

Ideas for a Post-COVID Bhutanese Economy

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Introduction

Bhutan is at a crossroads. Significant socio-economic development over the past two decades has positioned the country to graduate from the Least Developed Country (LDC) category in 2023, aligned with the end of its 12th Five Year Plan. Most Bhutanese are wealthier, better educated, and healthier than at any time in the past.¹ Bhutan also initiated the production of a 21st Century Economic Roadmap to be launched in 2021, a forward-looking strategy that targets further economic transformation over the next decade.

Like the rest of the world, Bhutan acutely felt the effects of COVID-19. While the Royal Government of Bhutan's (RGoB) strong public health response contained some of the worst consequences of the pandemic, socio-economic impacts were nonetheless severe. On the economic front, COVID disrupted the manufacturing and production sector, limited construction activity, and brought tourism and related services to a standstill. Lives of many Bhutanese were also affected. The unemployment rate grew to five percent in 2020 -- nearly double the 2019 level. Youth unemployment also rose from 12 to 23 percent over the past year.² Gross Domestic Product (GDP) growth was estimated at -6 percent in 2020 and future growth will likely be sluggish.³ Childhood development, meanwhile, was also affected through school closures and nearly a year of lost instruction. These wide-ranging impacts are likely to continue for some time even after Bhutan's national vaccination campaign.⁴

¹ For example, Bhutan's GDP per capita grew from US\$718 in 2000 to US\$3,316 in 2019. World Bank, *World Development Indicators*.

² National Statistics Bureau (2020), *Labour Force Survey Report 2020*. The pandemic was also cited in 2020 as one of the two main causes of unemployment (along with recently completed studies).

³ RGoB Prime Minister (2020), *State of the Nation Report*.

⁴ This is only a selected list of COVID impacts. For example, there is also evidence of a significant mental health toll (See UNFPA (2020), "COVID-19 sparks increased demand for mental health services", <https://news.un.org/en/story/2020/10/1075122>) and an increase in gender-based violence (See "Gender-based violence increases by 36.6 percent this year", Yangyel Lhaden, November 26, 2020, *Kuensel*, <https://kuenselonline.com/gender-based-violence-increases-by-36-6-percent-this-year/>). The RGoB and other partners have been active in assessing the consequences of COVID. Among others, see NSB's study on the COVID impact in the tourism sector and the new Labour Force Survey that assesses the overall labour market.

The current moment is also defined by the global climate crisis. Countries across the world are necessarily re-thinking their futures, including possible changes to development approaches. The models that fuelled growth in the past are no longer compatible with a sustainable future. But change has been slow despite global agreements seeking a reset, including the 2030 Agenda for Sustainable Development and the Paris Agreement on climate change.

Despite minimal impact on climate change and a strong environmental record, Bhutan has already experienced climate-related threats to biodiversity, agricultural production, and the liveability of urban areas. There is evidence of rising temperatures and changing rainfall patterns. For example, simulations by the RGoB's National Center for Hydrology and Meteorology forecast a 10–30 percent increase in annual rainfall from 2021–50.⁵ These challenges will likely become more pressing in coming years and a commitment to green investment and environmental protection more fundamental.⁶

The continuation of Bhutan's sustainable development growth path over the coming years is thus uncertain. Further human development will likely continue to be affected by COVID-19. Bhutan was already economically vulnerable before the pandemic owing in part to its small size, geography, and susceptibility to natural disaster. Pre-COVID UN analysis described this situation as a “Bhutan paradox”, with transformational progress visible but LDC graduation coming while the country was still economically vulnerable and investing to build and strengthen resilience.⁷

This is, therefore, a necessary moment to consider Bhutan's economic future. LDC graduation is imminent, the RGoB's commitment to economic transformation is clear, and Bhutan is starting to emerge from the COVID-19 crisis. Such an imagining of Bhutan's future was the impetus behind the UNDP-BCMD led conversation series in the fall of 2020 that aimed to inform national dialogue on the future of Bhutan.

⁵ National Center for Hydrology and Meteorology, RGoB (2019), *Analysis of Historical Climate and Climate Projection*. According to these data, Bhutan might expect to see an increase of 0.8 degrees–2.0 degrees Celsius from 2021–50.

⁶ For example, increased investment in climate and energy technologies such as solar, smart grid, micro-grid, and circular economy.

⁷ UN Committee for Development Policy (2018), *Vulnerability Profile of Bhutan*.

This essay builds on that discussion.⁸ It also draws from ideas and analyses in the 2018 edition of the Druk Journal focused on economic transformation.⁹ But the crisis has evolved significantly since its onset in 2020 and, at the time of this publication, the outlook is different from last year's dialogue. Bhutan has since, for example, both felt the impact of a six-week national lockdown from December, 2020, to February, 2021, and successfully launched a national vaccination campaign in March, 2021.

This essay thus takes a long view towards imagining the future.¹⁰ It aims to offer ideas to help guide future strategic thinking along with suggested actions to help support the long-term vision. It includes a brief description of Bhutan's economy in April, 2021, including a review of past trends and recent developments to help inform plans for what's next. Selected ideas for the future follow. This review, however, is not (and could not be) a blueprint. Instead it hopes to contribute to the ongoing wider dialogue on Bhutan's post-COVID and post-LDC future.

Bhutan in 2021

Re-imagining approaches to Bhutan's economic future was recognised as a necessity even before the crisis. This was the motivation for the 21st Century Economic Roadmap. But such an exercise became both more challenging and more critical with the onset of COVID-19. Financial resources have become scarcer, development spending needs have increased, and economic activity has stalled.

Bhutan's economic performance and its structural challenges are well documented. Over the past 20 years, Bhutan's average GDP growth rate has been about seven percent.¹¹ But this growth has also been volatile. Bhutan's reliance on hydropower has led to fluctuations in output, especially during construction and commissioning. The economy is also closely tied to the economic performance of India whose slow recovery may lead to declining export revenue, grants and budgetary support, and investment.¹²

⁸ This essay greatly benefits from the ideas and recommendations offered by the expert panelists in the October 2020 discussion: Dr Hamid Rashid, Thinley Choden, Phub Dorji, and Dorji Phuntsho.

⁹ Druk Journal (2018), *Transforming Bhutan's Economy*, Volume 4, Issue 2.

¹⁰ COVID-related uncertainty has also given many analyses a short shelf life, with forward-looking estimates of growth and other economic trends often becoming out of date soon after publication.

¹¹ World Bank, *World Development Indicators*.

¹² India felt in 2020 an historic contraction and the most severe among G20 countries. At the time of this publication, India was also experiencing its highest surge in COVID-19 cases.

There have also been sector imbalances. Almost 60 percent of the population works in the agriculture sector which contributes about 15 percent of output. This compares with the capital-intensive hydropower sector that accounts for fewer than one percent of jobs.¹³ Unemployment among educated youth has also been increasing. As mentioned above, the gap between the overall and youth unemployment rates has been exacerbated by the pandemic. In general, too few jobs have been created to absorb the growing and more educated labour force. Employment has increased instead, primarily in relatively low productivity services sectors.

Bhutan also has a unique debt profile.¹⁴ Despite a relatively high debt-to-GDP ratio before the pandemic its debt service has been considered sustainable and the risk of debt distress moderate. This is due to the special financing arrangement with India. A large share of Bhutan's external debt is linked to hydropower loans that are implemented under an intergovernmental agreement where India covers project costs and buys surplus electricity at a price reflecting cost plus a net return.¹⁵

Bhutan's debt-to-GDP ratio rose to 123 percent at the end of 2020.¹⁶ It may need to further increase its debt stock to support the recovery and long-term development in the coming years despite limited space for additional domestic borrowing unlike other countries with more developed financial sectors. The RGoB has signalled its intention to monitor the debt situation closely, especially through the new debt management strategy released in 2021 that lays out scenarios, risks, and plans.¹⁷

Bhutan's graduation from the LDC category is likely to have a limited direct impact on trade and development finance. On the trade side, Bhutan's main export products and destination markets will remain largely unaffected by graduation.¹⁸ Potential diversification into new products and markets would be affected although none of the affected products are yet major exports.

¹³ Specifically, the average agriculture share of employment was 57 percent and share of GDP was 15 percent from 2015-19. The corresponding shares over this period for industry were 10 percent of employment and 40 percent of GDP. World Bank, *World Development Indicators*.

¹⁴ For an overview of Bhutan's debt see Ishihara (2018), "How much should Bhutan worry about its public debt?", *Druk Journal*, Volume 4, Issue 2.

¹⁵ World Bank and IMF (2018), *Joint Bank-Fund Debt Sustainability Analysis -- 2018 Update*.

¹⁶ Ministry of Finance (2021), *Public Debt Situation Report: For the quarter ended 21 December 2020*. Over 97 percent of this is external debt and hydro accounts for 74 percent of external debt.

¹⁷ Ministry of Finance (2021), *Medium-Term Debt Management Strategy (FY2020/21 to FY2022/23)*.

¹⁸ India and Bangladesh represented about 90 percent of exports before the COVID-19 crisis and trade with both is unaffected by LDC status.

Global trade is also likely to be different, post-COVID, given the wide-ranging impacts on economies across the world and potential changes to the structure of demand, global supply chains, and protectionist policies.¹⁹ Most bilateral and multilateral development partners also do not use LDC status as a criterion for resource allocation. Access to development finance will, however, still be a critical issue as the trend of decreasing grants will likely continue but this decline will not be triggered by graduation.²⁰

Into this environment came COVID-19 with deep, widespread, and dynamic impacts. The crisis affected most Bhutanese and increased vulnerability across different dimensions.²¹ Coping capacity was also limited as many Bhutanese have little economic security (e.g, personal savings or employee saving schemes) and lived paycheck-to-paycheck before the crisis. On the positive side, the first round of the vaccination campaign rolled out quickly and successfully. While this does not signal the end of the crisis, it is a significant achievement and positive step towards the future.²²

Imagining Bhutan's Economic Future

Ensuring Inter-generational Growth and Development

As countries around the world consider their post-COVID futures they are confronted ever more urgently by questions about the compatibility of their economy with the future of the planet. It is too reductive to suggest this is as simple as deciding on a growth model and moving forward. But a guiding philosophy towards growth and development -- including targeted growth rates -- has an impact on the level and types of investments needed, the kind of jobs that might become available and to whom, and the environment and climate.

Realising double-digit growth over an extended period will be challenging. In the Asia-Pacific region, there are few examples of countries achieving a decade of real double-digit average growth in recent decades (e.g., China

¹⁹ See UNCTAD (2020), *Impact of the COVID-19 Pandemic on Trade and Development*.

²⁰ The RGoB is also preparing a smooth transition strategy that identifies priority areas to help prepare for graduation especially related to finance and trade.

²¹ For further details on impact see NSB and UNDP (2020), *Rapid Socio-Economic Impact Assessment of COVID-19 on Bhutan's Tourism Sector*.

²² Full recovery will depend on the speed of change outside Bhutan but the domestic vaccine success will likely help prevent costly future lockdowns, spur domestic economic activity and tourism, and ensure continuous education.

and Republic of Korea). Post-COVID growth will likely be constrained. Pursuing capital and resource-intensive growth may also come at the expense of other priorities that run counter to its benefits.

The concept of “green growth” has been promoted globally as a potential replacement for other types of growth. The central idea is that economic growth can be continued within ecological limits, primarily through technology upgrades and shifts in focus (e.g. investments, incentives to businesses, or training). There is evidence, however, that green growth is unlikely to fully replace capital and resource-intensive growth.²³ This means high growth rates around the world may not be replicable and trade-offs will be inevitable.

Economic growth in the past has already led to improved lives for many Bhutanese. Ambitious plans to further diversify the economy, increase private sector activity, and -- critically -- more widely spread economic benefits will be an important part of the future. But this approach will necessarily need to be linked to energy transition, lower resource intensity, climate adaptation and resilience.

It may thus be economically, philosophically, and pragmatically appropriate to prioritise green recovery and shifts to a green economy. This also includes explicitly considering distributional impacts and how policy actions affect different population groups, including those in the future. Bhutan’s long-term economic future may thus lie in a modified green approach anchored in climate resiliency, sustainable management of natural assets, long-term human development, and sustainable financing. This can include, specifically, incentives to encourage green business activity such as favourable taxes, access to low-interest finance, and support to product development and research.

Both Innovative and Non-innovative Approaches to Development Finance

Bhutan requires financial resources to ensure recovery from COVID-19 and continue investments in long-term development priorities. This will be one of the most critical challenges in the coming period. The pandemic resulted in fiscal tightening. Lower tax revenues led to a decrease in

²³ See Hickel and Kallis (2020). “Is Green Growth Possible?”, *New Political Economy*, Volume 25, Issue 4.

domestic resources while the launch of fiscal stimulus and other support measures increased spending (including frontloading capital expenditure to help the crisis response).²⁴

This fiscal challenge comes from a confluence of factors, including pre-COVID trends. Traditional development assistance was already on the decline before the pandemic. While the global emergency response provided a short-term boost of external resources, the longer-term downward trend (including away from grants) is likely to continue.

So-called “innovative financing” has been advanced as a means of helping countries overcome resource constraints.²⁵ This refers to a somewhat loosely defined range of instruments that have not been traditionally used by governments or the private sector (e.g., impact investment, thematic bonds, and crowdfunding). It also includes new approaches to financial services and platforms (i.e, rather than specific sources of finance) such as new technologies aimed at improving efficiency, lowering costs, or widening access to services (“Fintech”).

Bhutan will need both innovative and non-innovative approaches to financing. This means emphasising traditional reform initiatives such as improved tax administration and spending efficiency alongside experimentation with new sources of revenue. There will likely be a gap between available resources and the investment needed to meet Bhutan’s wide-ranging aspirations. Bhutan’s small private sector and financial market also limit the use of some instruments available to larger countries. In any case, new revenue sources alone are unlikely to cover the resource gap and will need to be combined with more traditional reforms.

This includes efforts to expand the resource base and improve expenditure efficiency and allocation. Bhutan plans to launch in 2021 the Goods and Services Tax after a COVID-related delay.²⁶ It can also benefit by continuing and expanding tax reforms such as customs administration, efficiency of collection, and reduction of tax holidays.

²⁴ For example, direct and indirect tax collection fell by 9 percent and 54 percent, respectively, in Q1 of FY 2020/21 (July to September 2020) compared to Q1 of FY 2019/20 (July to September 2019). Meanwhile total expenditure for FY 2020-21 is budgeted 20 percent higher than FY 2019-20. RGoB Prime Minister (2020), *State of the Nation Report*.

²⁵ UNDP (2019), *Innovative Finance and its Relevance to Bhutan in the Context of SDGs and 12th Five-Year Plan*.

²⁶ According to the Ministry of Finance, original estimates were that the new tax standardisation reform would increase revenue annually by Nu. 3 billion.

Fiscal policy has long been a critical tool for governments to address (or not) inequality. For example, in many countries taxes are the primary policy instrument for direct redistribution. This includes introducing more progressive schemes while identifying measures to expand the tax base. The dialogue around an inclusive economic transformation has also included exploration of progressive taxes, such as on inheritance and capital gains.

Meanwhile, Bhutan has also been exploring new financing approaches. This includes strengthening the depth and role of the capital market. Bhutan launched its first sovereign bond in 2020. This successful issuance was fully subscribed at \$41mn and a 6.5 percent interest rate with proceeds used to support the COVID-19 fiscal response. A strengthened capital market can help serve as an alternate source of funding to complement the banking sector and channel capital to key activities (including green investments). There is also space for exploring how even relatively small levels of public finance and external grants can help leverage new resources, especially for climate financing and through strengthened public and private partnerships.

The pandemic has highlighted how risk mitigation mechanisms can support a country's development. In Bhutan, this includes through the new Medium-Term Debt Strategy, the Bhutan Economic Stabilisation Fund, and the RGoB's evolving approaches to fiscal risk management. First, the debt strategy is guided by two key objectives, including strengthening the domestic capital market (e.g, through issuance of T-Bills and bonds) and emphasising concessional financing (i.e, low fixed interest rates, long grace periods, and long repayment periods).²⁷ Second, the RGoB also established a stabilisation fund in 2017 to help smooth spending and manage hydropower revenues and business cycle fluctuations. As of end-March, 2020, the fund balance stood around Nu. 344 million and was invested in India.²⁸ Finally, the RGoB is exploring approaches to fiscal risk management, including scenario planning, modelling, and forecasting, especially to help manage deviations from fiscal plans due to emergencies or crises.

²⁷ Ministry of Finance (2021), *Medium-Term Debt Management Strategy (FY2020/21 to FY2022/23)*. For example, World Bank IDA financing gives a grace period of 10 years, maturity period of 40 years, and an interest rate of 0.75%. By comparison, the average interest rate of all current external debt in Bhutan is 7.5 percent.

²⁸ Ministry of Finance (2020), *Budget Report FY 2020-21*.

Learning from the Past and New Approaches to Economic Diversification

Bhutan's goal of economic diversification is central to its transformation. But a sense of realism should drive the approach as this has traditionally been a difficult area of economic reform across the world. Many countries have aimed to diversify but successful examples are relatively few. Structural challenges have proven difficult to overcome in Bhutan, including high trade costs, small domestic market, investment gaps in infrastructure, and limited access to and high cost of capital.

Despite a range of reforms and policy initiatives over the past decade results remain elusive. GDP sector composition has changed little, with a marginal decline in the industry and manufacturing share and a gain in services. In real terms, Bhutan's trade in goods and services increased one percent since 2010 compared with the world trade growth of 37 percent over the period.²⁹ The export basket consists of 47 products and the number and distribution has remained stable over time, with electricity representing 40 percent. India remains the main export destination and source of imports.³⁰

Moving forward there are a range of approaches that build on the past.³¹ This can include improving alignment and prioritisation of investment and export promotion policies, such as further exploration of an Economic Development Board (EDB) to oversee the formulation and implementation of trade, business, and investment policy. The design of such a Board would need to be carefully considered to ensure buy-in through clear mandates and responsibilities vis-à-vis existing institutions.

Bhutan may also strengthen export and investment promotion in sectors with identified market potential in India and beyond. This can include continuation of industrial states and Special Economic Zones (SEZ) experiments, addressing binding constraints while strengthening investor targeting and aftercare. Analysis also indicates space for product diversification in the Indian market. Estimations using the unit value calculation³² suggest that 205 items have export potential to that market,

²⁹ RGoB Ministry of Economic Affairs (2020), *Diagnostic Trade Integration Strategy Update*.

³⁰ RGoB Ministry of Economic Affairs (2020), *Diagnostic Trade Integration Strategy Update*.

³¹ These ideas draw especially from Bernal, Standley and Wangchuk (2021), "Trade Diversification in Bhutan: LDC Graduation, Economic Transformation, and COVID Recover", UN Bhutan Policy Brief.

³² The unit value of a set of homogeneous products is the total value of the imports (in CIF) divided by the sum of the quantities. It is a quantity-weighted average of the different prices at which the product is imported.

representing 60 times the value of current total Bhutanese exports to India.³³

Bhutan can also establish a linkages programme to promote relationships between domestic firms and foreign companies. This includes a range of activities like support for technological upgrading and incentives for R&D cooperation. Linkages also enhance the spin-off effects of FDI on the local economy. Services also present opportunities for economic and trade diversification for Bhutan and serve as important enabling infrastructure and sources of linkages. An efficient ICT sector, for example, can help enable services to be traded or offshored unconstrained by the high transport costs that often characterise landlocked countries such as Bhutan. Promoting e-commerce and addressing barriers to e-payments can also help enterprises expand market access domestically and cross-border.³⁴

Stimulating Entrepreneurship and the Private Sector

Bhutan's future can also be supported by opening space for entrepreneurship and releasing constraints to business development. This is likely to be central to the new Roadmap. Entrepreneurship is, of course, only part of the solution. Most new businesses start small and will not be major sources of employment for some time. But entrepreneurs and small businesses may catalyse activity, like helping develop new industries and spurring investments into key projects.

An overall private sector strategy could include balancing State involvement with freedom for individuals. The government can provide policy incentives and a credible enabling environment but also give space for the private sector to experiment and operate. One approach could be a gradual transition from public to private ownership of State-owned Enterprises through cost-sharing and allowing the private sector to take equity over time.³⁵ At the same time the State may continue to play a role in supporting entrepreneurship, for example by helping local industries find markets abroad and keeping the cost of production low (i.e, subsidising consumers and producers at production).

³³ Ferrous metals have the highest export potential in India and the world at large. Others with strong export potential to world markets include high-value niche products that build on Bhutan's culture and identity.

³⁴ RGoB Ministry of Economic Affairs (2020), *Diagnostic Trade Integration Strategy Update*.

³⁵ The Republic of Korea included such a gradual approach in its reform strategy. See ADB (2021), *Reforms, Opportunities, and Challenges for State-owned Enterprises*.

Developing approaches for accessing capital will also be important. There are limited incentives and supportive policy frameworks for small firms to increase competitiveness. One example is experimentation with replacing tying credit access to assets and collateral. The government may also provide support through new credit facilities such as the example of the credit guarantee scheme launched by the Royal Monetary Authority during the pandemic.

There may also be gains from broadening support to entrepreneurship systematically across the business development cycle. This includes support from pre-seed and early stages through to scaling, including emphasis on developing supportive networks and new approaches to risk-taking and insolvency. This type of support includes targeted opportunities for young people such as incentives to take up business opportunities, skills development for enterprise planning and management, support for technology acquisition and finance, and matchmaking and advisory services. There are different models across the world of governments, private sector actors, and non-profit institutions all supporting start-up incubation.³⁶

Conclusion

As Bhutan plans its post-COVID and post-LDC future, it faces both longstanding and new challenges, like ensuring a green and sustainable economic transformation that responds to the climate crisis. The ideas in this essay will not be the solution to this future. A comprehensive approach will require longer-term structural reforms with impacts that may be most visible over decades, such as in education. But learning from and building on the past, combined with experimenting with new approaches, can help Bhutan overcome longstanding and emerging challenges. It can also help Bhutan take advantage of new opportunities such as those provided by technology. With further detailing and -- critically -- follow up implementation, these may be components of a forward-looking economic strategy consistent with the RGoB's broader transformative economic vision.

³⁶ Israel and Taiwan are both examples of comprehensive Government support to start-ups.