Institutional Setting: The Role of the Unheralded Factor in Bhutan's Growth Story

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What are Institutions and Why Do They Matter?

This year Bhutan was found eligible for graduation away from Least Developed Country (LDC) status, a group of 49 countries facing deep structural impediments to development. Its stellar performance in improving social outcomes and in raising average incomes provided the justification for such an assessment. It is a remarkable feat considering that since the categorization of LDCs was first acknowledged in 1970, only three countries have managed to graduate. What is even more impressive is that Bhutan built its first motor road less than a decade before this grouping of countries was identified and hence, we can surmise that it was the latest starter of development in the group.

While discussions on the driving factors behind Bhutan's success have mostly focused on how investment in hydropower or the social sector resulted in remarkable development outcomes, we seldom discuss the conducive framework that made this possible: that where countries faltered and squandered donor money, Bhutan made judicious use of every penny. We have not paid tribute to the underlying institutional fabric that made such an achievement possible.

I shall make a modest attempt to illustrate how Bhutan's institutional framework thus far has served its objective of improving social outcomes and preserving social cohesiveness while also delivering growth, thereby laying the foundations of a vibrant economy. However, we now stand at an inflection point and to successfully achieve a smooth transition to the next stage, our institutional framework needs to evolve accordingly. The institutional innovations I discuss are not exhaustive, as I have selected only a few of them.

When discussing the centrality of institutional frameworks it is important to go beyond the narrow definition of institutions, which conventionally refers to certain established organisational bodies with defined mandates. Hence I shall expand the concept to include certain established practices, whether explicit and legal or implicit, government policies, decision-making processes, and relationships as well.

Institutions define the rules of engagement in society and can harness the power of incentives, to mould human behaviour in a direction that is aligned with the longer-term benefits to society. Institutions must be dynamic and evolve with the changing nature of challenges. While broad principles on best practices for institutional design do exist, customising institutions to the peculiarities of a country requires a much more nuanced approach.

The working of institutions is so deeply embedded in the fabric of society that we take their existence and significance for granted. I would probably not bother honouring the loan repayment on my vehicle if the legal framework to penalise me did not exist. Similarly, Druk Air would not be able to purchase its new Boeing Aircraft if the institutions that consolidated the funds of pension holders did not exist to channel investments.

In short, Adam Smith's invisible hand would be groping in the dark if the institutions to prevent it from bumping into obstacles did not exist. In a way, if free markets give rise to the actions of the invisible hand, institutional provisions are the invisible legs that prop up the hands.

The disastrous outcomes of certain big-push initiatives, like in the former Soviet countries or financial liberalisation in Sub-Saharan Africa, without appropriate institutional reforms, corroborate the importance of institutional design. Today the topic has given rise to a vibrant school of thought labeled as 'Heterodox Economics' and led by luminaries such as Daron Acemoglu, Dani Rodrik and Ha Joon Chang.

Thus Far

Bhutan's institutional setting has also been condemned to an oblivious attitude by its beneficiaries. From a secluded nation that stepped out of the Medieval era and built its first roads merely five decades ago to a nation espousing a new development paradigm, the role of institutions is never underscored adequately.

Relatively low levels of corruption, trust, a strong government, and social capital have all invariably contributed to the success story of Bhutan. Even in Medieval Bhutan, institutional arrangements as implemented through taxes in-kind, labour contribution, and a complex network of administrative levels were critical in ensuring sovereignty and even executing famine relief efforts.

The role of institutions can best be illustrated by taking an approach based on their relevance to the various stages of development that Bhutan experienced. This will also motivate projections for the type of institutional refinements and evolution necessary to take us to the next stage of development.

No discussion of Bhutan's institutions is complete without highlighting the most instrumental institution to Bhutan's development success—the institution of monarchy. It is not your textbook explanation of institutions but there is no denying the unparalleled role of the monarchy. This can be explained in a number of ways.

First, the institution of monarchy as a long-term institution ensured that development planning had a long-term focus. Second, as a symbol of unity it ensured effective coordination and a uniformity of policy objectives. However, the quality that distinguishes Bhutan's monarchy the most is the progressive approach it took towards development—an approach that has been gradual yet inclusive.

While in most settings the institution of monarchy has been characterised by a resistance to change, in Bhutan institutional reform has emanated from the throne. From the establishment of the first parliament by the third king, to the gradual approach of decentralisation initiated by the fourth king with the most significant effort culminating in the formulation of a constitution and introduction of parliamentary democracy—eventually the most sustainable form of governance—all came as royal initiatives.

The institution of monarchy continues to provide stability and is of primary importance when discussing institutions. It was the conviction of His Majesty the Fourth King that institution building was of paramount importance and that authority should not rest with individuals. Of course, such an experience offers very little policy prescription that can be transplanted elsewhere, since much hinges on the presence of a benevolent monarch almost akin to the role of the benevolent central planner in textbook neoclassical economics.

The impact of some institutional innovations by the monarchy on the economy will help illustrate the significance of some reforms.

An illuminating paper by Dasho Karma Ura, 'Development and Decentralization in Medieval and Modern Bhutan' provides a fascinating account of the historical evolution of Bhutan's institutions. To refer to a few of them, in 1956 a groundbreaking reform was undertaken when the third king ended servitude with the granting of land titles to the freed serfs. To further symbolise this effort, he appointed several deserving people of serf origin to high positions.

It is worth taking a moment to analyse the implications that such a decision had on the economy. Overnight the throngs of freed serfs became property-owning citizens with an incentive to participate in economic activity. The institutional setting became more inclusive and property rights expanded to include previously excluded serfs. It may be difficult to trace the precise impact due to lack of data, but we can imagine how this move resulted in a cumulative augmentation of human capital as every generation of serfs availed themselves of education.

In essence it freed labour from low value activity for other productive purposes that would have inter-generational implications. Of course, libertarians may argue that this was bound to happen given that servitude was a thing of the past, but it is worth underscoring that when slavery was ended in the United States, the level of development was much higher than in Bhutan.

The next major institutional reforms were the reduction of tax burden and the transformation of taxes in-kind to taxes in cash. This helped to invariably lay the foundations for a modern economy.

The next set of institutional innovations based on the principles of decentralisation would be critical in creating an enabling environment for executing development activities. A clear pattern begins to emerge, in that every effort has been geared towards promoting the type of inclusive institutions that Daron Acemoglu described as conducive to growth and long-term progress. The relationship between effective utilisation of Official Development Assistance (ODA) and decentralisation is not discussed much, but I feel it is an overlooked factor in explaining some of the economic growth we have experienced.

While global debate on the effectiveness of aid was mounting, given the poor outcomes in Sub-Saharan Africa where most ODA was pumped, Bhutan was a poster child for ODA-financed development. It has been empirically documented that aid can be detrimental to growth where poor institutions exist, and conversely it can have multiplier effects when complemented by effective institutions.

By 1981, a District Development Committee (*Dzongkhag Yargay Tshogchung*, or DYT) was established in all 20 districts, enabling the participation of people in the planning and execution of development activities in their communities. According to Dasho Ura, the primary function of the DYT was coordination of development activities in the districts. The forum was also an extremely effective mechanism for mobilising information about people's needs and the status of development activities at the local level. Considering that the majority of the country's population resided in rural areas and given the scattered nature of settlements, this institutional innovation which was essentially interwoven with a Medieval era administrative practice played a critical role in spreading social infrastructure and consequently growth.

The Fifth Five Year Plan (FYP) represented a turning point in that prior plans were based on a broad national plan formulated centrally. With the enhancement of the capacities of local governments and given the population realities of Bhutan, the shift towards decentralised planning made further investments possible. The Planning Commission's role in ensuring an alignment of proposals from local governments and sectors with national level objectives was also of paramount importance.

In hindsight, the infrastructure and social needs of Bhutan were and continue to be intimidating. It is reasonable to concede that modern capital stock only began to accumulate in the early sixties with the advent of roads. There was no other way besides ODA and external loans to finance such colossal infrastructure deficits. Foreign aid continues to constitute nearly 35 percent of development resources with a large chunk coming from India.

The institutional combination of the Planning Commission and DYTs were instrumental in channeling aid money towards the social sectors of health, education and in enhancing agricultural productivity. The Central Government alone would not have been able to identify the list of priorities for channeling development resources let alone coordinating the formidable task. Decentralisation effectively facilitated the spreading of infrastructure across the country.

Such an institutional setting was conducive to mobilising the ODA necessary to transform Bhutan from a predominantly agrarian society and lay the foundations for a modern economy. This, coupled with a defining macroeconomic institutional characteristic of Bhutan in the now constitutionally emboldened policy to channel all external financing towards capital expenditure, has also ensured a healthy fiscal position for the government. By exhibiting sound debt management and project implementation, Bhutan was able to register some of the highest investment rates ever recorded globally. These investment rates have averaged close to 50 percent of GDP over the last few years. Such levels of investment cannot be sustained indefinitely.

The reason I bring this up is because investment or capital formation has played and continues to play a critical role in contributing to economic growth. But it appears that growth in Bhutan is largely dependent on new investments, whether in the form of roads or in hydropower, and only marginally dependent on previous investments. Hence it presents an ideal transition point for our discussion to the challenges we now need to overcome.

Inflection Point

A growth accounting framework is a powerful tool in empirically assessing the conduciveness of an economy's institutional framework for economic growth. It essentially decomposes the factors contributing to growth into labour, capital, and Total Factor Productivity (TFP), a widely accepted but far from perfect encapsulation of an economy's institutional framework. It is supposed to represent the efficiency with which an economy combines labour and capital. It is common for a developing country like Bhutan that is still building infrastructure to derive most of its growth from capital deepening. However, gradually productivity has to drive growth.

Bhutan's growth has largely been based on capital accumulation. These investments have primarily been social in nature, such as hospitals and schools or roads that connect rural pockets of Bhutan. Such investments usually require a generation to yield economic benefits. This explains why the so-called incremental capital output ratio is also alarmingly high at 7 implying that productivity contribution is disturbingly low. In essence, it means that 7 Ngultrum of capital investment is required to produce an extra Ngultrum of GDP. This could be due to the exorbitant costs of building infrastructure in a mountainous terrain. These investments have invariably contributed to enhancing Bhutan's potential, but now a shift needs to be achieved in leveraging these investments to propel Bhutan to the next stage of development.

The other side of the explanation lies in the investments in Bhutan's most abundant resource—hydropower. The investment requirements are formidable and returns take nearly a decade to materialise. Once operational, the returns on the export of energy are constrained by a bilaterally determined tariff and cannot adjust to market conditions. In certain ways this is beneficial and hedges us from downward swings. But it also prevents us from realising any favorable terms of trade swings. This served us well, when industrial capacity was virtually non-existent, by ensuring a steady stream of revenue from the export of electricity in its primary form. However, over the decades the economy has built a decent level of industrial capacity and entrepreneurship. Energy must now be considered as a means and not an end. It must be used strategically through a carrot and stick approach like what East Asian governments did with various incentives.

The spillover effects from using this resource strategically will far outweigh the costs of forgone export revenues, otherwise governments wouldn't bother engaging in industrial policy. This is about structural transformation, which is a prerequisite to move up the development ladder. It is critical that we avoid getting ensnared in a comfort zone in which we do not progress beyond the role of an energy supplier. There are potential pitfalls in supplying subsidised energy but none that cannot be addressed.

Bhutan could use a carrot and stick approach forcing industries to move up the value chain, by entitling industries to subsidised energy contingent on progressing within a certain period. Imposing progressive value addition requirements and designing incentives accordingly would also encourage a longer-term outlook for industries rather than a short-term static approach. The incentives could provide a declining tax rate as we go higher up the value addition ladder. The conditions and incentives would entice industries to take a more dynamic approach towards investments in plant, machinery and human resources. With incentives phasing out at each stage, making the next set of incentives contingent on value-addition requirements would facilitate continuous up-gradation.

So why all the fuss about productivity? A recent study by the Asian Development Bank (ADB) also decomposed the contribution of various factors to potential output growth and revealed that capital accumulation alone accounted for a 4.2 percentage point contribution, followed by labour at 1.8, and TFP at a lowly 1.6. These have implications on longer-term growth as shown in their simulations and projections. Even a doubling of the investment rate does not increase future potential output growth rate by a percentage point. The most sustainable and enduring increase comes about through an increase in productivity.

Institutional frameworks that facilitate partnership between the state and economic actors will be critical in executing productivity-enhancing strategies. This was epitomised by the sophisticated partnership between the private sector in the East Asian miracle economies and their respective governments. Contrary to most conventional advice on limited state intervention, governments like those in Korea and Japan took a coordinated approach to industrial development by using various policy tools such as credit subsidies, tax incentives, and export subsidies. Furthermore, contrary to the advice of multilateral institutions like the World Bank, Korea ventured beyond its comfort zone into industries like shipbuilding—one of the more advanced sectors during the 1970s.

Institutional arrangements between the state and private sector are critical in this day and age. Modern economic growth, as described by Maddison, is a process of continuous technological innovation, industrial upgrading and diversification, and improvements in the various types of infrastructure and institutional arrangements that constitute the context for business development and wealth creation. To facilitate such outcomes, state coordination is critical in overcoming information and coordination externalities.

Some broad principles for institutional design must also be discussed. While criticisms abound on the irrelevance of certain institutions in specific contexts, it must be understood that no universality exists in terms of the unique institutional structure that every country should adopt. As Dani Rodrik argues, economic principles do not necessarily map into unique institutional designs. The corresponding institutional design to deliver a certain outcome based on a widely accepted principle must be contextualised.

A classic case can be found in China's gradual approach towards liberalisation. This began with a dual track liberalisation of the agricultural sector in China, which was a strategic approach given the country's context. Farmers were allowed to sell any crops produced in surplus of the required amount that they had to supply to the state. This achieved two objectives—it enhanced productivity by providing an incentive to produce more, and it ensured that the state did not face a weakened fiscal position due to liberalisation of the quota system. These reforms were then extended to hybrid businesses called township and village enterprises.

Like China, Bhutan's institutional design as seen in its cautious approach towards tourism also illustrates in a nuanced way the importance of customization based on a country's circumstances and aspirations. In essence, Bhutan's tourism policy thus far is a case of partial liberalisation and yet another round of partial liberalisation will have to ensue. Although misconceptions on the objectives of such a policy abound, there is no denying that it served its dual mandate of promoting a high-end industry while simultaneously ensuring that a mass influx of tourists did not overwhelm the small population.

In hindsight, the approach was an ingenious acknowledgement of the priorities of the nation as well as the limitations of the economy. With limited infrastructure and tour operators with expertise, the economy would have succumbed to finding a shortcut. This would have involved engaging foreign partners and investing in sub-standard accommodation to respond quickly to the surging demand. The consequence would have been an undermining of Bhutan's longer-term tourism potential and the building of domestic expertise in the hospitality sector.

Instead, the regulated approach facilitated the emergence of numerous domestic businesses. It also ensured that investment in hotel infrastructure was above a minimum standard. The approach was effective in ensuring that competition in the sector was not reduced to the lowest common denominator. However, as is the case everywhere else, institutions tend to outlive their purpose and evolution is critical for survival.

Today, the debate revolves around the unintended ramifications of this cautious approach. While initially it served to promote a high-value low-impact form of tourism, today it has distorted incentives in the sector for innovation and competition. It has resulted in a monolithic industry with a narrow range of products. The scenario today is markedly different from what it was when Bhutan started tourism.

Today, an abundance of tour operators compete for 100,000 clients. The number of tourist grade accommodation is in excess of demand as hoteliers are left to the mercy of the most powerful players in the value chain. While there will be significant resistance to reform given the vested interests of a few groups who have built their businesses around earlier institutional arrangements, the international evidence on the risks of such institutional rigidness is overwhelming.

Perhaps Bhutan could also take a dual track approach to liberalisation of the daily tariff as was pursued by China in its early days of reform. This approach is already being proposed. Once a tourist has fulfilled the daily royalty payments, he or she would have the option to choose from a range of tour operators and packages and hotels at market determined rates. This would prevent any loss in royalty revenue for the government or it could possibly result in a surge in royalty revenues. More importantly, it would introduce more competition while maintaining a certain standard of tourism defined by the royalty amount.

Organizational Mandates and Tensions

So, we've discussed certain policies and practices, but what about the organisations mandated to execute the government's policies?

Today five institutional bodies play a decisive role in shaping the path of the economy: the Ministry of Finance (MoF), given its ability to design fiscal incentives; the Ministry of Economic Affairs (MoEA) as a facilitator with information about our resources and potentials; the National Environment Commission (NEC) as the vanguard of Bhutan's internationally lauded environmental aspirations; the Royal Monetary Authority (RMA) as the regulator of financial transactions; and finally, the Druk Holdings and Investments (DHI), based on its initially intended role to serve as a pioneer in investments in strategic areas.

Much of Bhutan's structural transformation will hinge on how these bodies can resolve inter-sectorial tensions, and strike a delicate and pragmatic balance between very real economic objectives and idealistic principles. Some of the tensions between such organisations are not unique to Bhutan and emanate from the very mandates on which each one of them are founded.

The MoEA would like to promote the competitiveness of the industries by lowering their costs through measures such as excise duty rebates on raw materials sourced from India. However, the MoF has an overriding mandate of balancing the budget and is inherently allergic to concepts such as subsidies, rebates, etc.

Alternatively, the MoEA might want to engage in aggressive industrial policy through prioritised and subsidised lending to sectors that present potential for value addition, but the RMA may impose macro-prudential limits or the MoF may restrict the channels of external commercial borrowing. Similarly, the MoEA's Department of Industries might see the economic merit in facilitating the establishment of certain energy intensive industries, but the NEC may demand a series of assessments before any furnace can even reach 1,000 degrees Celsius.

While the DHI should ideally venture into sectors that require colossal investments and cannot be undertaken by the private sector, its performance agreement to make a predetermined contribution to the national coffers may restrict investment in certain areas and compel them to stick to mundane sectors. In a way, such sectoral mandates offer checks and balances, but even these can be self-defeating if we are in a deadlock.

Central to ensuring that these institutions will serve their intended purpose, while fulfilling national objectives, is institutional design. To move to the next stage of development, a more nuanced approach that involves contextualisation is required. Latin America adopted classically sound policies wholeheartedly, but East Asia took a more nuanced and partial approach in leveraging the power of free markets and globalisation. The contrast in outcomes was stark.

Bhutan will also have to find the appropriate fit given its context and aspirations. Furthermore, a clear distinction between operational and policy independence needs to be advocated, as institutions in our young democracy grapple with finding their boundaries and interpret the conferring of independence in very extreme terms.

Only when our organisations are able to artfully accept their institutional boundaries with cognizance of the greater scheme of things can we ride the waves of earlier growth successes. Otherwise, institutional mandates will override larger objectives, as is evident in some economies where central banks conferred with the mandate to rein in inflation have pursued their narrow objectives to the detriment of the economy. No wonder it has often been said that 'The surest way to kill inflation is to kill growth.'

Bhutan's institutions will also have to look beyond parochial institutional mandates. This is ever more critical in today's context. Institutional evolution will also have to take cognizance of international trends and changes. For instance, Bhutan's protective treatment of convertible currency will also have to evolve based on Raghuram Rajan's commitment to make the Indian rupee convertible. Convertible currency is a means and not an end in itself.

The next balancing act will involve aligning the incentives of local governments with growth objectives. While we've discussed how the institutional arrangements to empower local governments created an environment conducive to spreading investment and achieving social outcomes, we must now discuss how their roles should evolve to prevent a painful tradeoff between economic objectives and governance mandates.

Currently the incentive to strike a balance between environmental conservation or some other priority and economic activity does not exist. Local governments receive dole-outs from the central government every year for recurrent and development activities. Since they do not have to raise their own revenues, they can focus exclusively on other priorities that may deter economic activity as has been highlighted in the news on multiple occasions.

A point of entry could involve refining the resource allocation framework to encourage communities to achieve a pragmatic balance. The existing allocation is determined by four parameters such as population, poverty, transportation costs and forest coverage. Hence there is limited incentive to promote economic activity. Perhaps tweaking the framework by assigning a certain weight to the amount of revenue a district can raise through corporate and business taxes would force local governments to strike a more pragmatic balance. A less severe amendment would involve local governments retaining a certain portion of the revenues they are able to generate.

Currently any revenue generated is the central government's resource and hence local governments have no incentive to raise revenues, which consequently distorts incentives for supporting economic activity. A conducive institutional framework will have to address such economy-wide misalignments. While it would be impossible to address every misalignment, we could start with the most binding ones.

Thereafter

The context and time for deliberating on this topic is ideal, considering the recent macroeconomic challenges Bhutan has been encountering and the inflection point that we have reached in terms of our imminent graduation away from LDC status. With the near fulfillment of the millennium development goals (MDGs) and the achievement of the lowest poverty rates among LDCs, it is now opportune to make the transition towards more economic-oriented institutional efforts to leverage our commendable investments thus far.

Reform is also critical because there is currently a dichotomy between the evolution of political institutions and economic institutions. While the former have evolved significantly the latter hasn't seen a concomitant refinement. However, as Daron Acemoglu argues, it is the political institutions that will determine the shape of economic institutions, so we must commend the strength of our political institutions, which although relatively new will eventually find the right balance.

Deng Xiaoping once remarked to his fellow Chinese citizens that 'reform is the only asset we have'. China began with a coordinated approach of asymmetric liberalisation whereby certain non-standard policy prescriptions like financial repression, depressed wages, and state capitalism were deployed. However, the dividends from some of these earlier reforms are plateauing and China is now poised to execute its next series of reforms.

In Bhutan, we have registered unparalleled social outcomes through heavy investments in social infrastructure and human capital facilitated by a nurturing institutional environment. Growth is currently buoyed by enormous investments in hydropower and will eventually plateau. The dividends from previous and existing development approaches are already beginning to flatten. We have laid the foundations for economic take-off, and growth must now be unleashed by leveraging existing capital productively instead of relying on unsustainable levels of capital formation.

We must now unlock new and more enduring sources of growth and sustain them, which is why our institutions must evolve and they must now be subjected to the forces of creative destruction. During transition, the biggest challenge that Bhutan faces is in striking a balance between growth objectives and individual institutional mandates. Furthermore, while the long run is important and short term efforts will have to be geared towards longer term goals, it will be critical to temper ideological temptations and longer-term aspirations with immediate priorities when formulating policies. For as John Maynard Keynes once said, 'in the long run we are all dead.'