and it continues to employ nearly 60 percent of the labour force. The Government needs to take specific measures to reduce the cost of borrowing and enhance access to agricultural credit. Investments in infrastructure to improve agricultural extension services, storage and distribution system would increase agricultural productivity and allow the surplus labour in the sector move to higher value added economic activities. Investments in agriculture will need to be coordinated with commensurate investments in education to ensure that the surplus labour in agriculture is adequately trained to move to higher value added sectors, including ICT and light manufacturing. The Government of Bhutan may dedicate a small portion of its hydropower revenue to set up a Productivity Fund to track labour and total factor productivity. UN-DESA stands ready to work closely with development partners, including UNDP-Bhutan, UN-ESCAP, UNIDO and UNCTAD, to strengthen the capacity of the Government for tracking and improving labour productivity.