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Graduation of Bhutan from the group of least developed countries: Potential implications and policy imperatives

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Graduation of Bhutan from the group of least developed countries: Potential implications and policy imperatives[+]

by

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Abstract

Despite confronted with such unfavourable conditions as mountainous topography and being landlocked and susceptible to natural disasters, Bhutan has demonstrated a strong track record in sustaining economic growth and reducing poverty over the past two decades or so. Its progress in other socio-economic indicators as reflected in its success in achieving many of the 2000-15 Millennium Development Goal (MDG) targets is also worth noting. It is unique in approaching development by valuing collective happiness as the goal of governance. Bhutan successfully met the least development countries (LDCs) graduation criteria in two United Nations triennial reviews of 2015 and 2018 and is set to graduate from the group of LDCs in 2023. The transition involves loss of certain trade preferences and other international support measures. However, as the significance of these benefits has been quite limited for Bhutan, LDC graduation should not be a major cause for concern. While most LDC-specific privileges are related to international trade, Bhutan's overwhelming dependence on trade with India is governed through a bilateral trade agreement insulted from LDC status. Overseas development assistance is important for Bhutan although its significance in the economy has fallen. Graduation should not have much implication for development financing as development partners do not use LDC status as an important factor in deciding about aid allocation. For Bhutan, dealing with general development challenges should remain important policy priorities. It has embraced a proactive policy stance for graduation by combining its eighth five-year development plan, Sustainable Development Goals (SDGs) and Gross National Happiness (GNH) indicators. Bhutan has huge potential for developing supply-side capacities and generate employment opportunities through further development of such sectors as tourism, agribusiness, ICT and hydropower. Major impediments for exerting dynamism in these sectors include lack of investment, infrastructure deficit, and poor connectivity. Diversification of economic activities is a challenge for which one priority attention should be on developing the private sector.

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***Keywords**:* least developed countries, LDC graduation, smooth transition, Bhutan.

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I. Introduction

Bhutan is a South Asian least developed country that has demonstrated a strong track record in sustaining economic growth and reducing poverty over the past two decades or so. Despite confronted with severe challenges exacerbated by unfavourable conditions such as mountainous topography and being landlocked and susceptible to natural disasters, the country is unique in approaching development by valuing collective happiness as the goal of governance.[1] Along with growth and poverty reduction, its progress in other socio-economic indicators is worth noting. This has been reflected in its success in achieving many of the 2000-15 Millennium Development Goal (MDG) targets. Bhutan met two out of three criteria for graduation from the group of least developed countries (LDCs) for the second consecutive triennial review, held in 2018, by the United Nations Committee for Development Policy (CDP).[2] However, upon a request from the government, the Committee recommended the country's graduation from the LDC category to be effective from 2023.[3] Despite fulfilling graduation thresholds, the CDP raised concerns about the country's low economic diversification and high vulnerability to natural shocks.

Having recognized LDCs' monumental development challenges, the international community has devised various support measures to help ameliorate the existing situations in those countries. In 2011, the United Nations Conference on Least Developed Countries, held in Istanbul, Turkey, set an ambitious goal to halve the number of LDCs (to 24), articulating a vision and strategy – known as the Istanbul Programme of Action (IPoA) for LDCs – with a strong focus on their developing productive capacities and achieving structural transformations. The IPoA also committed to providing favourable international support measures (ISMs) for these countries in various areas, including international trade, development financing, technical assistance, etc. There is a general recognition that many IPoA support measures have not been materialized. Nevertheless, some LDCs have made impressive progress towards their socio-economic development.[4] Indeed, it has been the case that some countries like Bhutan have fulfilled graduation thresholds without adequately achieving the objectives of building productive capacities as envisaged in the IPoA. The aim and objectives of IPoA have strong synergies with the goals and targets set in the 2030 Agenda for Sustainable Development Goals. In this respect, it is important for Bhutan to mitigate

[1] Gross National Happiness is a philosophy that guides the government of Bhutan in undertaking various national economic activities. The concept has a worldwide appealing factor, and in 2011, the UN General Assembly passed a resolution, "Happiness: towards a holistic approach to development" urging member nations to follow the example of Bhutan and measure happiness and well-being, and calling happiness a fundamental development goal.

[2] Graduation from LDC status requires a country to meet development thresholds under at least two of the three pre-defined criteria (of per capita income, human asset index and economic vulnerability index) in two consecutive triennial reviews. Bhutan first met the per capita income and human asset index criteria in 2015 triennial review. The country also met these two indicators for the second time in the 2018 triennial review. It is to be noted that there is also a provision for the 'income-only' graduation rule. Under this, if the 3-year average per-capita gross national income of an LDC has risen to a level at least double the graduation threshold, the country could be eligible for graduation regardless of its situation under the other two criteria. Once a country fulfills the graduation criteria in two consecutive triennial reviews, it is recommended to graduate from the group in three years' time.

[3] The Government requested the Committee that the graduation to be effective upon the conclusion of the twelfth national development plan, 2018–2023, which will serve as the country's development plan for the transition to non-least developed country status.

[4] The graduated counties are Botswana (1994), Cape Verde (2007), Maldives (2011), Samoa (2014) and Equatorial Guinea (2017).

any adverse consequences arising from changes in international support regime due to LDC graduation and stay firmly focused on dealing with the broader development challenges to achieve the Sustainable Development Goals (SDGs). Bhutan incorporated its graduation strategy in its 12th Five-Year Plan (2018–2023) combining with SDGs and Gross National Happiness (GNH) indicators and thus has considered a proactive policy stance in implementing SDGs as well as a smooth transition mechanism for LDC graduation.

The most important ISMs granted to LDCs are preferential market access conditions, special and differential treatment (S&DT) concerning the implementation of various international agreements, and special consideration for financial and technical assistance. The potential implications of LDC graduation will depend on the specific benefits a graduating LDC is making use of and thus will be foregone after graduation.

In the above backdrop, this paper assesses the likely implications of Bhutan's impending LDC graduation for its development prospects. This paper is organised as follows: after this brief introduction, Section II provides a short description of Bhutan's socio-economic outlook along with its path to graduation. Section III analyses various potential implications arising from LDC graduation. Section IV provides some discussion on the way forward, suggesting relevant policy options in dealing with any potential consequences and carving a smooth graduation strategy; finally, Section V concludes the paper.

II. Bhutan's socio-economic development and LDC Graduation

2.1 Socio-economic progress

Over the past three decades, Bhutan has made remarkable socio-economic progress as reflected in various indicators summarized in Table 1. Its economy expanded more than eight folds: from just about US$ 300 million in 2000 to US$2.53 billion in 2017 with an annual average growth rate of above 7 per cent (Figure 1). The incidence of poverty, measured by the proportion of the population living below $1.9 per day, declined from 17.8 per cent in 2003 to 1.5 per cent in 2017 (Figure 2). This rate of poverty incidence is the second-lowest in the region and far below the South Asian average (Figure 3). Similarly, the proportion of the population living below the national poverty line fell to 8.2 per cent in 2017 from 23.2 per cent in 2007 (Table 1). While the progress on poverty reduction has been admirable, the country is confronted with the last-mile challenge of eradicating poverty in all its forms (Royal Government of Bhutan, 2018). Bhutan has attained an average life expectancy (at birth) above 70 years (an increase of more than 17 years over the past three decades). In terms of gross secondary school enrollment, Bhutan outperforms Bangladesh and Nepal. Amongst other indicators, progress made on access to electricity, mobile phone and internet is notable. Accomplishments under different social indicators place Bhutan ahead of many other comparators at the same level of economic development. As the economy is growing, the importance of net official development assistance (ODA) has declined tremendously (from 16.36% of gross national income (GNI) in 1990 to above 2% in 2016).

Table 1: A Snapshot of major socio-economic indicators of Bhutan

Particulars	1990	2000	2010	2017
GDP (current US$, billions)	0.30	0.44	1.59	2.51
Annual GDP growth (%)	10.88	6.93	11.73	6.82
Per capita GDP (current US$)	558.0	765.9	2,178.9	3,110.2
GDP per capita, PPP (current international US$)	1,502.88	2,804.93	6,289.81	9,560.77
Merchandise exports (current US$ million)	70	103	641.31	590
Merchandise imports (current US$ million)	81	175	854	1,029
Merchandise exports (% of GDP)	23.33	23.41	40.33	23.51
Merchandise trade (% of GDP)	50.37	63.35	94.30	63.30
Services exports (BOP, current US$ million)	-	-	68.84	160
Services exports (% of GDP)	-	-	4.33	6.37
Exports of goods and services (% of GDP)	26.83	29.38	42.45	26.04
Total trade (% of GDP)	57.48	77.66	113.18	74.03
Personal remittances received (current US$ million)	-	-	8.27	43.15
Remittance (% of GDP)	-	-	0.52	1.72
Foreign reserve (BoP, current US$ million)	-	-	89.90	-20
Exchange rate (local currencies per dollar, period average)	17.50	44.94	45.73	65.12
External debt stock (% of GNI)	29.71	48.23	62.41	113.30
FDI net inflows (% of GDP)	0.53	0.25 (2015)	4.75	-0.66
Net ODA received (% of GNI)	16.36	12.17	8.77	2.53 (2016)
Inflation CPI (annual %)	10	4.01	7.04	3.86
Population (million)	0.54	0.57	0.73	0.81
Poverty headcount ratio at $1.90 a day (2011 PPP) (% of population)	-	8 (2007)	2.2 (2012)	1.5
Poverty headcount ratio at national poverty lines (% of population)	-	23.2 (2007)	12 (2012)	8.2
Average life expectancy at birth (total years)	52.88	60.76	67.79	70.20 (2016)
Gross secondary school enrollment (%)	-	30.12	63.61	83.98 (2016)
Access to electricity (% of population)	0.01	34.92	73.28	100 (2016)
Mobile cellular subscriptions (per 100 people)	0	0	54.19	90.47
Individuals using the Internet (% of population)	0	0.40	13.60	41.77 (2016)

Source: World Development Indicator and World Bank (2019).
Note: '-' denotes the unavailability of data.

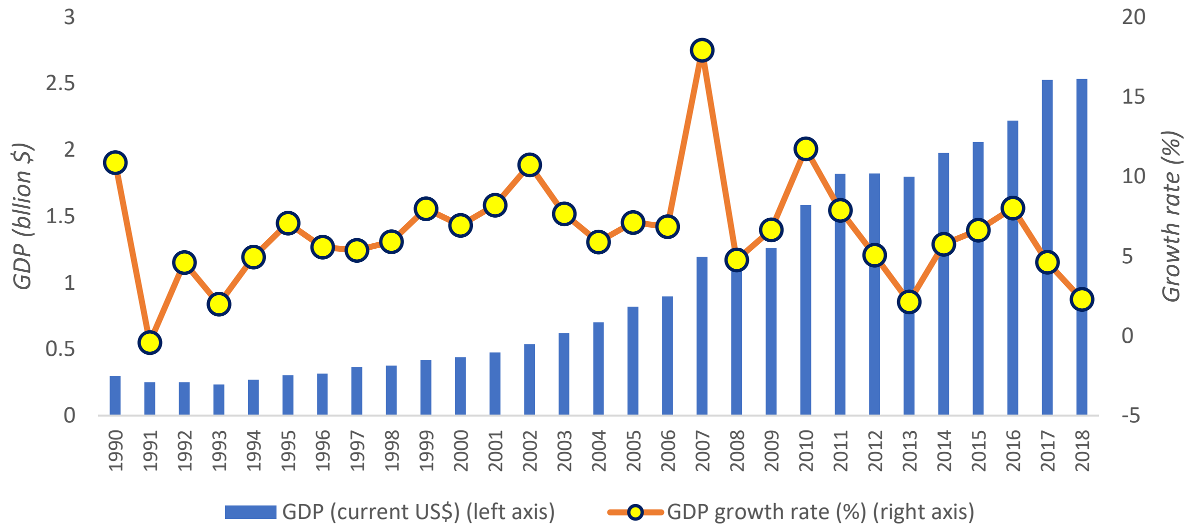
The Bhutanese economy, however, grew being driven mainly by hydropower-led industrial and tourism-led services sector activities. Over the past decade, economic growth has been marked by significant volatility, which can largely be explained by investment trends in hydropower projects.

Since 2017 a declining trend in growth is noticed when the rate of economic expansion fell by 3.4 percentage points, followed by another 2.3 percentage points reduction in 2018 (Figure 1). The recent downturn in growth has been attributed to a slower hydropower construction and temporary decline in electric power production (ADB, 2019).

Available statistics seem to suggest the structure of the economy remaining more or less unchanged over the past decade (Figure 2). Industry and services account for almost the same level (about 42 per cent each) of economic activities while the rest (around 16 per cent) is due to agriculture. Hydropower, which is included within the industrial sector, alone accounts for 16 per cent of GDP (Royal Government of Bhutan, 2018). The manufacturing value-added, which is often used to assess structural transformation, is low 7.3 per cent of GDP and lower than that of all other LDCs in the region except Nepal (Figure 3). It has been suggested that the dependence on the state-led hydropower might have resulted in crowding out of the private sector (World Bank, 2019) as its relative significance in domestic value-added stood just at 57 per cent during 2011-2017. Other demand and supply-side constraints including skills shortages, the small size of the domestic market along with limited access to foreign markets (arising from being a landlocked country), lack of competition due to lacklustre private sector activities, etc. have also inhibited the country from exploiting its full growth potential. Furthermore, the development of hydropower based on public sector investments requires high import content contributing to large external imbalances. The external debt reached 113 per cent of GDP in 2017 (Table 1). Despite the huge potential in various sectors, the country has so far not been able to attract significant foreign direct investment (FDI) inflows. Rather, the net FDI inflows were negative at 0.66 per cent of GDP in 2017.[5]

[5] Atypical geographical location, barriers to internal and external integration, lack of proper connectivity, inadequate infrastructure and logistics etc. account for this finding.

Figure 1: Bhutan's GDP size and its GDP growth



Source: Author's presentation using data from the World Development Indicator (WDI), World Bank.

Figure 2: Poverty headcount ratio (% of population) in Bhutan

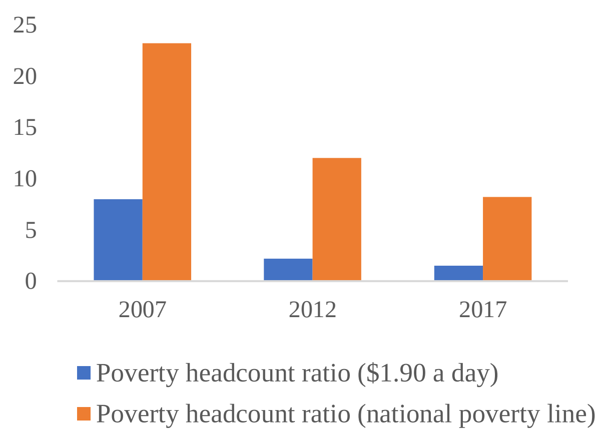
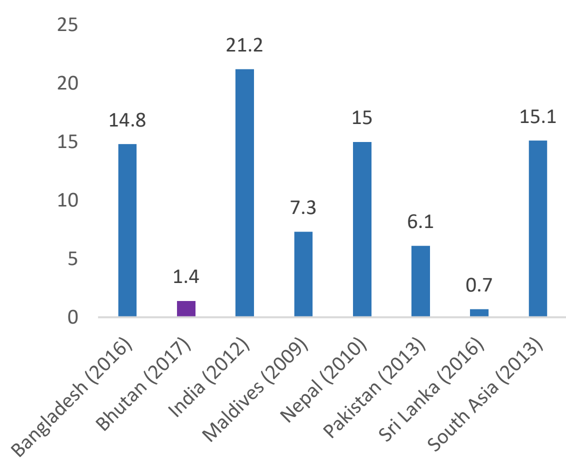
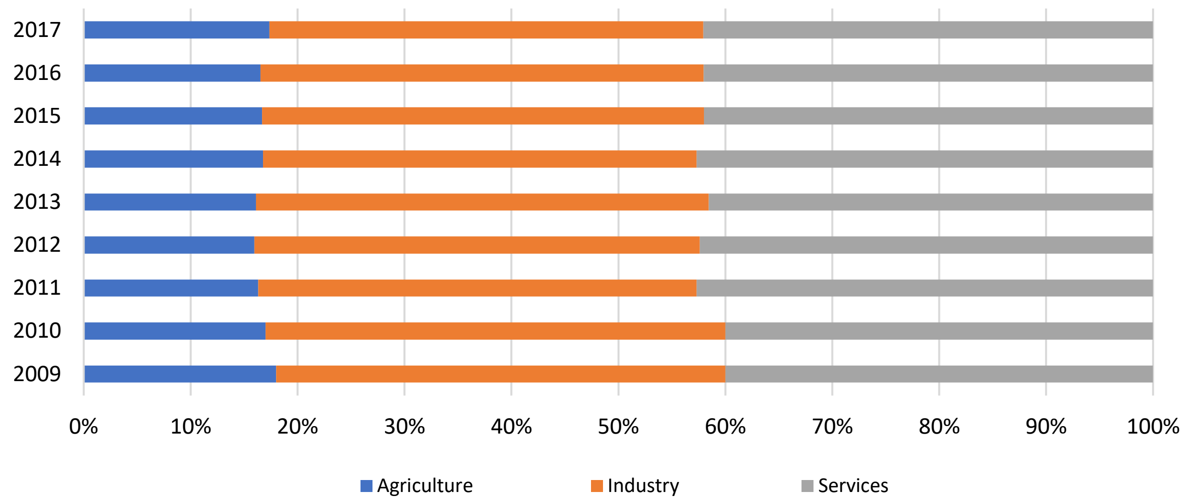


Figure 3: Headcount poverty rate (%) in South Asian countries



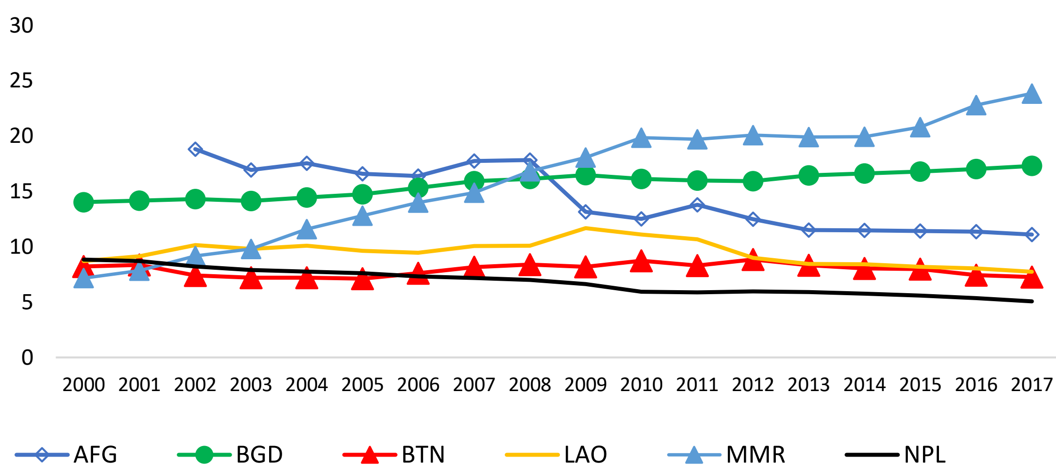
Source: Author's presentation using data from WDI and World Bank (2019).

Figure 4: Composition of GDP by major sectors (%)



Source: Author's presentation using data from the National Statistics Bureau, Bhutan and World Development Indicators (WDI).

Figure 5: Manufacturing value added (% of GDP)

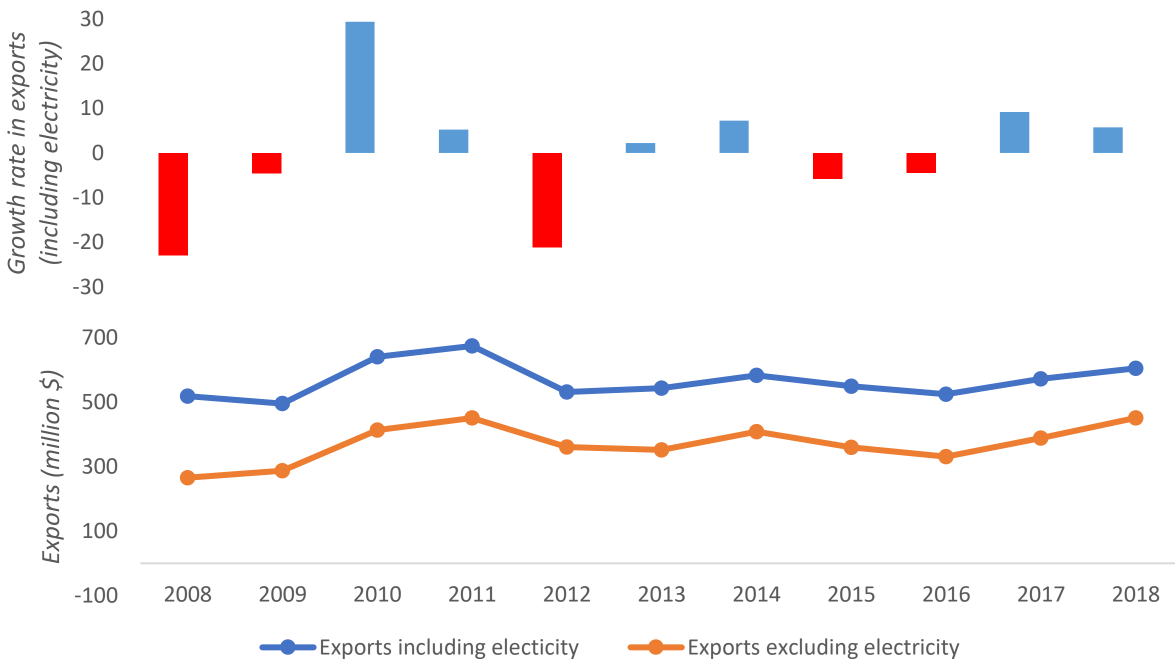


Source: Author's presentation using data from the National Statistics Bureau, Bhutan and World Development Indicators (WDI).
Note: Countries are denoted as AFG – Afghanistan, BGD – Bangladesh, BTN – Bhutan, LAO – Lao PDR, MMR – Myanmar, and NPL – Nepal.

Tourism is an important sector for Bhutan and it attracts a large number of tourists. The sector has helped expand the country's services sector activities. Besides, the importance of remittance inflows has gained momentum over the past decade or so with remittance inflows since 2010 rising by about US$35 million. But, in terms of the ratio to GDP, it is still quite low: 1.72 per cent.

Like many other landlocked LDCs, Bhutan lacks dynamism in merchandise exports. The total merchandise exports stood at $605 million (including electricity) in 2018, which remained lower than the peak ($675 million) reached in 2011. [6] Electricity alone, on average, constituted one-third of all exports during the last decade. It declined to 25 per cent in 2018 due to the low production mentioned above. Apart from electricity, iron and steel[7] (HS 72) are the most important exporting items (46%), followed by salt and sulphur (HS 25) 27 per cent, inorganic chemicals (HS 28) 6 per cent, coffee, tea, mate (HS 9) 5 per cent, plastics and articles thereof (HS 39) 3 per cent, beverages, spirits and vinegar (HS 22) 3 per cent etc. (Figure 7).[8]

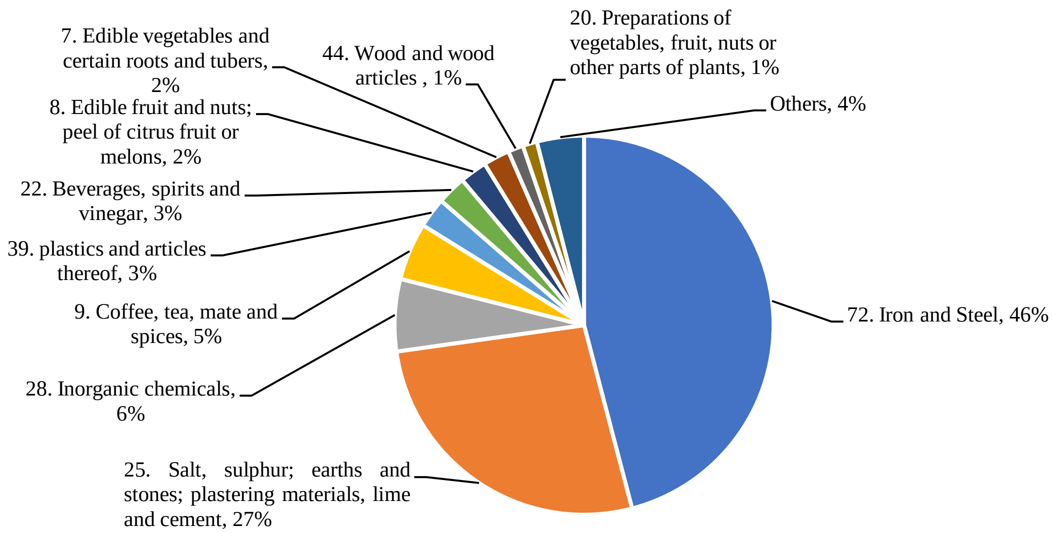
Figure 6: Bhutan's merchandise exports and its growth



Source: Author's calculation and presentation using IMF data. Retrieved from http://data.imf.org/regular.aspx?key=62805740

[6] Export values are reported in Bhutanese ngultrum in the Bhutan Trade Statistics published by the Ministry of Finance, Royal Government of Bhutan. The values are converted into millions of US dollars using the exchange rate between two currencies. According to the Bhutan Trade Statistics, exports of goods were Nu. 41.4 billion in 2018.
[7] Bhutan exports mostly ferro-alloys (HS 7202) under this category.
[8] Export composition is based on the average share of 2016 to 2018.

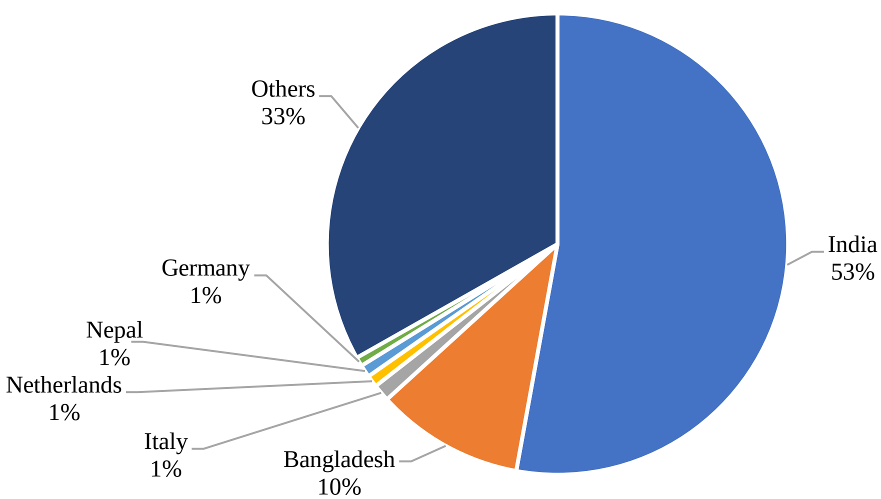
Figure 7: Export composition of Bhutan excluding electricity (%)



Source: Author's calculation and presentation using data from the Ministry of Finance, Bhutan.

Landlocked countries tend to trade more with countries sharing common land borders. India, being the neighbouring country and the single largest export destination of Bhutan, accounts for about 53 per cent of exports excluding electricity (Figure 8). The corresponding share becomes more than 80 per cent when electricity export is considered.[9] Bangladesh ranks second among Bhutan's export destinations with approximately 10 per cent of exports (excluding electricity) while Germany, Italy, Nepal and the Netherlands are other major destinations.

Figure 8: Bhutan's top export destinations excluding electricity

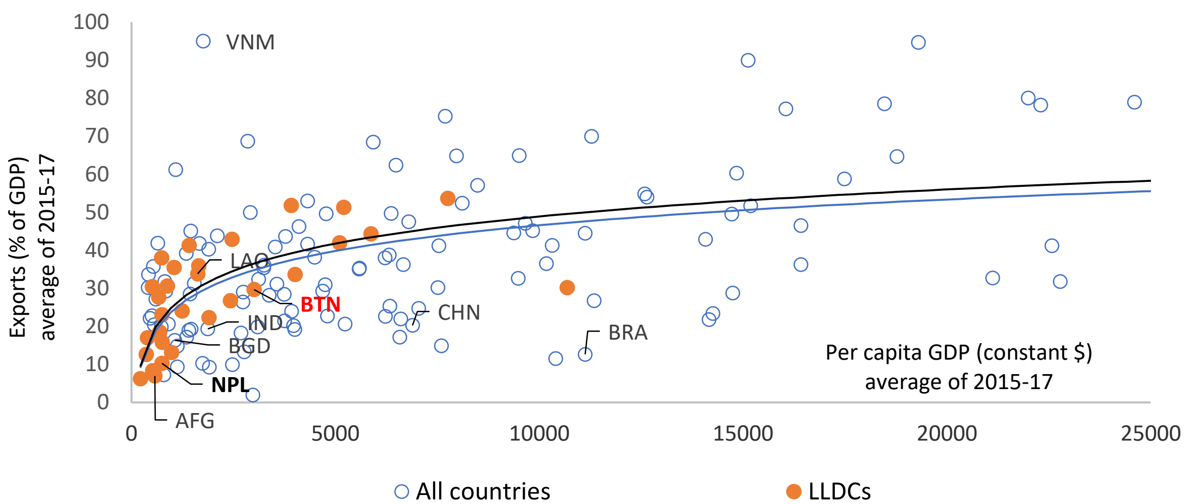


Source: Author's calculation and presentation using data from the Ministry of Finance, Bhutan.
Note: Top export destinations are calculated based on the average export values of three years (2016–2018).

[9] The export share is calculated taking average of 3-year (2016, 2017 and 2018) exports data.

For landlocked countries, the transportation cost to external markets is higher compared to the countries with access to maritime transport. This, in turn, would imply a lower share of trade in economic activities. However, dependence on trade with India through a free trade arrangement and its relatively small size of the economy mean Bhutan's trade-orientation is considerably higher than other comparators such as Bangladesh and Nepal. Particularly, in comparison with Nepal, which has an export-GDP ratio of just about 9 per cent, Bhutan shows a much higher ratio of 26 per cent, which is however still smaller than the average of landlocked developing countries (Figure 9).[10]

Figure 9: Export-GDP ratio and per capita GDP in developing countries



Source: Author's analysis using data from the World Development Indicators (WDI), World Bank.

Notes: BGD – Bangladesh, BRA – Brazil, BTN – Bhutan, CHN – China, IND – India, LAO – Lao PDR, and NPL – Nepal. "Blue" line indicates the predicted relationship between exports (% of GDP) and per capita GDP whereas "black" line reflects the same for landlocked developing countries.

Bhutan's trade orientation, measured by exports of goods and services as a proportion of GDP, on the other hand, is slightly higher than what can be predicted from the average relationship between trade-GDP ratios and per capita income of landlocked developing countries. (Table 2). This is mainly because of large imports of construction materials and machinery goods that are needed to develop hydropower projects.

[10] Bhutan's export and trade GDP ratios vary significantly (Table 1) to reflect varying exports of electricity and imports of capital goods largely for hydropower projects.

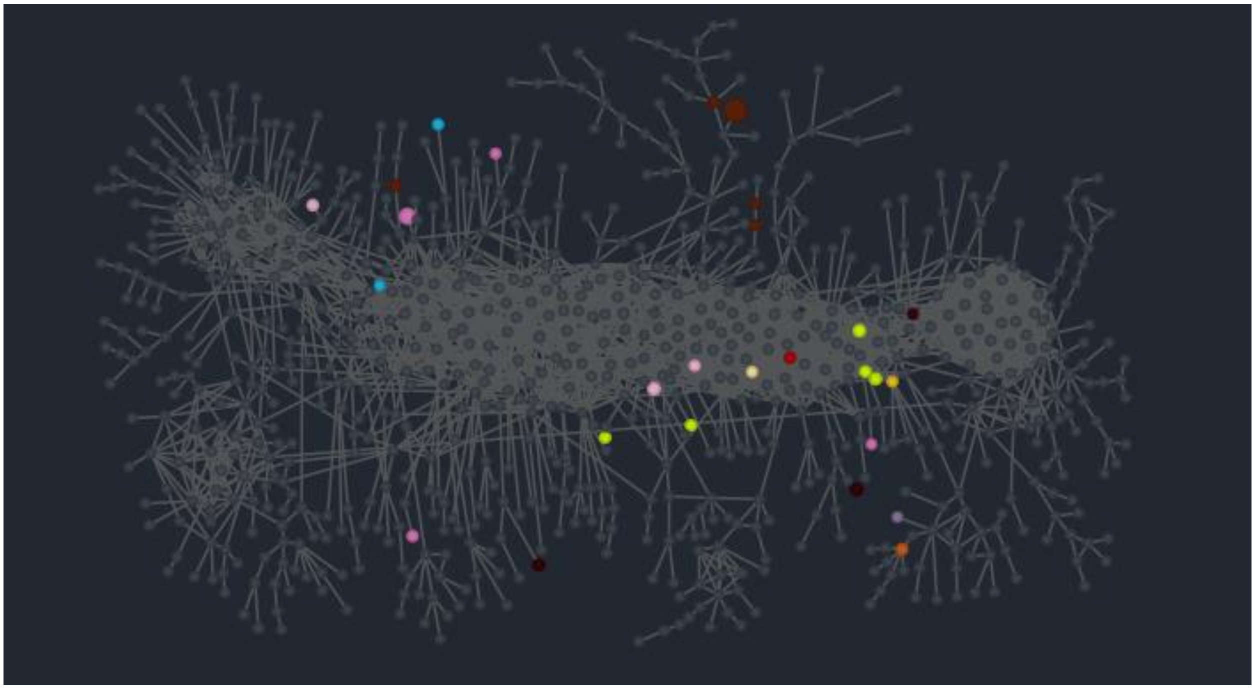
Table 2: Trade-GDP ratio vs. GDP per capita

	GDP per capita (average of 2015-2017) ($)	Trade GDP ratio (average 2015-2017)	Estimated trade-GDP ratio (average of 2015-2017)
Afghanistan	572.3	55.9	70.7
Austria	48447.1	102.7	180.9
Burundi	220.8	37.1	69.9
Bhutan	3006.1	83.9	76.3
Botswana	7756.8	101.4	87.3
Switzerland	76979.9	117.4	246.5
Czech Republic	22000.0	153.1	120.0
Lao PDR	1622.2	78.9	73.2
Lesotho	1410.4	123.8	72.7
Mali	746.2	63.1	71.1
Mongolia	3919.3	100.8	78.4
Nepal	746.2	51.2	71.1
South Sudan	739.5	83.3	71.1
Slovakia	19306.0	186.4	113.8
Kosovo	3928.8	75.5	78.5

Source: Author's presentation using data from World Development Indicators (WDI).

Lack of productive capacities and diversification are also captured in the so-called product space analysis (Hidalgo, et. al., 2007) depicting the locations of Bhutan's export items in connection to all possible export products (Figure 10). It reflects the fact that there are limited export items for Bhutan. A few of the export items, e.g. metal products and foodstuffs, appear to show possibilities of linkages with other products. However, weak productive capacities, nascent private sector, excessive market access costs of a landlocked country, etc. can be major impediments for expanding exports and thus achieving structural transformation.

Figure 10: Representation of Bhutan's product space

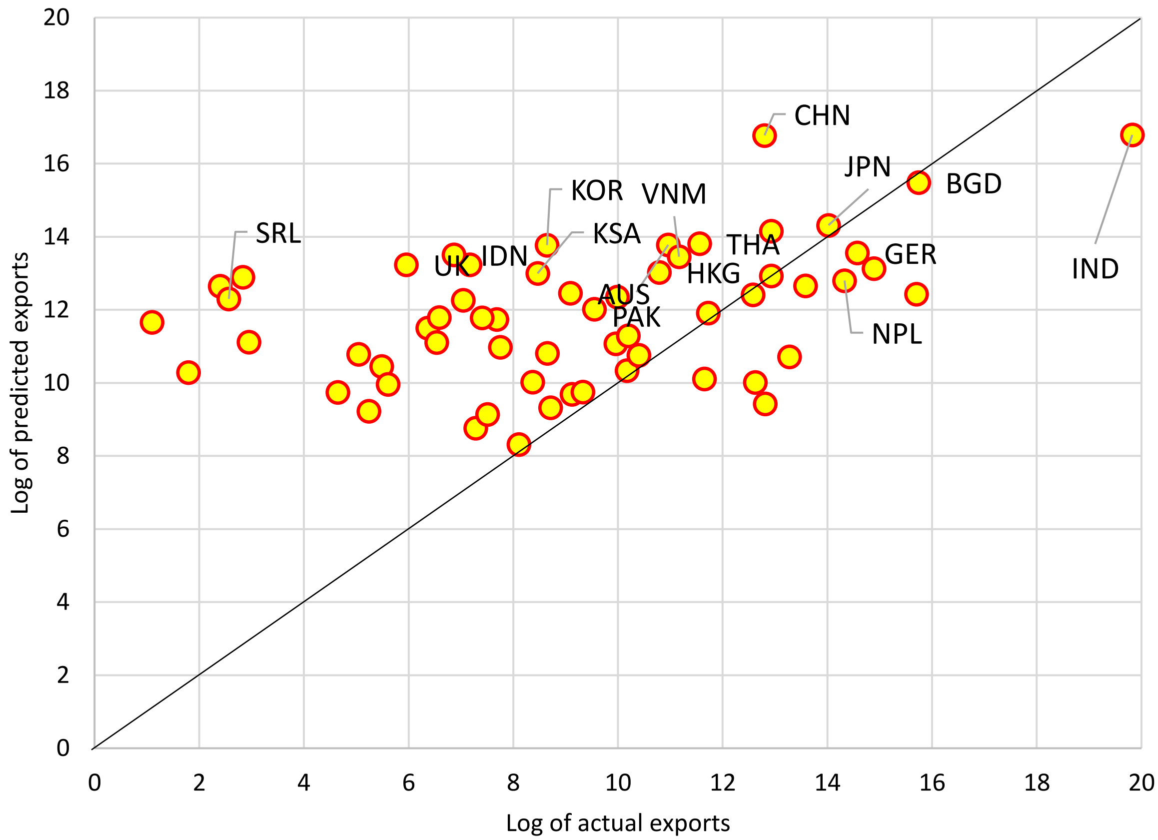


Source: https://oec.world/en/visualize/network/hs92/export/btn/all/show/2017/

One way of gauging the potential export opportunities is to consider how global economies trade between themselves (i.e. various pairs of trade partners) and from that cross-country (and overtime as well) trade relationship what can be predicted for any country of interest. This is usually done by estimating a gravity model of international trade, which can be utilized to identify the partners where a country is exporting less than what is predicted based on cross-country experiences and vice versa. Partners that receive exports-less-than-predicted could be considered as markets with potential for export expansion while those that receive exports-more-than-predicted would indicate niche markets.[11] The estimated model suggests that Bhutan has the highest untapped potential in China. Other countries where Bhutan has high unrealized export potential are the Republic of Korea, Pakistan, Thailand, Indonesia, the United Kingdom, France and Japan (Figure 11).

[11] The gravity model takes into consideration numerous factors in explaining bilateral trade flow such as, countries' incomes; geographic distance between trade partners; countries' having common borders, language, and currencies, past colonial linkages; other country specific characteristics such as if a country is landlocked or an island economy; etc. Amongst others, the results from estimated gravity models show that while bilateral trade flows are positively influenced by country sizes (measured by GDPs) but are negatively affected by geographical distances. Amongst others, having common land borders, common language, and past colonial linkages, tend to augment trade flows between two countries.

Figure 11: Actual and predicted exports of Bhutan to partners: the gravity model results



Source: Author's estimation and presentation.
Notes: The actual and predicted exports of Bhutan from the estimated global gravity model is summarised in the figure for 2017. The partner countries that lie above the 45-degree line (the diagonal line from the origin) are those where Bhutan exports more than what could be predicted from the model. AUS – Australia, BGD – Bangladesh, BRA – Brazil, BTN – Bhutan, CAN – Canada, CHN – China, GER – Germany, HKG – Hong Kong, IDN – Indonesia, IND – India, JPN – Japan, KSA – Saudi Arabia, NPL – Nepal, PAK – Pakistan, PHL – the Philippines, THA – Thailand, UAE – United Arab Emirate, and UK – United Kingdom.

2.2 Bhutan's path to LDC graduation

With the inception of the LDC category in 1971, Bhutan was included in the group. Over the past decades, it made remarkable progress in its socio-economic situations to two of the three graduation criteria namely per capita GNI and Human Asset Index (HAI) (Table 3). [12] Bhutan first

[12] A country is eligible for graduation if it meets two of the three graduation criteria (per capita GNI, Human Asset Index-HAI and Economic Vulnerability Index-EVI) in two consecutive triennial reviews undertaken by the United Nations Committee for Development Policy (a subsidiary body of the United Nations Economic and Social Council. There is also the 'income-only criterion' under which if a country's per capita GNI is at least twice the threshold level (i.e. at least US$ 2,460 as per the CDP Triennial Review 2018), it will graduate irrespective of its situations under the

met graduation conditions in 2015 and then again in 2018. As such, Bhutan was supposed to graduate in 2021. However, the CDP considered a reasonable request by Bhutan for aligning the effective graduation date with the ending of the country's twelfth national development plan in 2023 (CDP, 2018).

Although lower than the graduation threshold, Bhutan still managed to make significant progress in the Economic Vulnerability Index (EVI) as well. On this index, it performs well in six indicators out of a total of eight indicators and is projected to achieve the threshold value of 32 or less in the CDP's next triennial review in 2021 (UNCDP, 2018).[13] It is worth mentioning that no Asian landlocked LDCs – Bhutan, Nepal and Lao PDR, has yet met the EVI criterion.[14] Overall, if Bhutan graduates in 2021, it will be the second landlocked country after Botswana, and first in Asia to graduate out of LDC status.

Table 3: Bhutan's way to LDC graduation

Criteria	Thresholds	2006	2009	2012	2015	2018
Per capita GNI (US$)	Inclusion thresholds	749	905	992	1,035	1,025
	Graduation thresholds	900	1,086	1,190	1,242	1,230
	Bhutan's situation	690	1,487	1,700	2,277	2,401
HAI	Inclusion thresholds	58	60	60	60	60
	Graduation thresholds	64	66	66	66	66
	Bhutan's situation	44.4	58.6	59.0	67.9	72.9
EVI	Inclusion thresholds	42	42	36	36	36
	Graduation thresholds	38	38	32	32	32
	Bhutan's situation	46.6	52.9	44.2	40.2	36.3

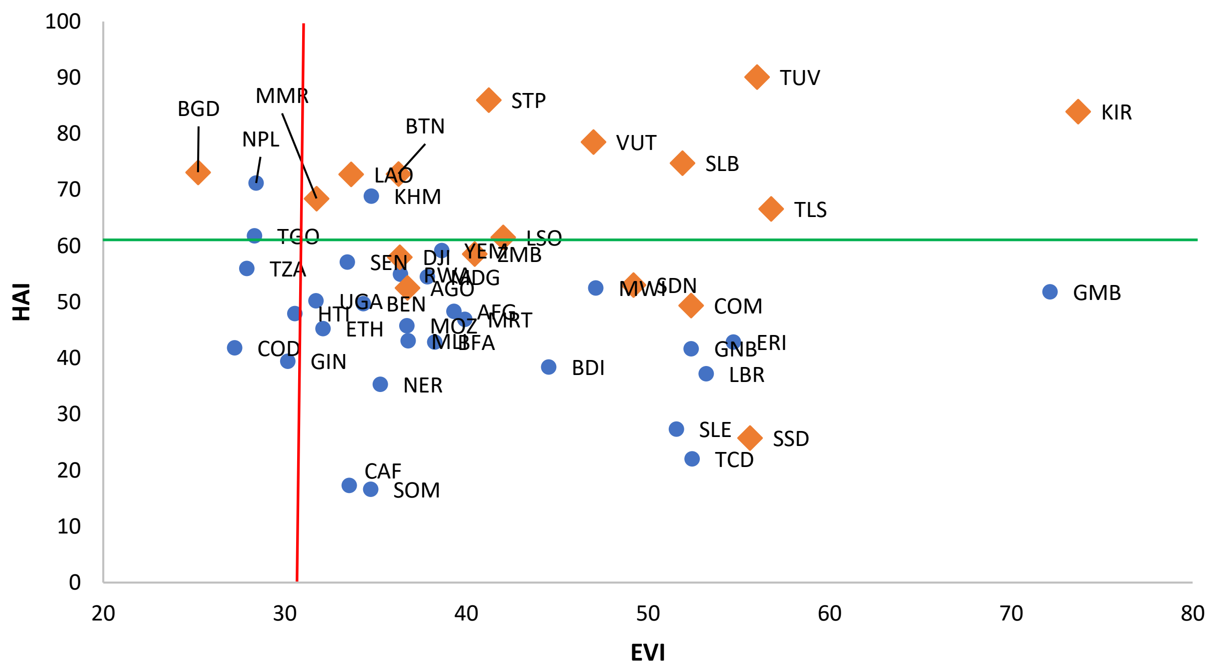
Source: Author's presentation from LDC dataset.

two other criteria. Bhutan fulfills the graduation criteria of per capita GNI and Human Asset Index in the consecutive two triennial reviews of 2015 and 2018.

[13] The remaining two indicators under EVI where Bhutan's performance is poor are instability in agriculture and a small population component and thereby making Bhutan a vulnerable economy.

[14] Indeed, landlocked LDCs perform poorly under the EVI criteria since landlockedness poses an added disadvantage in comparison to countries having sea ports.

Figure 12: EVI and HAI scores of LDCs



Source: Author's analysis using CDP Triennial Review Dataset (2018).
Notes: Orange diamonds denote countries with per capita GNI above the threshold level of per capita GNI. blue The red line parallel to the vertical axis represents the EVI threshold value of 32 (countries need to have a value of less than or equal to 32 to achieve this graduation threshold) while the green line, parallel to the horizontal axis, indicates the HAI threshold value of 66 (countries will have to score more than or equal to 66 to achieve the relevant graduation threshold). The threshold levels for EVI and HAI are provided as per the CDP's Triennial Review (2018). Countries denoted as AGO – Angola, BGD – Bangladesh, BTN – Bhutan, COM – Comoros, DJI – Djibouti, KIR – Kiribati, LAO – Lao People's Democratic Republic, LSO – Lesotho, MMR – Myanmar, STP – Sao Tome and Principe, SLB – Solomon Islands, SSD – South Sudan, SDN – Sudan, TLS – Timor-Leste, TUV – Tuvalu, VUT – Vanuatu and ZMB – Zambia.

III. Potential Implications of LDC Graduation

Considering severe economic challenges confronted by the LDCs, the global community has designed various international support measures to help LDCs develop capacities to mitigate their challenges.[15] These measures include development partners' special attention and commitments to support with concessionary development finance and technical assistance; trade partners' granting trade preferences; special and differential treatment concerning various multilateral trade rules and regulations. However, with the graduation, Bhutan will no longer be entitled to avail

[15] The setbacks are listed as being caught in low-income trap, risk of failing to overcome poverty, vulnerability caused by external economic shocks, natural and man-made disasters, communicable diseases, limited productive capacities (predominantly dependent on primary commodities for domestic production and exports), limited export diversification scopes, critically dependent on foreign aid due to limited economic activities compounded by unfavourable fiscal and trade balances etc.

these LDC specific preferences and international support measures (ISMs). Implications for LDC graduation can arise broadly from (i) preference erosion in the international trade potentially affecting competitiveness, (ii) loss of policy space (tightening the scope of supporting exporters and domestic market-oriented industries), and (iii) any unfavourable impact on the prospect for obtaining development finance. However, Bhutan is different from many other LDCs in two respects: first of all, for trade, its overwhelming dependence is with India and a bilateral trade agreement, with no relevance to LDC graduation, is in place for this trade relationship; and Bhutan is not a member of the WTO and therefore, is not obligated to implement WTO provisions.

3.1 Preference erosion in international trade

Being an LDC, Bhutan enjoys favourable market access conditions and less stringent preferential rules of origin in exporting to most developed and several developing country markets under various Generalized System of Preference (GSP) schemes. After graduation, these benefits will either cease to exist or will be subject to less favourable terms of access. However, implications for LDC graduation will depend mostly on the nature and extent of favourable market access currently being utilized. In many cases, LDCs have not been able to utilize the market access provisions and thus the resultant implications are likely to be limited. Similarly, LDC graduation will have no impact on the products that are currently not covered by LDC-specific preferences and will have no relevance in those export destination countries that currently do not provide any preferential market access. In addition, the graduation impact can be limited due to an LDC's having any bilateral or regional trading arrangement.[16]

3.1.1 Market access conditions in India

Bhutan's exports with India is solely governed under a trade treaty between the two countries. In 1972, the Agreement on the Trade, Commerce and Transit between the Government of the Republic of India and the Royal Government of Bhutan was signed to promote economic cooperation between the two countries. The agreement was renewed in 2016. It allows duty-free exports of all Bhutanese products to Indian territories, regardless of the former's LDC status. The agreement stipulates that Bhutan's trade with India is not restricted by rules of origin criteria.[17] Therefore, LDC graduation will not entail any significant impact on Bhutan's exports to India. Therefore, more than half of Bhutan's total exports are not affected by graduation.

3.1.2 Market access conditions in the European Union

Bhutan benefits from duty-free, quota-free preferential market access in the European Union under the Everything but Arms (EBA) initiative, which is an arrangement offered exclusively to the LDCs. After graduation, Nepal will continue to benefit from the same preferences for another three years of transition period granted by the EU. After that, it will no longer benefit from EBA but will have access to either GSP+ or Standard GSP, depending on the fulfilment of certain conditions. The market access conditions under GSP+ are more favourable, but to benefit from it

[16] Graduation will have implications for LDCs exports under regional trading arrangements if the provisions are LDC-specific.
[17] See http://www.intracen.org/country/Bhutan/Domestic-and-Foreign-Market-Access/ for details.

a country must fulfil the Standard GSP criteria[18] along with two additional criteria:[19] (1) the vulnerability criteria including (i) the import share criterion – which requires the country's share of GSP-covered import must remain below 6.5 per cent of GSP-covered imports of all GSP countries; and (ii) the diversification criterion, which stipulates that the seven largest sections of GSP-covered imports must constitute 75 per cent of imports from the beneficiary country for three years; and (2) the sustainable development criterion requires the applicant country to have ratified and effectively implemented 27 international conventions on labour rights, human rights, environmental protection and good governance.[20] The share of GSP-covered import from Bhutan is 0.01 per cent of GSP-covered imports of all GSP countries which is far below the 6.5 per cent threshold.[21] Again, the largest seven sections of GSP covered imports is 99.9 per cent. Therefore, the import share and diversification criteria are satisfied. Further assessment is needed for its meeting sustainable development criterion. However, it can be expected that Bhutan would be able to access GSP+ benefits.

If Bhutan is qualified for GSP+, its major exporting items will continue to benefit from duty-free access. However, it will be subject to more stringent rules of origin as the country is exposed to major supply-side constraints. The minimum local value-added content for exports, under both GSP+ and Standard GSP, would increase from 30 per cent to 50 per cent (except for apparels). For apparels, products must go through a double-transformation process[22] against a single-transformation rule applicable for LDCs under the EBA. It is to be pointed out here that the current EU GSP regime will be replaced by a new regime in 2023, which will coincide with Bhutan's graduation. Therefore, any changes in the forthcoming GSP provisions will apply to Bhutan's post-graduation period market access conditions. the forthcoming EU GSP regime after 2023 does not make changes to the existing coverage of products and eligibility criteria.

An analysis of market access conditions for major exporting items in the EU suggests that under GSP+ Bhutan will retain duty-free access for its largest exporting items included in HS72 (Table 4). This category alone accounts for almost fourth-fifths export earnings from the EU. The exports under the second-largest category of HS 88 is irregular involving exports of used parts of aircraft.[23] Tariff implications for this will also remain unchanged after graduation. Some minor export items that will be subject to significant changes in tariffs include dairy products (CDP, 2018). However, given its small volume of exports to the EU, no notable impact is expected. In fact, Bhutan will

[18] Any developing country will benefit from Standard GSP unless (i) it has another type of special trade access to the EU granting the same tariff preferences as the scheme or better for substantially all trade, (ii) it has achieved a high- or upper-middle income economy status during three consecutive years according to World Bank classification.

[19] This information is obtained from the European Commission website. URL: https://trade.ec.europa.eu/tradehelp/gsp

[20] If the applicant meets all criteria, it is added to the list of GSP+ countries through a delegated act (source: European Commission website).

[21] Based on the information obtained from European Commission website.

[22] A double transformation implies that the preference-seeking countries will have to prove that they can produce fabrics and the domestically produced fabrics are used in making garments.

[23] Mostly airplanes and other powered aircraft of an of an unladen weight > 15.000 kg (excl. Helicopters and dirigibles) (HS 880240), parts of airplanes or helicopters (excl. those for gliders) (HS 880330) and parts of aircraft and spacecraft (HS 880390). These items are not consistently exported in every year.

get duty suspension on most of its major exports even under Standard GSP. Therefore, the impact of graduation on export performance due to the EU will be negligible.

Table 4: Market access conditions for major exporting items in the EU (avg. 2016-18)

HS code	Product description	Share 2016-18	MFN rate	GSP+	Standard GSP
72	Iron, steel, ferro-silicon	79.3	0%-5.7%; mostly 0%; Average 0.22%	Duty suspension except HS 72011011 (1.7%)	Duty suspension except few products
88	Aircraft, spacecraft, and parts thereof	15.2	2.7%-7.5%; mostly 2.7% average 3.4%	Duty suspension	Duty suspension
28	Inorganic chemicals; organic or inorganic compounds of precious metals, of rare-earth metals, of radioactive elements or of isotopes	2.1	0%-5.5%; mostly 5.5% average 4.65%	Duty suspension except for HS 28046900, 28051910 and 28183000	0%-5.5%; 0% for most items Average 0.4%
33	Essential oils and resinoids; perfumery, cosmetic or toilet preparations	0.9	0%-17.3%; 0% for many products average 2.84%	Duty suspension	Duty suspension
82	Tools, implements, cutlery, spoons and forks, of base metal; parts thereof of base metal	0.4	1.7%-8.5%; mostly 1.7%; and 2.7%; average 3.06%	Duty suspension	Duty suspension except few items
84	Machinery, mechanical appliances, nuclear reactors, boilers; parts thereof	0.2	0%-8%; mostly 1.7%; Average 1.93%	Duty suspension	Duty suspension except HS 84072110 (2.1%)
90	Optical, photographic, cinematographic, measuring, checking, precision, medical or surgical instruments and apparatus; parts and accessories thereof	0.2	0%-6.7%;) per cent for many items average 2%	Duty suspension	Duty suspension except for selected few items
61	Articles of apparel and clothing accessories knitted or crocheted	0.1	8-12%; 12% mostly: average rate 11.6%	Duty suspension	6.4%-9.6% 9.6% for most products and average tariff rate of 9.3%

Source: Author's analysis using data from the International Trade Centre and the World Integrated Trade Solution (WITS).
Note: Average tariff rates are calculated as simple averages. Exporting items are selected taking 3 years' (2016, 2017 and 2018) simple average of export values.

3.1.3 Market access conditions in the United States

Bhutan being an LDC can enjoy GSP facilities under its least developed beneficiary countries (LDBDCs) (USTR, 2016). The LDBDCs allows duty-free market access for more than 5,100 items (out of 12,000 products) at the HTS (Harmonized Tariff Schedule) 8-digit tariff line.[24] After graduation, Bhutan will no longer be eligible for the GSP designed for LDBDCs. However, it could enjoy preferential duty-free treatment under a US GSP scheme designed for developing countries. This would result in Bhutan's losing duty-free preference in 1,500 HTS items. Graduation will have no implications on the rules of origin provisions as they are same for both LDCs and developing countries. A GSP beneficiary country is required fulfilling a local content rule of not less than 35 per cent of the appraised value of a product at the time of entry.

Graduating Bhutan is not expected to lose any significant market access in the United States as its most exporting items will continue to enjoy duty suspension under the GSP for the Beneficiary Developing Countries (BDCs) (Table 5). A major increment in tariff would be due to footwear (HS 64) for which average post-graduation tariff would be about 15 per cent. However, given the small volume of exports to the US and most exporting items being subject to duty suspension under GSP for BDCs, Bhutan's graduation from the LDCs is expected to have a negligible impact on its exports.

[24] The United States provides GSP facilities to 131 designated beneficiary countries and territories including 44 least developed beneficiary countries (LDBDCs).

Table 5: Market access conditions for major exporting items in the United States

HS code	Product description	MFN rate	Current rate GSP for LDBDCs	Post-graduation tariff GSP for BDCs
28	Inorganic chemicals; organic or inorganic compounds of precious metals, of rare-earth metals	0%-5%; mostly 3%; Average 2.23%	Duty suspension	Duty suspension except few products
72	Iron and steel, ferro-silicon	0%-10%; mostly 0%; Average 0.27%	Duty suspension	Duty suspension except few items
87	Vehicles other than railway or tramway rolling stock, and parts and accessories thereof	0%-25%; mostly 2%; Average 2.25%	Duty suspension	0%-25%; mostly 0%; Average 1.60%
84	Machinery, mechanical appliances and parts thereof	0%-9%; mostly 0%; Average 1.19%	Duty suspension	Duty suspension except few products
97	Works of art, collectors' pieces and antiques	MFN rate 0%	Duty suspension	Duty suspension
39	Plastics and articles thereof	0%-6%; average 4.24%	Duty suspension except few items	Duty suspension except few items
64	Footwear, gaiters and the like; parts of such articles	0%-48.33%; Average 15.35%	Same as GSP for BDCs	MFN rate applicable for almost all products; Average 14.97%
90	Optical, photographic, cinematographic, measuring	0%-16%; mostly 0%; average 1.03%	Duty suspension	Duty suspension except few products
21	Miscellaneous edible preparations	0%-40.49%; Average 9.78%	Duty suspension for few products; Average 5.63%	Duty suspension for few items; Average rate 7.70%

Sources: Author's analysis using data from WITS, ITC Trade map and US ITC.

Note: Average rates are calculated as a simple average. Exporting items are selected taking the last 3 years (2016, 2017 and 2018) simple average of export value.

3.1.4 Market access conditions in Canada

Bhutan is currently enjoying duty-free market access in the Canadian market under its Least Developed Country Tariff (LDCT) programme – a designated GSP scheme for LDCs (UNCTAD, 2013; Canadian Border Service Agency). Canada grants LDCT to all imports from LDCs except for dairy, poultry and egg products. It also provides preferential access to developing countries for some selected agricultural and industrial products under the Generalised Preferential Tariff (GPT) scheme.[25]

Graduating Bhutan will no longer benefit from LDCT and will be entitled to GPT treatment only. The transition from LDCT to GPT have implications for both tariff and rules of origin.[26] The analysis of tariff at the detailed product level shows that Bhutan's major exporting items under HS 72 (iron, steel and ferrosilicon) and HS 28 (inorganic chemicals) will continue to enjoy duty-free access under GPT (Table 6). Tariff implications for other exports are also minimum. However, to benefit from preferential access, Bhutan post-graduation will have to comply with more stringent rules of origin compared to that under LDCs: the minimum local content requirement would increase from 40 per cent to 60 per cent.

Table 6: Market access conditions for major exporting items in Canada

HS code	Product description	MFN rate	Current rate LDCT	Post-graduation tariff GPT
72	Iron and steel	MFN rate 0	Duty suspension	Duty suspension
28	Inorganic chemicals	MFN rate 0% except HS 28529010 (6.5%)	Duty suspension	Duty suspension except HS 28529010 (3%)
68	Articles of stone, plaster, cement, asbestos, mica or similar materials	0%-15.5%; Average 3.18%	Duty suspension	Partial reduction on most products 0%-15.5%; Average 1.08%
90	Optical, photographic, cinematographic, measuring	0%-8.5%; mostly 0%; Average 0.84%	Duty suspension	Duty suspension except HS 90171020 and HS 90178010; 5% tariff for both products
32	Tanning or dyeing extracts; tannins and their derivatives; dyes, pigments and other colouring **...**	0%-6.5%; mostly 0%; Average 1.75%	Duty suspension	Partial reduction for all products by more than 50 per cent items

[25] The GPT is Canadian preferential treatment designed for developing countries.
[26] GPT tariff rates range from duty-free to reductions in MFN rates while LDCT rates are entirely duty-free.

85	Electrical machinery and equipment and parts thereof	0%-9%; 0% mostly; Average 1.19%	Duty suspension	Duty suspension except few items
97	Works of art, collectors' pieces and antiques	0%-7%; 0% for most items Average 1.4%	Duty suspension	Duty suspension
63	Other made-up textile articles; sets; worn clothing and worn textile articles; rags	0-18 17% & 18% for most items Average 15.3%	Duty suspension	Duty reduction for few items; 17% and 18% for most items Average 14%
94	Furniture	0%-15.5%; 9.5% and 7% for almost 50 per cent products; Average 4.94%	Duty suspension	Partial reduction for most products 0%-15.5%; Average 3.18%
84	Machinery, mechanical appliances and parts thereof	0%-8%; 0 for most items Average rate 0.3%	Duty suspension	Duty reduction

Source: Authors' analysis using data from ITC Trademap, World Integrated Trade Solution (WITS) and Canada Border Service Agency.
Note: Average rates are calculated as a simple average. Exporting items are selected taking last 3 years' (2016, 2017 and 2018) simple average of export value.

3.1.5 Market access conditions in Bangladesh

Bangladesh is an important export destination of Bhutan. Since both the countries are members of SAFTA (the South Asian Free Trade Agreement), Bhutan have preferential access in Bangladesh. However, the margin of preference is low as a large number of goods are kept under the so-called sensitive list in which there is no liberalization or preferences.[27] After graduation, Bhutan will lose preference in only six items at the HS 6-digit level. This is however expected to have either negligible or no impact. However, in terms of rules of origin, there will be an increment in local value-added content from 30 per cent (for LDCs) to 40 per cent (for non-LDCs). It is worth noting that Bhutan currently enjoys duty-free market access for 18 products in Bangladesh under a bilateral (preferential) trade agreement between the two countries which was signed in 2014 (CDP, 2018). Apart from this, Bangladesh and Bhutan have started negotiating a preferential/free trade

[27] Under the SAFTA agreement, the sensitive list of Bangladesh includes 987 items for LDCs and 993 items for non-LDCs.

and transit arrangement to facilitate larger bilateral trade (in terms of both value and volume) (Ahmed, 2018).[28]

3.1.6 Market access conditions in other countries

According to UNCTAD (2016), China is providing duty-free quota-free (DFQF) market access to 40 LDCs, in which Bhutan is not listed as a beneficiary. Consequently, LDC graduation of Bhutan will not have any significant impact on the terms in accessing the Chinese market.

Thailand, an emerging and upper-middle-income Asian country, provides duty-free quota-free (DFQF) market access for a wide range of LDC products under its LDC-specific preferential trade scheme (OECD and WTO, 2015).[29] Under this scheme, 6,998 products at the HS 8-digit level (accounting for almost three-quarters of Thailand's all tariff lines) are exempted from customs duties and quotas. After graduation, Bhutan will face significant tariff increment in Thailand particularly in agricultural and mineral items (CDP, 2018). However, given the relatively small share of Thailand in Bhutan's exports, no major impact is expected.

Japan grants preferential tariff treatment to 138 developing countries along with 5 territories including 47 LDC countries (UNCTAD, 2011). Bhutan being an LDC enjoys the duty-free quota-free special preferential market access provided to LDCs for 9,068 tariff lines. Should Bhutan graduate from the LDC group, it will be eligible for a GSP scheme provided to developing countries. The GSP for developing countries offers duty-free or various tariff reductions for selected agricultural and industrial products only. A product-level analysis shows that post-graduation Bhutan will have to pay 24.8 per cent tariff for dairy products and other items included in HS 04. Average tariff rates will be 10.79 per cent and 7.28 per cent for beverage products and edible vegetables, respectively.

In Nepal, Bhutan has preferential access under SAFTA. After graduation, 38 products will be excluded from preferential access.[30] Regarding the rules of origin, the local value addition would increase from 30 per cent for LDCs to 40 per cent for non-LDCs.

Other countries where Bhutan gets preferential access (either GSP or LDC-specific preferences) include Armenia, Australia, Chile, Iceland, Kazakhstan, Kyrgyzstan, Montenegro, New Zealand, Norway, Republic of Korea, Russian Federation, Switzerland, Taiwan Province of China, Tajikistan and Turkey.[31] LDC graduation would have some implications on export competitiveness to these countries. However, given the currently non-existent preference utilization, the resultant impacts will be trivial.

[28] http://www.moea.gov.bt/?p=7637. Nonetheless, bilateral trade agreement exists between Bangladesh and Bhutan, exports from Bhutan to Bangladesh are subject to MFN only. See http://www.moea.gov.bt/wp-content/uploads/2017/07/pub6jf2987xg.pdf

[29] The rules of origin requirement for this scheme is either wholly produced or obtained in the DFQF beneficiary country or qualifying value content is not less than 50 per cent (of f.o.b) for not wholly produced or obtained.

[30] Nepal sensitive list for non-LDCs includes 1,036 products against 998 for LDCs

[31] http://ptadb.wto.org/Country.aspx?code=064

3.2 WTO issues for Bhutan

Bhutan is not a member of the WTO. It initiated its accession process in the WTO and was granted observer status in 1999. After a series of accession negotiations, the Government deferred accession in October 2017 (Lamsang, 2017). WTO members are required to keep conformity with the provisions of various agreements. LDCs – due to their capacity constraints – are granted some flexibilities and the so-called special and differential treatments (S&DT) to implement these regulations. Since Bhutan is not a member, it is not obliged to implement WTO provisions. This would also imply that Bhutan is not protected by multilateral rules either. In that sense, the duty-free, quota-free market access treatment, for example, is not something that is available to Bhutan via WTO commitments. Any preference donor country can withdraw it without being subject to non-violation of multilateral trade rules. On the other hand, it is also true that Bhutan did not make much use of WTO-backed trade preferences.[32] Therefore, one issue for Bhutan is to weigh the pros and cons of WTO accession.

Countries that accede to the WTO face very tough accession negotiations and end up undertaking many more commitments than the original or founding WTO members. WTO accession will also imply greater scrutiny of Bhutan's trade regime by WTO members and Bhutan may also have to undertake commitments in new areas involving institutional reforms (e.g. WTO commitments related to TRIPs). These measures can be demanding both in terms of resource commitments and administrative reforms/changes. When an overwhelming portion of trade is governed through bilateral trading arrangements, the need for multilateral trading arrangements might appear to be less than appealing. It is perhaps also true that large trading nations (e.g. the EU, Japan, the USA, etc.) will impose more stringent trade measures against such a small exporter like Bhutan just because it is not a WTO member. On the other hand, even with all multilateral trade rules, small WTO members will still find it difficult to resolve a trade dispute through the WTO system.[33]

However, further expansion of exports in the future can get facilitated by joining the WTO.[34] From this perspective, accession will require undertaking some demanding tasks and in the process compromising some policy space. WTO members have recognized the capacity constraints of LDCs and agreed to consider more liberal terms and approaches in dealing with accession negotiations of LDCs. Therefore, once Bhutan graduates, the accession negotiation and the terms of accession could be more stringent. Therefore, joining the WTO now presents a dilemma for Bhutan.

[32] It was mentioned earlier that Bhutan's main trade partner is India. Its trade with India is governed by a bilateral trade agreement.

[33] This is despite the fact that the WTO has a clear and effective dispute settlement procedure. Taking a case to the WTO is not easy and given the technically and financially demanding nature of trade disputes, small countries and capacity constrained graduating LDCs will always find it a daunting prospect to pursue a case in the WTO.

[34] Chinese accession to WTO helped expand its exports by several folds.

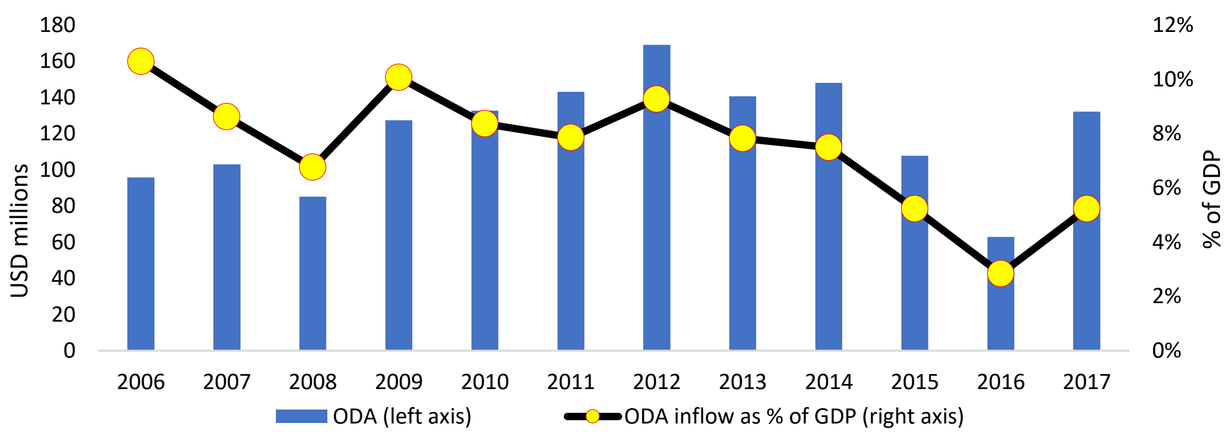
3.3 Implications for development financing

Financing development projects has been the key to shape a country's development trajectory. Bhutan receives sizeable foreign assistance although its relative share has declined in recent times. It would appear from the discussion below that LDC graduation as such is unlikely to affect the flow of foreign assistance to a recipient country like Bhutan.

3.3.1 Multilateral and bilateral development assistance

The Official Development Assistance (ODA) is bilateral and multilateral support (grant, aid, concessional loans) provided by the members of the Development Assistance Committee (DAC). DAC members have commitments to provide the equivalent of 0.15 to 0.20 per cent of their GNI in the form of ODA to LDCs (which is in parallel to their commitment to providing the equivalent of 0.7 per cent of GNI in overall ODA). As the most vulnerable and underdeveloped economies, LDCs are supposed to be given special attention in allocating ODA. Yet the LDC status of a country is not an important determinant of ODA. The global patterns and trends in aid allocation suggest that recipient countries' historical and bilateral relationships with donors and country-specific emergencies such as civil wars and unrests, natural disasters, health epidemic, refugee crisis are important determinants of aid inflows. In 2017, LDCs received less than 30 per cent of all ODA. Between 2013 and 2017, among top ODA recipients, only four were LDCs.

Figure 13: ODA inflows into Bhutan



Source: Based on OECD database.

Bhutan's public expenditure accounts for about 40 per cent of its GDP. It maintains a relatively high level of expenditure on social sectors such as health and education. A substantial portion of capital expenditure is sustained through bilateral and multilateral ODA, external grants or borrowing. The Bhutanese government's five-yearly budgetary plans to a large extent have been supported by ODA and bilateral flows. With three-fourth of the share, ODA was the predominant source of development financing for Bhutan in 2017. Nevertheless, the share of ODA in Bhutan's economy has declined considerably: from more than 10 per cent in 2009 to just above 5 per cent in 2017 (Figure 13). During 2006–12, the share of ODA in GDP on average was 8.8 per cent, which came down to 5.7 per cent during 2013–2017. In 2017, the $132.18 million ODA received by Bhutan puts it at 91st position in terms of the amount of ODA received. Therefore, Bhutan is not a major ODA-recipient country and is unlikely to face any major disruption in ODA prospects solely because of graduation.

Key multilateral development partners of Bhutan are the Asian Development Bank (ADB), European Union institutions, World Bank, United Nations Development Programme (UNDP), United Nations Children's Fund (UNICEF), International Fund for Agricultural Development (IFAD), World Health Organization (WHO) etc. Among them, ADB and the World Bank have their own criteria for selecting beneficiaries for concessional loans. They mostly follow the World Bank's income-based classification of low-income, lower-middle-income, upper-middle-income countries in allocating loans. Bhutan is already included within the group of lower-middle-income countries in which there exist significant opportunities for receiving loans on soft terms and conditions.

Amongst others, the assistance from the WHO and IFAD is also not related to the LDC-identity of a country. However, several UN bodies have LDC-specific budgetary quota commitments. For example, UNDP and UNICEF keep 60 per cent of core budgetary allocation for the members of the LDC group. Any potential loss of financial support for Bhutan is difficult to measure, as these benefits target LDCs as a group, not as separate countries. But, the UN agencies like the UNDP have elaborate development programmes in most non-LDC lower-middle-income countries.

Amongst, bilateral donors, India and Japan have been longstanding development partners of Bhutan. Japan is the source of largest bilateral assistance and between 2011 and 2016 it came up with more than $124 million ODA (more than 16 per cent of all ODA inflow into Bhutan during that period). Japanese support to Bhutan continuously focuses on socio-economic development and poverty alleviation. Japan's support to Bhutan is not directly related to the LDC status, rather it considers the World Bank income classification. Although interest rates charged for lower-middle-income countries are slightly higher than those of the low-income countries, they remain much lower than the commercial rates available to countries.

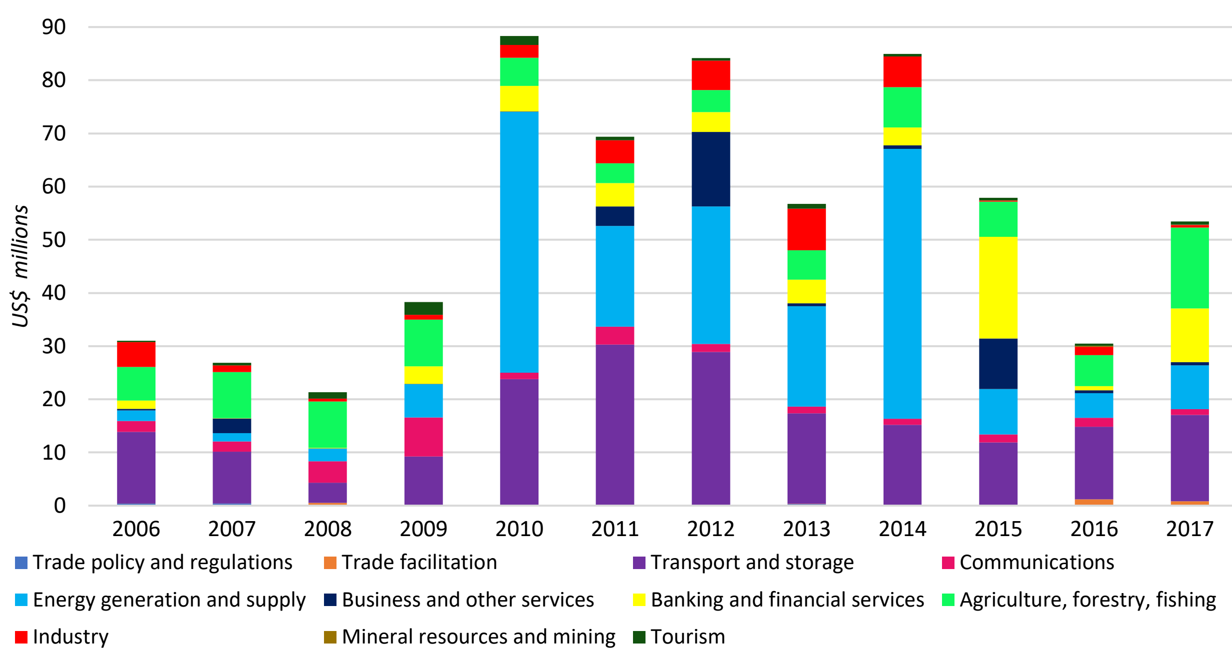
Non-DAC donor India accounts for close to 80 per cent of grants provided to Bhutan. In fact, Bhutan has remained the main destination for Indian aid over the past several decades. Given the past ties between the two neighbouring countries, it is extremely unlikely that Indian assistance will decline as a result of Bhutan's LDC graduation.

3.3.2 Aid for Trade

For over last seven decades, international trade of goods and services has been instrumental to foster growth and rapid socio-economic progress in the developing world. However, the LDCs account for less than 1 per cent of global export. Shortage of trade-related infrastructures and supply-side constraints such as lack of adequate productive capacities make it arduous for LDCs to effectively participate in global trade. To address these challenges, a portion of ODA has been directed as trade-related programmes and projects, which are known as Aid for Trade (AfT). Although part of ODA, AfT has received a lot of attention given that the need for supply-side capacity building was recognized by WTO members as a fundamental determinant of trade performance. The WTO has also been leading a global review of AfT once in every two years. Many LDCs and low-income countries have attached special importance to AfT projects in promoting export competitiveness and improving supply response. AfT is an important component of development financing received by Bhutan and it accounted for more than two-fifths of all ODA received by the country in 2017. Top three priorities for Bhutan in the utilization of AfT are i) Export diversification; ii) Trade policy development; and iii) Services sector development (OECD and WTO, 2019).

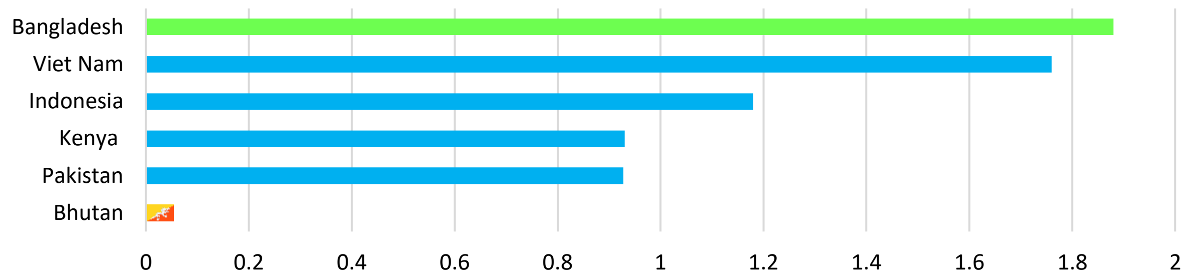
In absolute terms, Bhutan is however amongst one of the smallest AfT recipients. In comparison with an annual average flow of close to $260 million, the maximum amount Bhutan has received in any year was less than $90 million. In 2017, it received $53.9 million of ODA which was related to AfT. Besides, there was $4.2 million worth of trade-related other official flows (OOFs). The trend in AfT has been quite irregular for Bhutan (Figure 14). In 2010, Bhutan received $88.2 million as AfT, which was the highest amount received since 2006. In the years it received higher than average AfT (e.g. 2010, 2012, 2014), the key targeted sector was energy generation and supply. This indicates Bhutan’s priority in hydropower development and export. Transport has been another constant focus of AfT disbursement.

Figure 14: Sector specific Aid for Trade received by Bhutan (2006-2017)



Source: Based on OECD database.

Figure 15: Top five Aid for Trade recipients and Bhutan in 2017 (U$D billions)



Source: Based on UNCTAD data.

Although being a relatively small recipient, AfT is important in developing trade-related infrastructure and export competitiveness. However, it is to be noted that LDC graduation is unlikely to have any significant impact on AfT prospects. In 2017, only one (Bangladesh) out of the top five AfT recipients was an LDC (Figure 15). Also, it is worth pointing out that AfT is not additional to the overall ODA support provided and thus additionality of resources (i.e. beyond the existing level of ODA resources) has always been an issue in the policy discourse on AfT. Therefore, it can be concluded that LDC graduation is not going to have any significant impact on AfT unavailability. but the challenge is however mainly in utilizing the resources in generating enhanced supply response. After the recent success in energy exportation, Bhutan can perhaps now focus on export diversification.

Among other trade-related aid measures, Bhutan receives some LDC specific technical support and diagnostic trade integrated studies from the Enhance Integrated Framework (EIF) of the WTO. The EIF is a small part of AfT, which is reserved exclusively for LDCs. A graduating LDC can continue to access EIF support for a period of up to five years after its graduation. Given the current volume of EIF support, it should not be any major concern for Bhutan. Furthermore, the country can plan effectively to maximise the utilization of the EIF assistance for the next five years as it graduates.

3.3.3 Climate change funding

Home to a pristine environment, clean air and protected forests, the Himalayan kingdom of Bhutan is a carbon-negative country. Absorbing more than 6 million tonnes of carbon per year, Bhutan cleans almost three times more CO_2 emissions produced by a population of 728,000. The country has taken significant steps in strengthening the international battle against climate change and promised to maintain 60 per cent forest cover "in perpetuity". Despite these efforts, Bhutan remains extremely vulnerable to the global phenomena of climate change. The country is heavily reliant on climate-sensitive sectors such as agriculture, hydropower, and forestry. Major threats that are facing Bhutan due to global warming are the formation of supraglacial lakes from melting ice and glacial lakes outburst floods (GLOFs). Since key economic establishments, settlements and infrastructures are concentrated in the surroundings of large river valleys in Bhutan, GLOFs or landslides can potentially impair growth and development.

Currently, Bhutan's LDC status gives it access to LDC-specific global climate change fund or Least Developed Countries Fund (LDCF), which is managed by the United Nations Framework Convention on Climate Change (UNFCCC). Bhutan approved its National Adaptation Programme of Action (NAPA) back in 2006 to access LDCF funds. Currently, phase II of NAPA is close to completion, which received $11.5 million in funding from LDCF. Bhutan's adaptation projects include a disaster management strategy, a weather forecasting system, landslide management and flood prevention and community-based forest fire management and prevention etc. These programmes will be funded until their completion regardless of the country's LDC status. Graduation would mark an end to receiving support from the LDCF climate funds.

Nonetheless, Bhutan also receives support from such climate change funds like Global Environment Facility (GEF), Green Climate Fund (GCF). For two GCF approved projects, Bhutan is supposed to receive approximately $52 million (GCF, 2019).[35] Apart from these, Bhutan is implementing around 30 more projects at the national and regional levels. As many as 27 of them are being implemented with the help of GEF. At the national level, Bhutan has been granted above $62 million to implement 22 projects.

Table 7: Key climate change funds operating in Bhutan

Climate fund	Total projects (national/regional)	Total Financing	Total Co-Financing
GEF (Global Environmental Facility)	27	$165,197,221	$210,296,863
LDCF (Least Developed Countries Fund)	4	$21,135,250	$146,766,470
NPIF (Nagoya Protocol Implementation Fund)	1	$4,500,000	$15,963,559
MTF (Multilateral Technology Fund)	1	$13,967,124	$42,630,300

Source: GEF (2019).

Bhutan will lose access to the LDCF fund after graduation but there will be other funds to support its climate change projects. As climate change situation is likely to get accentuated, the post-graduation era might require competing against other developing countries for environmental funds. Bhutan's longstanding reputation for environment-friendly policies and Gross National Happiness (GNH) -targeted policies are expected to keep it as a strong contender for climate-related support.

[35] GCF funded projects in Bhutan are FP050 (Bhutan for Life) and FP107 (Supporting climate resilience and transformational change in the agriculture sector in Bhutan)

IV. Ways forward for Bhutan

It follows from the above that most LDC privileges and benefits are related to international trade from which Bhutan could not benefit much given its inherent and natural challenges (such as being a landlocked country) affecting its external competitiveness. This provides the rationale for addressing the general development challenges which are prerequisites for building productive capacities, achieving structural transformation and promoting international competitiveness. To achieve these, a graduating country like Bhutan can consider the following measures.

4.1 Staying Focused on Achieving Sustainable Development Goals

Guided by the development paradigm of GNH, Bhutan is committed to realizing the 2030 Agenda for Sustainable Development and intends to graduate from the group of LDCs by 2023 with its 12th five-year plan providing major directions. In line with Bhutan's commitment to the implementation of the SDGs, Bhutan decided to participate in the Voluntary National Review at the 2018 High-Level Political Forum.

The IPoA's objectives[36] and key priority areas are closely aligned with the goals and targets outlined in the Agenda 2030 for Sustainable Development Goals (United Nations, 2018). Therefore, contingent upon drawing effective synergies and coherence, successful implementation of IPoA will lead to achieving SDGs as well (LDC IV Monitor, 2016). However, most LDCs confronted with critical challenges continue to demonstrate their weaknesses in achieving SDGs (Kim, 2018). Furthermore, it is a matter of concern that the LDC average GDP growth has been below 5 per cent which is not compatible with IPoA's target of a 7 per cent yearly growth (UNCTAD, 2018).[37]

Bhutan, expected to graduate by 2023, has shown a generally stronger growth performance. It has successfully incorporated the SDGs within the GNH domain and national development framework (Table 8). According to Bhutan's Voluntary National Review (2018), the 12th Five-Year Plan (2018–2023) is the country's first policy stance towards implementing SDGs and at the same time, it serves as "the last mile plan" as well as transition platform to ensure smooth and sustainable graduation from LDC.[38] The 12th FYP further facilitates and better integrates the GNH and SDGs

[36] The objectives include: "(i) achieving sustained, equitable and inclusive economic growth by strengthening the LDCs productive capacity; (ii) building human capacities by fostering sustained, equitable and inclusive human and social development, gender equality and the empowerment of women; (iii) reducing the vulnerability of LDCs to economic, natural and environmental shocks and disasters through strengthening their resilience; (iv) ensuring enhanced financial resources; and (v) enhancing good governance at all levels, by strengthening democratic processes, institutions and the rule of law" while the key priority areas consist of "(1) productive capacity; (2) agriculture, food security and rural development; (3) trade; (4) commodities; (5) human and social development; (6) multiple crises and other emerging challenges; (7) mobilizing financial resources for development and capacity-building; and (8) good governance at all levels."

[37] IPoA aims at least 7 per cent growth to be maintained in LDCs while SDG 8.1 stipulates "sustain per capita economic growth in accordance with national circumstances and, in particular, at least 7 per cent gross domestic product growth per annum in the least developed countries".

[38] The 11th FYP (2013–2018) of Bhutan also considered the issue of LDC graduation. Also, see Namgyel (2018) for further discussions.

through addressing and mainstreaming the crosscutting issues related to climate-induced natural disasters, gender equality and women empowerment, support for vulnerable groups etc.

Table 8: Synergies among Bhutan's 12th Five-Year Plan, Sustainable Development Goals and GNH domains

The 12th FYP (2018-23) National Key Results Areas (NKRAs)	SDGs (2015-30)	GNH domains
1. Macroeconomic stability ensured	SDG 8: Decent work and economic growth	Living standards
2. Economic diversity and productivity enhanced	SDG 9: Industry	
11. Productive and gainful employment created	SDG 8: Decent work and economic growth	Psychological well-being; Good governance; Living standards; Time use
3. Poverty eradication and inequality reduced	SDG 1: No poverty SDG 10: Reduced inequalities	Living standards; Good governance
7. Quality of education and skills improved	SDG 4: Quality education	Education
8. Food and nutrition security ensured	SDG 2: Zero hunger	Living standards
5. Healthy ecosystem services maintained	SDG 11: Sustainable cities and communities SDG 15: life and land	Psychological well-being; Good governance; Living standards; Time use
6. Carbon neutral, climate and disaster-resilient development enhanced	SDG 7: Affordable and clean energy SDG 9: Industry, innovation and infrastructure SDG 13: Climate action	

Source: Adapted from World Bank (2019).

However, Bhutan's challenges are well-acknowledged in its national development visions and strategies and also in the reviews undertaken by various development partners. A landlocked least developed country with a highly undiversified economy and strong dependence on public sector and hydropower-led growth, it is exposed to climate-induced vulnerabilities. Instability in exports and agricultural production, limited export diversification and high dependency on a single market keeps it vulnerable to natural shocks. It could not meet the EVI criteria for graduation (CDP, 2018) as it underperformed in six out of a total of eight EVI indicators.[39] There are also challenges in managing foreign debts. The country's Voluntary National Review identifies some other key issues related to SDGs such as the imperatives for tackling rising inequality, addressing the need for vulnerable groups, promoting diversification of investments (emphasizing more on private investments), generating youth employment, and strengthening domestic resource mobilisation efforts, etc.. To consider these issues holistically, Bhutan focuses on three areas for sustainable development: (i) economic resilience and transformation, (ii) environmental resilience and (iii) enhancing human capital and productive capacity. Table 9 provides a summary of the key issues that Bhutan aims to address, the policy opportunities that it has in dealing with them and potential strategies to transform policy intents into actions.

Therefore, it is quite obvious that Bhutan's path towards the achievement of SDGs is spelt out. Like many other countries, the challenge is now the effective implementation of the strategies. From the discussions above on Bhutan's economic conditions, nature and performance of international trade and the trends and state of development performance, it can be inferred that LDC graduation as such might not have any significant deleterious impact. Bhutan has taken a very positive approach in which LDC graduation is being seen as a major leap forward in making further progress. Given its deriving very limited benefits from the LDC-related trade preferences and other support measures, such an approach is most appropriate.

Table 9: Challenges and strategies towards LDC graduation and SDG implementation

	Key issues	Opportunities	Strategies
Economic resilience and transformation	• Highly capital-intensive economic growth • Limited employment opportunities • Underdeveloped private sector • Undiversified economy • A narrow-based domestic economy with limited scope for expansion • Limited scoped for export expansion • Vulnerable to global price fluctuations	• Revision and adoption of the *Economic Development Policy (EDP) 2016* • Priority Sector Lending (PSL) scheme in 2018 to facilitate the growth of Cottage and Small Industries (CSI) through providing loans with preferential interest rates • Enacting Fiscal Incentives Act of Bhutan 2017 • Adopted Public Debt Policy, 2016 to manage public debt effectively • Strengthening critical Information Communication Technology (ICT) infrastructure • Establishment of TechPark through Public-Private Partnership (PPP) • Building and expansion of the road network	• Expanding investments in tourism, organic agriculture, and CSIs • Setting up an entrepreneurship ecosystem combining public and private sectors • Start-up and Cottage and Small Industries Development Flagship Programme' will provide comprehensive support to set up new production and manufacturing CSIs including up-scaling existing CSIs. • One Gewog One Product Flagship Programme' will provide income-generating opportunities and enhance the livelihood of rural communities across all Dzongkhags by building local capacities

[39] Most of the EVI indicators are sufficient enough and/or irrelevant to measure Bhutan's unique geographic position i.e. landlockness, remoteness etc.

Environmental resilience	• increasing temperatures and emerging desertification • Water shortages in local areas • Increasing waste generation and its poor management • Increasing frequency and intensity of climate change induced disasters • vulnerability to external shocks caused by natural hazards (aggravated by inappropriate land use and construction practices) • Issues concerning the quality of water and air	• Drafting climate change policy to strengthen coherence and coordination among the concerned agencies based on national and sectoral priorities • Preparing 2016 National Integrated Water Resource Management Plan • Conducting several national surveys and studies to provide critical information for advancing conservation and sustainable management of the country's rich biodiversity, ecosystem and natural resources. • Preparing and continuing to implement its National Adaptation Programme of Action (NAPA). • Developing Sectoral Adaptation Plan of Action (SAPA for better sectoral focus • Implementing National adaptation plan • Implementing *Disaster Management Strategic Policy Framework 2015-2025* • Implementing *Bhutan Transport 2040: Integrated Strategic Vision* with special focus on increasing electric vehicle	• Human resource development strategy under Bhutan's resilience-building agenda • Exploring and mobilising innovative means of financing and other domestic and international support measures • Consistent financial resources
Enhancing human capital and productive capacity	• Poverty especially rural poverty • Vulnerability of children to child poverty • Chronic malnutrition among under 5 children • Increased non-communicable disease (NCD) • Challenges in accessing equitable and quality education • Limited number of schools quipped for Special Education Needs (SEN) and inclusive education	• Establishing of Central Schools, Extended Classrooms, and expansion of primary and secondary schools • Developing a Technical and Vocational Education and Training (TVET) Blueprint • Implemented *Education ICT Master Plan (iSherig) 2014-2018* • Students Loan Scheme for Tertiary Education instituted in 2014 • Non-Formal Education (NFE) programme towards adult literacy • Schools with SEN programme and two specialized institures as well as Draktsho Vocational Training Centre for Special Children and Youth (a non-governmental organisation) provides basic education and vocational skills training	• Investing in the provision of quality and inclusive Early Childhood Care and Development (ECCD) programmes • Creating an attractive and conducive environment for nation teachers and promoting value education through a GNH-inspired teaching learning environment • Strengthening TVET system

Source: Authors' presentation from the Joint Task Force (JTF) of Royal Government of Bhutan (RGoB) and the United Nations System in Bhutan (2019).

4.2 Proactive engagements with trade partners

As mentioned earlier, Bhutan's single most important trading partner in India and there exists bilateral FTA between the two countries. While this trading arrangement will help mitigate any graduation-related consequences, Bhutan can proactively engage with other potentially vital trading partners looking for increased trading opportunities. Bhutan will avail the duty-free access in the EU for three more years after its official graduation as part of a smooth graduation strategy offered by existing EU provisions. After that, it is expected to be eligible for GSP+ for which it should start working to make sure that the conditionalities for entering into the programme can be met. The European Commission's current GSP regime will apply until 2023 when it will be replaced by a new regime. Therefore, Bhutan can engage with the European Commission for the most favourable GSP arrangement after graduation. Coalition-building with other graduating LDCs can be an effective policy option to avail a favourable trade policy regime in the post-graduation era.

Table 10: An overview of Bhutan's preferential trade arrangements of Bhutan

RTA	Members	Starting date	Products under coverage
SAFTA (South Asian Free Trade Agreement)	- 8 members - Afghanistan, Bangladesh, Bhutan, India, Nepal, the Maldives, Pakistan and Sri Lanka	Signed in 2004	Duty-free access for products excluding the products in the sensitive list
BIMSTEC (Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation) Free Trade Area	- 7 members (Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka and Thailand)	Proposed	-
Bilateral FTA/cooperation agreement			
Agreement on Trade, Commerce and Transit	Bhutan and India	-Singed on 17 January 1972; Last renewed on 12 November 2016 (renewed for 5 times)[40]; Entered into force July 2017	Duty-free access for all tariff line products
Agreement on Trade (preferential)	Bangladesh and Bhutan	-Signed in 1980; last renewed in 2014	Duty-free access for 18 products
Nepal-Bhutan Bilateral Trade	Bhutan and Nepal	Proposed[41]	
Cooperation agreement/MoU/Bilateral trade treaties			
Trade and Economic Cooperation Agreement	Bhutan and Thailand	Signed in 2013[42]	Tax and duties exemption for the temporary importation of some products for non-commercial purposes[43]

Source: Authors' compilation from various sources.

[40] https://pib.gov.in/newsite/PrintRelease.aspx?relid=154916
[41] https://kathmandupost.com/money/2019/08/30/nepal-bhutan-prepare-draft-bilateral-trade-agreement
[42] http://sasec.asia/index.php?page=news&nid=510&url=trade-commission-initiates-bhutan-thailand-relations
[43] As per Article IV of the agreement, the products - samples of merchandise (fit only to be used as such and with no commercial value), articles of imported for repair purposes, tools and equipment for building and construction, articles temporarily imported intended for public exhibition will be subject to exemption from duties and taxes.

Bilateral trade agreements with other major trading partners can help Bhutan look for new trading opportunities in the post-graduation era. In this regard, increased trading opportunities in China can be extremely helpful for export market diversification. Bhutan is currently seeking extended market assess in Bangladesh under a preferential trading arrangement, which is a move in the right direction and should be pursued. Finally, it must be borne in mind that Bhutan can expand its exports to India by many folds. The market in India is expanding fast and the existing bilateral free trade agreement can help seek FDI either from the region and elsewhere to take advantage of the existing market access. Given the locational advantage of being neighbours of China and India and the fact that other regional South Asian partners are growing at a brisk pace, there exists huge export market prospect for a small country like Bhutan. A post-graduation effective trade strategy for Bhutan could be to explore and take advantage of nearby export markets trading more within the region using the regional trade platform can be an effective tool. Bhutan is a member of SAFTA, however, its trade with other SAFTA members except for India and Bangladesh is negligible. Although lacking progress, BIMSTEC FTA could be another opportunity for expanding trade with Myanmar and Thailand.

4.3 Dealing with general development challenges

Bhutan being largely a single sector-driven economy has been reliant on the hydropower generation to propel its growth trajectory. However, delays in hydropower project completion have become a common phenomenon, which, in turn, exert an adverse impact on the economy (World Bank, 2019). It has been estimated that a decline in electricity production could result in 3–4 percentage points decrease in GDP, and approximately US$250–US$300 reduction in exports, and forgone government revenue by around 0.5–1 per cent of GDP.[44]

Table 11: Likely consequence of a delay in hydropower construction

Subject	Source of impact	Estimated impacts/consequences
GDP (production account)	Decline of electricity production	About 3–4 percentage points of GDP
Exports	Decline in export growth	About US$250–US$300 million a year (about 50 per cent of actual exports in 2015)
Government revenues	Decline in corporate taxes, dividend and royalty	About 0.5–1 per cent of GDP

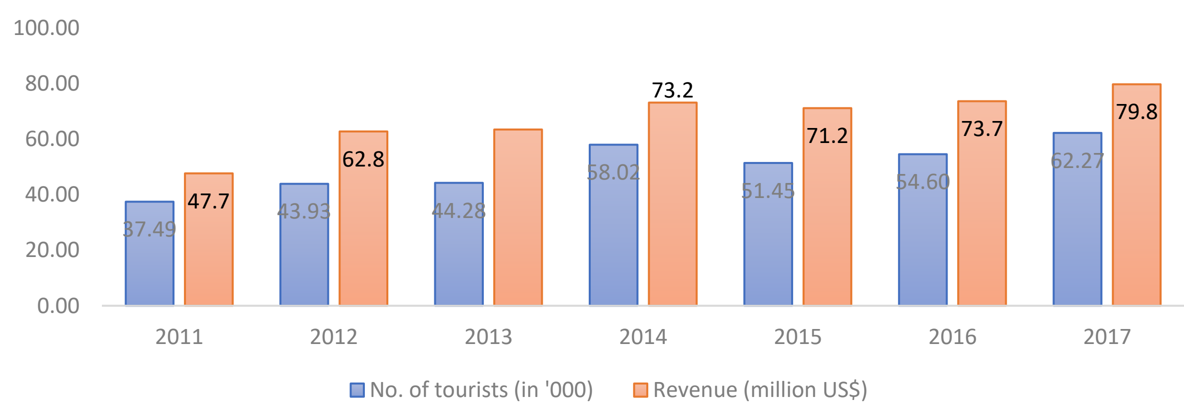
Source: Adapted from World Bank (2019).
Note: This analysis is undertaken considering a delay of Puna I or Puna II project.

[44] Furthermore, Bhutan is subject to hydro-meteorological disasters since the country is situated in the eastern part of the Himalayan Arc which is seismically active (World Bank, 2019). This issue increases Bhutan's proneness to natural disasters which can offset the development achievements over the years.

Economic diversification is, therefore, critically important for the Bhutanese economy. Bhutan undertook an initiative, the Economic Development Policy (EDP) 2016 with to the objectives to (i) achieve economic self-reliance by 2020 (ii) sustain full employment (97.5%) (Royal Government of Bhutan, 2016). Intending to achieve these objectives, Bhutan adopted 8 strategies as follows: (1) promote the five Jewels (2) diversify the economic base with minimal ecological footprint (3) harness and add value to natural resources in a sustainable manner (4) increase and diversify exports (5) promote Bhutan as an organic brand (6) promote industries that build the Brand Bhutan image (7) reduce dependence on fossil fuel (8) promote industries through a cluster effect and championing approach (Royal Government of Bhutan, 2016).[45] The EDP 2016 identifies 'five jewels' comprising hydropower, agriculture, cottage and small industries (CSIs), tourism and mining and several other specific sectors including finance, construction, ICT, trade, transport, education, health and other legislative initiatives. There is no denying that these sectors remain amongst the most important avenues to build productive capacities and achieve economic diversification. Dealing with various development challenges will critically depend on stimulating these sectors for growth and productive employment generation.

The tourism sector deserves special mention given its enormous potential for development and earning foreign exchange. The sector has seen steady and upward growth in recent years (Figure 16). The number of tourists visiting the country increased from 100,000 in 2012 to more than 274,000 in 2018. Of this, the number of tourists arriving from international destinations rose from 37,000 to close to 80,000. During the same time, the associated rise in tourism revenues rose from $48 million to about $80 million. Clearly, there exists tremendous potential for development in this sector.[46]

Figure 16: International tourists' arrival



Source: Author's presentation using data from the National Statistics Bureau, Bhutan.

45 The 'Five Jewels' is comprised of hydropower, Cottage and small industries (CSIs), mining, tourism and agriculture.
46 According to the Royal Government of Bhutan (RGoB), tourism sector is regarded as 'high value, low impact' sector. The vision of Bhutan's tourism policy is "to promote Bhutan as an exclusive travel destination based on Gross National Happiness (GNH) values". See https://www.tourism.gov.bt/about-us/tourism-policy for details.

Crosscutting strategies formulation targeting the high priority sectors as outlined in the EDP 2016 and World Bank (2019) and effective implementation of these strategies can help Bhutan diversify its economy adequately to push the country to upper stairs of the development ladder (Table 12).

Table 12: Sector-specific recommendations

Sector	Crosscutting recommendations	Implementation period	
		Short	Medium
Tourism	- Building capacity of three-star accommodation and restaurant providers - Supporting the development of programs to geographically and temporally diversify flows	√	
ICT	- Developing sector-specific high-skilled migration channel - Upgrading skills of existing and prospective ICT workers - Developing and implementing a sector-specific investment promotion strategy	√	
	- Upgrading internet infrastructure		√
Agribusiness	- Developing regulations, oversight roles and communication strategy for Brand Bhutan	√	
	- Promoting storage and logistics investments to facilitate exports of high-value products - Reforming subsidies and interventions to optimize incentives for private investment		√
Hydropower	- Commissioning study of the involvement of local firms/workers in hydropower	√	
	- Increasing capacity of local firms/workers to participate in hydropower projects - Ensuring that hydropower agreements including appropriate provisions to facilitate contracting of Bhutanese firms and employment of Bhutanese workers		√

Source: Adapted from World Bank (2017).

Being a landlocked and mountainous terrain means improving connectivity is a challenge for Bhutan. In addition, the frequent occurrence of different types of natural calamities (i.e. earthquakes, glacial lake outburst flooding-GLOF, landslides, flooding and windstorms)[47] and uneven geographical topography make the task of developing transport infrastructures and maintaining them extremely expensive. This is reflected in high transportation cost along with notable loss of physical infrastructure (UNDP, 2018).[48] Due to the nature of geographic terrains, no railway connectivity is established in Bhutan while there exist very limited airport facilities. Underdeveloped trade logistical services and infrastructures coupled with poor transport network

[47] Bhutan's position in terms of techno plate.

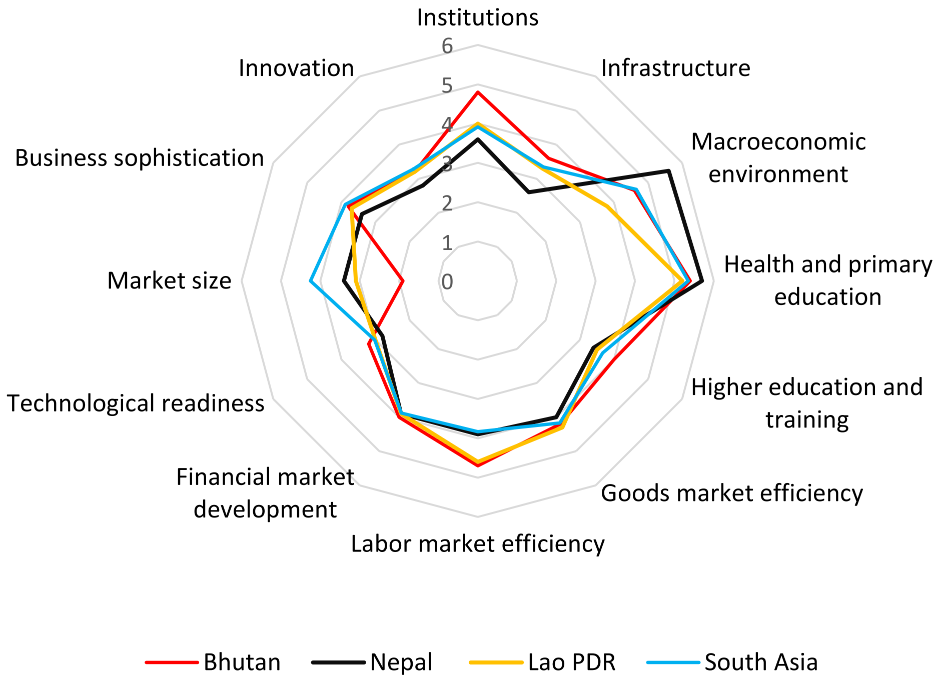
[48] https://www.un.org/development/desa/dpad/wp-content/uploads/sites/45/CDP-PL-2018-Bhutan.pdf

are regarded as impediments in generating supply-side response accessing international markets (ADB, AusAID and JICA, 2013). Reliance on second-country ports for external trade makes it exceedingly difficult for Bhutan to increase trade volume. A study by World Bank (2019) suggests that inefficiency in handling ports in neighbouring countries, limited domestic connectivity, cumbersome logistic support, etc. compound the transportation costs and thereby trade costs.[49]

Along with the above, like many other developing countries, Bhutan also has opportunities for making improvements in areas that can help augment external competitiveness. According to the Global Competitiveness Report 2017–2018, Bhutan ranks 82nd amongst a set of 137 countries. In many of the broad indicators of competitiveness, Bhutan performs better than other landlocked countries in the region and the average performance of South Asian countries. Understandably however in terms of the Logistical Performance Index (2018), Bhutan's position is amongst the lowly ranking countries: 149th out of 160 countries. Performance in many of these indicators is influenced by various structural factors and that are often beyond the control of a country. These structural bottlenecks result in diseconomies of scale with additional costs and difficulties to diversify economic activities. It is however quite striking that Bhutan does quite well in Ease of Doing Business Index where it ranks 81st with a set of 190 countries.[50] This shows Bhutan has a strong commitment to sound 'doing business' environment. As such, any further improvements in other indicators can enhance Bhutan's external competitiveness.

[49] Though exporters of Bhutan are availing efficient custom facilities along with low tariff barriers.
[50] However, Bhutan has seen its ranking in ranking in East of Doing Business slipping in the recent past three years.

Figure 17: Performance in Global Competitiveness Index 2017-18: Bhutan vs. selected countries



Source: Author's presentation from the Global Competitiveness Report (2017–2018).

Therefore, tackling infrastructure bottlenecks in Bhutan should be given utmost importance. While prioritizing, developing and maintaining infrastructure-related projects, Bhutan should focus on three interrelated issues: (i) the current state of existing infrastructure, (ii) challenges in developing and maintaining infrastructure and (iii)focusing on those projects where its priority lies (ESCAP, 2017). To expand road transport connectivity, Bhutan undertook 'The Road Sector Master Plan 2007–2027' which developed a framework comprising the areas of planning, designing, constructing and maintaining roads and related infrastructure. This plan urgently needs to be expanded to cover investments in new and existing roads at the national and district levels, capacity and institution building, operation and maintenance and regulatory-related matters (ADB, AusAID and JICA, 2013).[51] Connectivity enhancements can be achieved either by fast-tracking the construction and/or upgrading the high priority road projects. For a country like Bhutan, it has been argued that air transport and connectivity can play a significant role by providing opportunities to counter the disadvantages of road transportation and constructing linkages with regional and global markets (ADB, 2014). Bhutan can enlarge and advance its existing air transport

[51] One issue with road transport is the higher the quality the higher the cost. But, due to the limited budgetary allocation entails low quality roads which are extremely vulnerable to rainfall (Bhutan Media and Communication Institute, 2016).

systems by creating linkages with other Asian hubs and regional centres through bilateral air transport agreements which can result in the increased number of international tourists, business travellers and expanded cargo services (ADB, AusAID and JICA, 2013). Not only road and air connectivity, but Bhutan should also focus on increasing dry ports as well as upgrade trade logistics services. The 11th Five-Year Plan of Bhutan focused on improving in all these areas. Therefore, the policy attention in identifying the areas of infrastructural development has been quite appropriate. What is more important going forward is to ensure timely and effective implementation of the projects and developing new complementary projects.

Besides structural bottlenecks, youth unemployment, especially among women, is increasingly becoming a cause for concern in Bhutan (World Bank, 2019).[52] Another report by the World Bank (2019) shows that about 67 per cent of the educated youth having a bachelor's degree were unemployed in 2016. Consequently, while hydropower development has been a core element of public investment, the sector accounts for less than 1 per cent of the total labour force. Therefore, diversification of the economy led by a reinvigorated private sector along with promoting youth entrepreneurship should be a priority. Moreover, imparting technical and vocational education and training can be an effective policy option to deal with the youth unemployment problem.

Further development challenges lie in the areas of achieving quality health outcomes, especially in controlling non-communicable diseases, reducing the gap between rural-urban poverty rates with curtailing the national poverty incidence, tackling chronic malnutrition among the children under 5, rising inequality etc. It is also important to keep in mind that maintain sound macroeconomic environment and policies is always important for achieving economic growth and boosting external competitiveness. Bhutan's accumulated foreign debt (of above 110 per cent of GDP) should be carefully handled and a prudence debt management will be important after graduation.

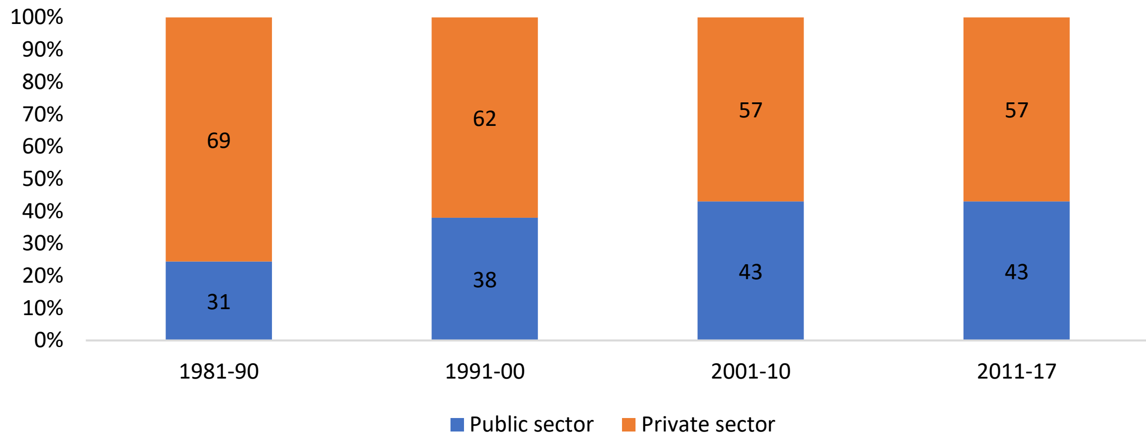
4.4 Developing a vibrant private sector

The Bhutanese economy is extremely dependent on public sector-led activities. The state-owned hydropower sector has been the dominant investment sphere over the past four decades or so (Figure 18). With the construction of the hydropower sector, the public sector's share in total investment is a staggering 43 per cent. The dominance of the public sector in combination with a high cost of doing business (due to such factors as challenging geographical terrains, inadequate infrastructures and limited connectivity) has not helped the private sector to develop. The private sector is further confronted with supply and demand-side constraints including a lack of adequately skilled workforce, limited competition, small local market, etc. (World Bank, 2019). The interactions of the smaller size of the economy with high transportation costs limit the scope for the exploitation of scale economies thereby affecting the private sector development. Furthermore, according to the World Bank Enterprise Survey 2015, difficulties in accessing finance (because of

[52] According to World Bank (2019), the youth unemployment was 13 per cent in 2016 and 12.3 per cent in 2017 respectively. See https://rtm.gnhc.gov.bt/wp-content/uploads/2019/03/Background-Report-for-14th-RTM.March_.7.19.pdf

complex financial procedures and high collateral requirements) is cited as the most important impediment for business firms to flourish.

Figure 18: Public vs. private sector investment in Bhutan (%)



Source: World Bank (2019).

Note: The public sector comprises of utility, construction and public services.

The Royal Government of Bhutan (RGoB) has undertaken various measures to encourage private sector growth. These include physical infrastructural development as well as building ICT infrastructure to enhance connectivity. To address the issue of financing, Bhutan prioritizes certain sectors (especially the cottage and small industries – CSIs) and provides loans at preferential interest rates ranging between 8 to 8.5 per cent through initiating the Priority Sector Lending (PSL) initiative.[53] The firms having access to PSL loans will automatically be entitled to exempt from income tax as outlined in the Fiscal Incentive Act 2017. To help overcome the problem of skill shortage, various skill enhancement training programmes and workshops are being undertaken. Besides, the development schemes for rural industries, supported by the Department of Cottage and Small Industries under the Ministry of Economic Affairs, are in operation to help firms procure capital goods. There is also the growing awareness of striking a balance between public and private sectors so that the private investors can be accorded with incentives to encourage them to invest more. Strengthening the incentive mechanism can stimulate private sector development (Table 14). Effective implementation of the above-stated issues and creating an enabling private investment-friendly environment will be congenial for a buoyant private sector in Bhutan.

[53] This pilot project of Priority Sector Lending (PSL) started its journey on January 2018.

Table 14: Recommendations to increase private sector growth

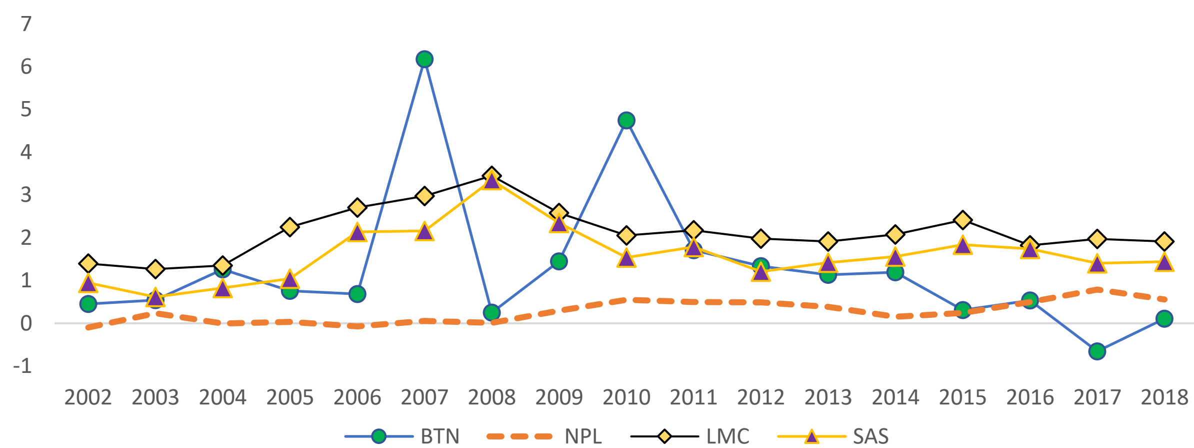
Key policies	Facilitation strategies	Timeline	
		Short	Medium
Access to finance	- Expanding the scope of collateralizable assets - Deepening and broadening credit information	√	
	- Approving and implementing new insolvency bill - Reducing risks of e-banking for customers		√
Access to labour	- Introducing a dedicated channel for skilled migration - Providing vocational training to the adult labour force	√	
	Realigning public compensation packages with the private sector		√
Access to markets	- Promoting the use of e-commerce platforms - Increasing awareness and using quality standards and certifications - Developing and implementing an investment promotion strategy	√	
	Introducing risk-based border inspections and coordinate border procedures		√
Competition	- Creating a public-private dialogue platform to provide equal access to policy feedback - Monitoring anticompetitive practices and the effect of state-owned enterprises on private investment	√	
Taxation	Increasing awareness of taxation policy and accounting standards	√	

Source: Adapted from World Bank (2017).

4.5 Attracting FDI

Attracting FDI can be a tool for investment stimulation and export diversification. The role of FDI in expanding exports and promoting diversification is well-established. The most direct impact of FDI is through employment generation, skill upgradation, and improvement in productivity. The spillover effects arising from knowledge and technology transfers and better management practices have also been widely considered as highly significant. The emergence of a global value chain (GVC) means production processes are being increasingly fragmented with many countries participating in the production of the same product. This allows for specialization in tasks without the need for having the capacity for producing the entire product. GVCs can help LDCs and developing countries to better integrate with the world market to exploit trading opportunities to stimulate economic growth (ITC, 2013). Foreign direct investment firms are widely known to be the most important vehicles for integrating into the GVCs. FDI inflows into Bhutan have been low and highly volatile. According to the recent statistics by the World Bank, the net inflow of FDI was just 0.1 per cent of GDP in 2018 (i.e. $2.6 million in absolute terms). (Figure 19). FDI inflows over the years were centred into hydropower, while non-hydro centric FDI activities were minimum (World Bank, 2019). About 70 per cent of investments are sourced from Asia, most of which are from India. In 2017, FDI companies employed 5,285 people which is about 1.4 per cent of total employment. Amongst many landlocked economies, Bhutan received the lowest FDI inflow compared in the last decade (World Bank, 2019). This low level of FDI inflow can be attributed to inadequate infrastructure, poor trade logistics services, small domestic market size, lack of adequate skilled labour, regulatory barriers, etc.

Figure 19: Net FDI inflow (% of GDP)



Source: Author's presentation using data from the World Development Indicator (WDI), World Bank.

Bhutan has undertaken policies to attract FDI inflows. This includes simplification of FDI registration and approval processes, streamlining of support services provided to investors, and improving the enabling environment to encourage the participation of the private sector. The government has also been working to create a favourable investment climate by investing in infrastructure, energy, transportation and G2B services.[54] It formed a task force to develop an investment promotion strategy to attract FDI. Currently, there is no investment promotion authority in Bhutan. There is a need for establishing investment promotion authority to formulate investment guidelines, monitoring regulatory mechanisms, and for providing well-coordinated support services to investors. Recently, the government in collaboration with the World Bank has reviewed the existing FDI policy to make it more attractive to foreign investors. Establishment of special economic zones (SEZs), free trade zones, and industrial parks can also help attract FDI. Deepening of existing investment incentives can also be helpful in this regard (Table 15). It is possible to identify potential sectors for attracting foreign investments and accord special incentives to these sectors.

[54] Sustainable Development and Happiness: Bhutan's Voluntary National Review Report on the Implementation of the 2030 Agenda for Sustainable Development.

Table 15: Existing investment incentives in Bhutan

Free Trade Zones	Incentive Scheme
✓ Bhutan operates two industrial estates: the Pasakha Industrial Estate (272 acres) located in Chhukha district (southern Bhutan) and Bjemina Industrial Estate (34.4 acres) located in Thimphu district (western Bhutan). ✓ Three new industrial zones are in the planning phase, which is going to be located in Samtse, Samdrup Jongkhar and Lhamoizingkhain in Dagana.	- General business incentives (not limited to the industrial estates) include: - Sales tax and customs duties exemption on manufacturing and service industries for the import of plants and machinery - Sales tax exemption for permissible raw materials and primary packaging materials used by all manufacturing industries - Income tax exemption on earnings in the convertible currency of business enterprises - Tax holidays for industries operating in suburban and remote areas - Tax rebates for technological upgrades beyond the minimum standard required by law - Industries that maintain higher environmental standards than legislated are provided additional incentives

Source: Adapted from HKTDC (2019).

4.6 Taking advantage of LDC graduation issues to look for better market access opportunities through using the ports of neighbouring countries

The most of Bhutan's external trade with countries other than India is conducted through the Indian ports especially the Kolkata Port. This singular dependency on a seaport for third-country trade makes Bhutan vulnerable. Moreover, Bhutanese exporters are facing multidimensional challenges in Kolkata Port due to the infrastructural bottlenecks (i.e. increased lag and lead time) (World Bank, 2019). Therefore, exploring opportunities to use additional ports of any other country can help leverage the benefit of seaports. This will provide an opportunity to diversify port usages subject to the location of third-country trade destinations. Bhutan can explore the possibility of using Mongla and Chattogram ports in Bangladesh. This could generate cost advantages, as the cost of transportation and charges in Kolkata port are perceived to be high. Bhutan has already shown its interest to use Mongla port of Bangladesh. It should effectively pursue with the Government of Bangladesh to have the transit facilities using this port.

Landlocked developing countries can access to seaports through leasing as well as building seaports in the nearby countries having maritime frontiers. This can significantly reduce transportation costs. Bhutan can learn from the experience from other landlocked countries using third country seaports for trade. Mongolia – an Asian landlocked country, for instance – have access to both Chinese and Russian seaports.

V. Conclusion

Bhutan successfully met the LDC graduation criteria two times consecutively in CDP triennial reviews of 2015 and 2018 and is set to graduate from the groups of LDCs by 2023. Despite having unfavourable circumstances, largely due to its geographical location, it has achieved remarkable socio-economic progress. LDC graduation involves the loss of certain trade preferences and other international support measures. However, as the significance of these benefits has been quite limited for Bhutan, the transition from LDC to non-LDC status should not be a major cause for concern. Bhutan already has a policy framework to tackle development challenges and to achieve sustainable development goals (SDGs). Strengthening of the policy measures and the effective implementation of various development programmes will be the pragmatic way forward for Bhutan.

Most LDC-specific privileges are related to international trade, in which Bhutan has limited participation because of its being a landlocked country, prompting excessive trading costs. Bhutan will, however, continue enjoying the same level of market access that it currently enjoys in much of its trade. India is by far the largest trading partner where market access conditions are secured through a bilateral trade agreement. Furthermore, it is also expected that the market access conditions in Bangladesh, which is another relatively important and emerging market for Bhutan, will not be affected. After graduation, Bhutan should apply for GSP Plus facilities in the EU. If successful, the EU market access will also largely remain unchanged. In other markets, LDC graduation can lead to considerable tariff increase but as Bhutan has a very limited export presence in those countries, one should not expect any major adverse consequences.

Overseas development assistance is important for Bhutan although its significance, measured as a proportion to GDP, has fallen over the past decade or so. Graduation should not have much implication for development financing as development partners do not use LDC status as an important factor in deciding about aid allocation. However, accessing certain LDC-related funds such as LDC climate change fund (LDCF) and Enhanced Integrated Framework (EIF) will have to be discontinued after the relevant transition periods.

Notwithstanding the potential implications of graduation, addressing the general development challenges should continue to be a major policy issue. Bhutan has put in place a policy framework that identifies policy priorities and action plans to achieve the Sustainable Development Goals. Successful implementation of this policy will require building productive capacities and boosting external competitiveness. Such sectors as tourism, agribusiness, ICT and hydropower have huge potential for developing supply-side capacities and generate employment opportunities particularly for the youth. Major obstacles to inject dynamism in these sectors include lack of investment, infrastructure deficit, and poor connectivity. Diversification of the economic activities is a challenge for which one priority attention should be on developing the private sector.

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