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# 1. Introduction

Bhutan is expected to graduate out of least developed country (LDC) status in 2023, following the country's request to the United Nations for the graduation date to coincide with the end of the implementation of Bhutan's 12th Five-Year Plan (12 FYP). The country is scheduled to graduate on 13 December 2023 (CDP, 2018a). In granting the five-year preparatory period, the General Assembly asked Bhutan to prepare its national smooth transition strategy. Given this backdrop, the smooth transition strategy can be expected to cement the gains from the 12 FYP, complement the overall national development strategy and configure the implementation of the 13 FYP.

Considerable uncertainty remains about the extent of the socio-economic damage from the ongoing COVID-19 crisis on economies worldwide. What is immediately evident is that the containment measures, including the nationwide lockdown in Bhutan, brought large parts of the economy to a standstill, decelerating the country's economic growth. The strategy can thus be expected to build on and seek synergies with Bhutan's COVID-19 national response programmes, including the Economic Contingency Plan, Four Point Formula for boosting recovery from the COVID-19 crisis, and the 21st Century Economic Roadmap being developed with the aim of charting the long-term development vision for the country. This vision encompasses the leveraging of technology and innovation and empowering all citizens to achieve well-being improvements.

This report is intended to propose key elements for consideration by the Royal Government of Bhutan (RGB), its development and trading partners, and other interested stakeholders, as the country seeks to develop a national smooth transition strategy. Bhutan's national smooth transition strategy is expected to accord special consideration to the challenges that pose a potential hindrance to Bhutan reducing its economic and natural vulnerabilities and adjusting to the loss of LDC-associated benefits. It is also expected to consider the support that Bhutan could receive from the United Nations system in cooperation with Bhutan's bilateral, regional and multilateral development and trading partners during the transitional period to enhance the country's ability to adapt to functioning in the global economic and trade landscape post-graduation. The report thus identifies and discusses LDC-associated benefits that are likely to be vital for Bhutan's continued growth and development and that merit being retained beyond graduation to avoid a roll back on Bhutan's development gains and the disruption of the country's current development trajectory.

# 2. Background to LDC Graduation

The creation of the LDC category in 1971 was underpinned by the recognition of the structural impediments hindering these countries from achieving their development aspirations. LDCs are expected to graduate to developing country status once they have attained a level whereby, they no longer require LDC-specific support from the international community. Graduation from LDC status represents a significant milestone for Bhutan.

The United Nations defines LDCs through an assessment of their scores for gross national income (GNI) per capita, the Human Assets Index (HAI) and the Economic and Environmental Vulnerability index (EVI) against graduation thresholds.[1] The GNI threshold for graduation from LDC status stands at US$ 1,222 as of 2021. The HAI is composed of indicators for the under-five mortality rate, the maternal mortality ratio, the prevalence of stunting, the gross secondary school enrolment ratio, the adult literacy rate and the gender parity index for gross secondary school enrolment. Its graduation threshold is set at 66. The EVI is composed of indicators of share of agriculture, hunting, forestry and fishing in GDP, remoteness and landlockedness, merchandise export concentration, instability of exports of goods and services, share of population in low elevated coastal zones, share of the population living in drylands, instability of agricultural production, and victims of disasters. The EVI graduation threshold is set at 10 per cent below the inclusion threshold at 32 (or below). For a country to graduate from LDC status, it must exceed the graduation threshold for at least two of the above criteria in two consecutive United Nations Committee for Development Policy (CDP) triennial review periods. A country can also be recommended for graduation if its GNI per capita rises to twice the set threshold, regardless how it has performed in the other two criteria.

Special international measures (ISMs) were developed to support countries in the LDC category to meaningfully benefit from the global economy and transform into advanced economies. United

1 https://www.un.org/development/desa/dpad/least-developed-country-category/ldc-graduation.html.

Nations General Council Resolution A/RES/59/209[2] identifies the broad range of ISMs for a smooth transition, which can be clustered into official development assistance (ODA), trade-related measures such as LDC-specific preferential market access, and other means such as travel-related benefits. The Resolution also encourages development partners to aid the transition of graduating LDCs and circumvent immediate disruptions in the assistance given to a graduating country. It also urged trading partners to preserve trade preferences or to phase them out in a gradual manner to allow the graduating country to adapt to preference erosion. Furthermore, World Trade Organisation (WTO) members are encouraged to consider extending special and differential treatment (S&D) and exemptions to graduated countries to help them to participate meaningfully in the multilateral trading system.

In 2011, the Fourth United Nations Conference on the Least Developed Countries (LDC-IV) adopted the Istanbul Declaration mandating that the LDC graduation process 'should be coupled with an appropriate package of incentives and support measures so that the development process of the graduated country will not be jeopardised.'[3] The United Nations Member States at the Conference also agreed 'to work on the development and implementation of smooth transition strategies for graduating and graduated LDCs'.[4] Subsequently, with the support of the United Nations system and in cooperation with its development and trading partners, the graduating country may prepare a smooth transition strategy to be implemented in preparation of the country's graduation.[5] The purpose of the smooth transition strategy is to ensure the full adaptation of the graduating country to the phasing out of LDC-specific support measures, as well as to identify practical actions that can be taken by the graduating country, its development and trading partners and other stakeholders, such as the United Nations system, to ensure successful graduation. Because the Istanbul Declaration restricts incentives and support measures to the development and implementation of smooth transition strategies, the United Nations has increased its focus on supporting graduating countries to adapt to functioning in the post-graduation environment to avoid countries sliding back to LDC status. Effectively, this justifies concern for LDCs to achieve graduation with the necessary development momentum to continue to advance their structural economic transformation to ensure sustainable progress economically and socially (UNCTAD, 2016).

### *Bhutan's performance under graduation thresholds*

Bhutan can be said to have made rapid progress towards graduation. With a spectacular rise from 19 per cent of the graduation threshold in 2000 to 183 per cent in 2015 and 239 per cent in 2020,[6] Bhutan has demonstrated the fastest progress among non-oil exporting LDCs under the GNI per capita criterion. Between 2007 and 2010, the annual income of the country (based on the gross domestic product/GDP) grew at an average rate of 10 per cent, thereby reflecting a diversification pace which remains unique in the economic history of LDCs (UNCTAD, 2018a). The CDP noted in its February 2020 Monitoring Report of countries that are graduating and have graduated from the list of LDCs, that Bhutan's GNI per capita has been growing fast and was estimated as $2,941, which was more than double the LDC graduation threshold (CDP, 2020).

Bhutan's HAI score has also shown rapid improvement and stood at 72.9 at the time of the CDP's triennial review in 2018 and has continued to improve since then. The HAI score exceeded the threshold of 66 in 2013 and has increased ever since. For 2020, the HAI is 77.5, which constitutes further improvement by 0.9 score points since 2019. Bhutan has not been able to meet the EVI criterion, giving cause for concern about whether its economic vulnerability can improve after graduation. The EVI stood at 35.4 in 2020, having improved slightly from 2018 (36.2), but remains above the graduation threshold established at 32 or below by the 2018 review. Bhutan has invested considerably in human capital and the provision of free education and health services, which has contributed to improved human development. However, given the current fiscal pressures and the geographical disparities that exist, there is a need to explore ways of investing in people's capabilities to enhance productive capacities and simultaneously improve social inclusion and economic growth.

2 Resolution adopted by the General Assembly on 20 December 2004, 25 February 2005, A/RES/59/209.

3 Draft Istanbul Declaration: Renewed and strengthened global partnership for the development of least developed countries, 12 May 2011, A/CONF.219/L.1.

4 Ibid.

5 Resolution adopted by the General Assembly on 21 December 2012, 26 March 2013, A/RES/67/221.

6 Data as of 19 February 2020; see https://www.un.org/development/desa/dpad/wp-content/uploads/sites/45/CDP-excerpt-2020-4.pdf.

The methodological and statistical lens used by the United Nations to assess performance under graduation thresholds requires complementary analysis to ascertain a more comprehensive picture of Bhutan's vulnerabilities. Like other LDCs, Bhutan has suffered far lighter health-related impacts from the COVID-19 pandemic than developed countries but is likely to pay a heavy price in terms of lasting economic impacts. Following the official confirmation of Bhutan's first COVID-19 case on 6 March 2020, the Royal Government of Bhutan executed containment and preventive measures that encompassed the restricted entry of foreign tourists and workers, as well as a 21-day mandatory quarantine requirement as of 31 March 2020. Other measures included the closure of borders, the closure of schools and a prohibition on public gatherings. A three-week national lockdown was instituted from 11 August 2020.[7] As of 12 December 2020, the National Situational Update reported zero deaths with a total of 436 confirmed cases, out of which 396 recovered and 40 were housed in quarantine facilities.

[7] At the time of finalizing this report in December 2020 and beginning January 2021, Bhutan had reinstated the national lockdown.

## 3. Development Trajectory

The country's development path is guided by five-year planning (FYP) cycles that lay out the socio-economic development priorities and objectives for each five-year implementation period. The first FYP launched in 1961 focused on infrastructure development to reduce Bhutan's isolation. More recently, the 11th and 12th FYPs have targeted LDC graduation and the Sustainable Development Goals (SDGs), the latter having strong synergies with Bhutan's philosophy of Gross National Happiness (GNH). For example, 16 SDGs were integrated into the 11 FYP (RGB, 2018a; Wangmo, 2016). Compared to the 11 FYP, the 12 FYP has a focus on the diversification and strengthening of Bhutan's economic base (Box 1) and integrates SDG targets and indicators.

Bhutan relies on external aid, including bilateral and multilateral assistance, to sustain the country's rising capital expenditure. For example, ODA constituted

**Box 1 Summary of 12 FYP goals**

Crafted in the context of the pursuit of GNH, the 12 FYP seeks to enhance citizens' well-being and happiness. The overall objective of the Plan is to achieve a "just, harmonious and sustainable society through enhanced decentralisation" is anchored on Bhutan's principle of leaving no one behind and narrowing the gap between the rich and poor to ensure equality and justice.

The 12 FYP outlines several strategies which include: (i) creating an investment-enabling environment to attract foreign direct investment (FDI); (ii) promoting and supporting cottage and small industry (CSI) production of high value-added products; (iii) diversifying the tourism sector and promoting Bhutan as a high-end tourist destination; (iv) diversifying into allied hydropower industries; (v) enhancing, mitigating and adapting to climate change; (vi) strengthening preparedness and response to both natural and man-made disasters; (vii) promoting entrepreneurship; (h) skills development; and (viii) leveraging information and communication technologies (ICTs) as an enabler and an industry (RGB, 2019).

With respect to the goal of enhancing economic diversity and productive capacities, emphasis is placed on developing industries other than hydropower. Economic diversity, enhanced productivity, education and skills quality were introduced as new national key result areas (NKRAs). Five priority sectors, namely agriculture, CSI, hydropower, tourism and mining, are identified for the pursuit of expanded domestic production and reduced import dependency.

The priority areas for a sustainable society are:

(a) Ensuring renewable energy supply
(b) Ensuring macro-economic stability
(c) Enhancing economic diversity and productive capacities
(d) Securing water, food and nutrition security
(e) Improving efficiency and effectiveness of public services delivery
(f) Preserving cultural authenticity
(g) Ensuring community vitality

*Source:* RGB (2019) and World Bank (2018b).

more than 55 per cent of the 11 FYP total capital expenditure and 54 per cent of the 12 FYP total capital expenditure. External grants accounted for 50 per cent of capital spending in 2018. Most grants (50 per cent) are extended by India, underlining the role of South-South Cooperation. The European Union, Japan, the World Bank, the Asian Development Bank (ADB) and United Nations agencies are other significant sources of grants. In 2018, the top four sources of development finance were India, the World Bank, the ADB, and the European Union (Table 1).

Bhutan is a landlocked least developing country (LLDC) facing several challenges and limitations to development. The country faces considerable economic vulnerabilities, including from natural disasters. Characterised by a mountainous topography, small and dispersed population, small domestic market, industry in its early stages of development, limited access to international markets, and a limited range of products that meet international standards, the country embodies most of the characteristics of a small, vulnerable economy.[8] Having a small domestic market limits Bhutan's growth potential, making it imperative for the country to develop sustainable access to stable global markets.

Bhutan has sustained an annual average GDP growth rate of 7.6 per cent since 1981 — the third highest in the world — driven mainly by the state-led hydropower sector (World Bank, 2018a and 2019a; RGB, 2019). Although GDP growth fell to 3 per cent in 2018, due to delays in hydropower construction and a reduction in electricity generation, it recovered to 5.5 per cent in 2019. The 12 FYP had projected an average annual real growth rate of 6-7 per cent during the plan implementation period. Following the nationwide lockdown in August 2020, GDP growth — previously forecast at 6.9 per cent in 2020 — was projected to nosedive to -6.1 per cent following the August 2020 lockdown,[9] the lowest ever in Bhutan's economic history. Estimates place the economic loss across all sectors at around Nu 3.4 billion in 2020.[10] This will have knock-on impacts on tax revenue (compounding revenue losses from diminished trade due to global COVID-19 containment measures implemented globally) and the fiscal space available for the Government's continued ability to provide stimulus packages and social grants for the duration of the pandemic and beyond. Like most LDCs, Bhutan is a price taker for its main commodity exports (Table 2), which makes the economy vulnerable to global price fluctuations and other trade shocks. Growth is projected to recover to 4.3 per cent in 2021, contingent on the continued support extended by the Government to productive sectors and the population.

Bhutan's development success is marked by a dependence on natural resources-based activities, such as hydropower generation and tourism (Bhutan's rich biodiversity and cultural heritage being unique assets), with a relatively limited degree of manufacturing. Thus, the rapid rise of per capita income evidenced by the evolution of Bhutan's GNI per capita likely signals a form of quick prosperity that can hide structural impediments to economic diversification. Capital-intensive hydropower generation has been the main area of commercial investment and the mainstay of development, contributing about 30 per cent to the GDP in 2018, and generating spillover effects in terms of the emergence of energy-intensive industries, such as ferrosilicon, iron, steel, and the chemicals and construction sector growth. Perhaps the biggest concern for Bhutan is the impact of climate change on economic development, and the possibility of impacts rolling back the gains from developmental progress.

Adverse weather events could negatively affect electricity generation from existing plants and, in turn, affect energy-intensive industries, and reduce tourist inflows. However, the link between high energy-intensive manufacturing and the hydropower sector means that much of Bhutan's manufacturing and small export basket is vulnerable to natural shocks on the hydropower sector in the light of increased climate-change impacts. For example, unfavourable weather in 2018 resulted in a 9 per cent decrease in the export of electricity due to a 3 per cent decrease in the production of hydropower, which were compounded by a 66-per-cent increase in the domestic manufacturing demand for energy (World Bank, 2018b).

In 2018, the services sector (mainly tourism-related activities) contribution to GDP was estimated at 42 per cent. The share of agriculture in GDP dropped from 43 per cent in 1980 to 17 per cent in 2017,

8 LLDCs face greater obstacles to graduation because their geographic remoteness and vulnerability to the economic and political vagaries of transit countries for the movement of goods in and out of their own countries presents additional challenges that make their economies perform considerably less well compared to other LDCs (UNCTAD, 2016).

9 June 2020 estimates, *Budget 2020-21, Ministry of Finance*.

10 Prime Minister's State of the Union address during the 2020 winter session of Parliament.

while the share of industry has increased from 12 per cent to 41 per cent during the same period, as the country embarked on structural transformation and economic diversification. However, there has not been a commensurate shift in the workforce from agriculture to manufacturing (RGB, 2019).

The tourism sector is projected by the 12 FYP to average 8.3 per cent growth during the implementation period. Tourism is a key growth driver and a major source of hard currency earnings after hydropower. Around 16 per cent of the country's working population[11] are employed directly in this sector or in allied activities; tourism represents a major source of employment opportunities for a growing number of the youth. Bhutan's long awaited Tourism Policy (pending final approval at the finalization of this report) is expected to drive the adoption of the 'high-value low-volume' approach intended to place the sector on a stronger growth trajectory that focuses on quality and environmental sustainability post COVID-19. Bhutan is regarded as one of the most exclusive travel destinations in the world and enjoys a reputation of authenticity, remoteness, and a well-protected cultural heritage and natural environment. Planned initiatives under the new policy include boosting eco-tourism, operationalising a plan for year-round tourism and diversifying beyond cultural tourism, promoting Bhutan as an exclusive tourism brand, improving tourism sites, and encouraging a regional balance of tourism within the country. The Tourism Levy Act of Bhutan 2020 was passed and became effective in July 2020. Under this Act, regional tourists are also required to pay the Sustainable Development Fee (SDF) of Nu 1,200 per person per night paid by international visitors and enjoy the same level of services and exemptions provided to international tourists.

Table 1

**Main sources of development finance in 2018**

| Source | Per cent share |
|---|---|
| India | 52 |
| World Bank | 11 |
| Asian Development Bank | 5 |
| European Union | 5 |
| Others | 6 |

*Source:* Bhutan National Budget Financial Year 2019-2020.

The sector was immediately and disproportionately affected by the ongoing COVID-19 crisis with multidimensional socio-economic impacts transmitted to tourism-related and allied sectors. The sector itself was brought to a standstill. According to a rapid assessment undertaken by the National Statistics Bureau from 2–16 April 2020, 32 per cent of employees in the sector lost their jobs or took involuntary leave without pay. For most households surveyed, 63 per cent had income from tourism as their only source of livelihood, 74 per cent reported a significant drop in income (declines of more than 50%), and many had no other source of subsistence or means to carry them through the crisis.[12]

Table 2

**Bhutan's top 5 exports**

| BTC Heading Description | Commodity Description | % of total exports |
|---|---|---|
| Ferroalloys | Containing by weight more than 55% of silicon | 42 |
| Granite, porphyry, basalt, sandstone and other monumental or building stone, whether roughly trimmed or merely cut, by sawing or otherwise, into blocks or slabs of a rectangular (including square) shape. | Boulders | 6.9 |
| Semi-finished products of iron or non-alloy steel. | Other of rectangular (other than square) cross-section | 4.6 |
| Dolomite, whether calcined or sintered, including dolomite roughly trimmed or merely cut, by sawing or otherwise, into blocks or slabs of a rectangular (including square) shape; dolomite ramming mix. | Dolomite, not calcined or sintered, chips | 4 |
| Portland cement, aluminous cement, slag cement, super sulphate cement and similar hydraulic cements, whether coloured or in the form of clinkers. | Portland pozzolana cement | 3.5 |

*Source:* Bhutan Trade Statistics 2018, and the Bhutan Trade Classification and Tariff Schedule 2017.

11 As reported in the December 2020 Parliamentary Session by the Foreign Minister, in his capacity as Chairperson of the Tourism Council of Bhutan (TCB).

12 See https://www.undp.org/content/dam/bhutan/2020/RSEIA%20report%20final%20v%20web%2018th%20May%202020%20(002).pdf.

The economic fallout from COVID-19 on the tourism sector spread to other key sectors, such as construction and manufacturing; industrial production is suffering from severe supply chain disruptions, rising input and transaction costs, and labour shortages due to restrictions imposed on foreign workers, on which these sectors are dependent. As a result of pandemic-related restrictions, the supply of both skilled and unskilled workers fell short by 41 per cent. According to the Ministry of Labour and Human Resources (MoLHR), in June 2020, total demand for foreign workers across the country stood at 35,567, of which 53 per cent were skilled workers. Labour shortages also had negative implications for 12 FYP capital projects and programmes, much of whose activities were frontloaded in the 2020/21 fiscal year. Five months into the 2020/21 fiscal year, only 6 per cent of the capital budget[13] had been used due to prevailing shortages in the supply of workers and inputs. Resultant delays in implementation will likely contribute to foreign labour bottlenecks in the post-pandemic period, as domestic labour is unlikely to pick up the slack.

Bhutan's export market is highly concentrated, with India accounting for about 70 per cent of Bhutan's exports (Table 3), rendering the country highly vulnerable to exogenous shocks from India. For example, when India introduced its Goods and Services Tax (GST)[14] in 2016, Bhutan's cement industry exports to India were adversely affected (RGB, 2018b).[15]

Table 3

**Bhutan's Top 10 Export Markets**

| Country | Export Market share % |
|---|---|
| India | 70 |
| Bangladesh | 19 |
| Italy | 3 |
| Netherlands | 2 |
| Nepal | 2 |
| Germany | 1 |
| Spain | 0.41 |
| Hong Kong | 0.34 |
| Turkey | 0.33 |
| Singapore | 0.32 |

*Source:* Bhutan Trade Statistics 2018 (Ministry of Finance, 2018).

Bhutan faces a considerable challenge in achieving the large-scale production of goods for export and must rely on niche markets to compete with its neighbours, such as China and India. The competitiveness of Bhutan's exports on the international markets is further constrained by underdeveloped trade infrastructure and high transport costs, owing to Bhutan's unfavourable geographical terrain. Figure 1 shows that in the past decade, Bhutan has not been able to significantly increase the value of its total trade in goods and services compared to, for example, other LDCs in the South Asia region, such as Nepal.

Over the past decade, except in 2007 when electricity exports to India increased following the completion of the Tala Hydropower Project, Bhutan has experienced trade deficits (Table 4). The trade balance for financial year 2018–2019 was expected to be -9.1 per cent of GDP (Ministry of Finance, 2019a). The trade deficit has contributed to the country's current account deficit, which in turn, poses macroeconomic challenges and leads to a shortage of foreign exchange, hampering medium to long term macroeconomic stability.

Despite the constraints on trade, it has played an essential role in the development of Bhutan. Figure 2 shows that since 2012, the trade contribution to GDP has remained above 75 per cent and albeit at a declining trend, has been an important development driver, helping to raise living standards and contributing to full employment.

Amidst the COVID-19 crisis, Bhutan and Bangladesh signed a preferential trade agreement (PTA) that added an additional 16 products onto the duty-free exports list to the 18 products covered by a pre-existing agreement. This initiative is expected to boost bilateral trade between the two countries and potentially incentivize economic diversification and expand non-hydro exports.

India agreed[16] to open four new trade points in Nagarkata, Agartala, Jogighopa and Pandu, availing alternative trade routes to India and facilitating trade transit to Bangladesh. The new riverine ports of Jogighopa and Pandu are located in Assam, where the Dhubri port previously served as the single transit route between Bhutan and India. These developments potentially enhance logistical

13 As reported in the December 2020 Parliamentary Session by Finance Minister.

14 The GST is a destination-based tax charged at each point of sale. The GST is levied on the supply of goods and services and works as a replacement for several indirect taxes, including value-added-tax (VAT), excise duty, service tax etc.

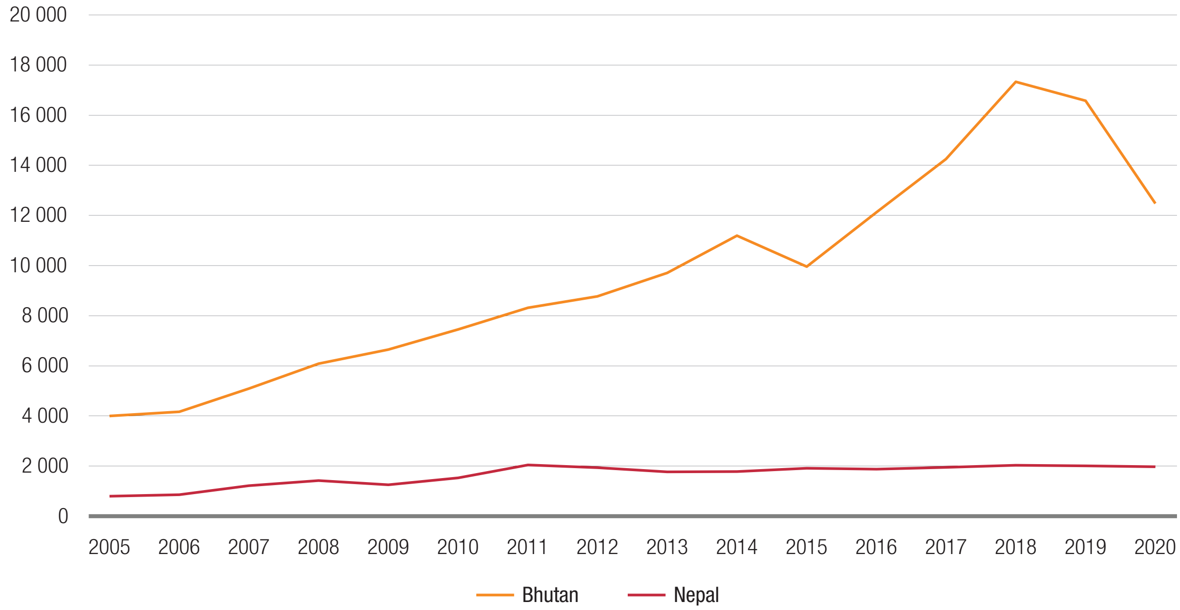
15 https://www.un.org/development/desa/dpad/wp-content/uploads/sites/45/CDP-PL-2018-Bhutan.pdf.

16 *Kuensel*, December 4, 2020 issue.

Figure 1

**Total Trade in Goods and Services**

(US Dollars at current prices, in millions)




*Source:* UNCTADStat.

Table 4

**Overall Balance of Trade, Total Trade in Goods and Services**

(US Dollars at current prices in millions)

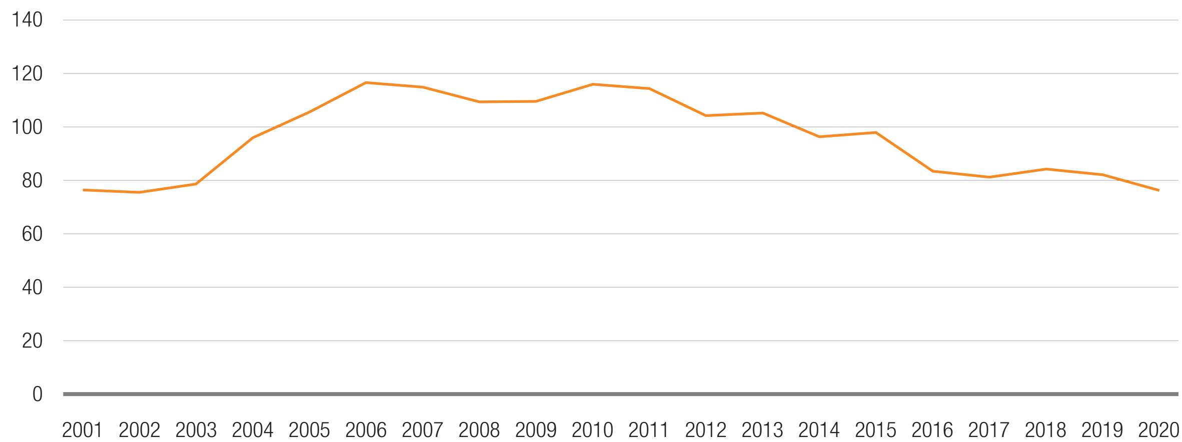
| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Exports | 254 | 364 | 637 | 654 | 574 | 590 | 746 | 729 | 668 | 659 | 707 | 642 | 716 | 782 |
| Imports | 543 | 499 | 586 | 766 | 682 | 935 | 1 305 | 1 208 | 1 101 | 1 118 | 1 204 | 1 237 | 1 235 | 1 256 |
| *Balance* | *-289* | *-135* | *51* | *-112* | *-108* | *-345* | *-559* | *-479* | *-433* | *-459* | *-497* | *-595* | *-519* | *-474* |

*Source:* UNCTADStat.

Figure 2

**Total Trade**

(% of GDP)




*Source:* World Bank World Development Indicators.

efficiency in terms of time and cost, and encourage bilateral trade with India and other countries.

Bhutan places increasing importance on the development of cottage and small industries[17] (Box 1). In this regard, the 2019 CSI embodies measures intended to update the 2012 CSI policy and improve the regulatory environment to spur the growth of CSI and the diversification of the economy. The share of industry (inclusive of electricity generation) in GDP had risen to 40.6 per cent by the end of the 11 FYP implementation, but the share of manufacturing remained very small at just 11 per cent of total CSIs, with most engaged in the production of low value-added products. Constituting about 95 per cent of total industries in Bhutan, the CSI play an essential role in the growth and development of the domestic economy, creating employment, driving innovation and reducing poverty.

The 2019 CSI Policy aims to realign the sector with the changing business environment, stimulate investment and enhance the growth of the sector (Ministry of Finance, 2019b). With cottage and small industries accounting for 90 per cent of non-hydro productive activities in 2018, the COVID-19 crisis has dealt a heavy blow on a still nascent productive base and seriously damaged the export of non-hydro goods and services. Smaller firms are, by default, less resourced and have severely limited ability to withstand shocks. This has negative implications for the 12 FYP goal of expanding and diversifying the country's economic base, diminishing the reliance on imports and narrowing the country's trade deficit.

As part of its policy shift towards improving the country's investment climate, Bhutan has undertaken regulatory reforms aimed at improving processes related to starting a business, access to credit, property registration and the enforcement of contracts. As a result, Bhutan outperformed its regional neighbours, such as Bangladesh and Pakistan, in the World Bank's ease of doing business rankings. Ranked at 75 out of 190 countries in 2018, Bhutan was the best-ranked country in the South Asia region and remains among the best-ranked countries in the region (World Bank, 2019a). More recently, Bhutan has eased the payment of taxes and pledged to redouble efforts to further improve the country's business and investment climate through additional reforms, such as measures to refine construction permits, strengthen credit bureaus, improve land registration and identify ways to protect minority investors.

The Foreign Direct Investment Rules and Regulation 2019 is expected to attract FDI into and enhance growth of the CSI sector by opening the space for FDI joint ventures with local partners in specific small-scale production and manufacturing activities, and thereby contribute to building a resilient and diversified economic base, including through encouraging the adoption of new technology, skills acquisition, and fostering enhanced market access.[18] The minimum level of FDI participation is set at Nu 5 million, with maximum foreign investor's equity capped at 49 per cent. The new FDI policy also proposes to fast track approval and clearance of FDI in select small-scale production and manufacturing activities once it comes into effect.

However, for the past two decades, overall inflows of FDI to Bhutan have been quite limited, averaging about US$ 16 million annually since 2000. In 2016 and 2017, FDI inflows turned negative US$ -7 million and US$ -10 million respectively and recovered in 2018 at US$ 6 million.[19] FDI inflows to Bhutan are significantly lower than FDI flows to other LDCs in the South Asia region. The limited inflow of FDI is partly due to Bhutan's small size and the preponderance of state-owned enterprises.

### *Productive capacities*

Bhutan has achieved steady progress in the evolution of the United Nations Conference on Trade and Development's (UNCTAD) Productive Capacities Index (PCI) score over the last two decades, maintaining a trajectory of productive capacities accumulation that outperforms other LDCs and South Asian economies (Figure 3). By 2016, Bhutan had closed the performance gap with other developing countries (ODCs — i.e. non-LDC developing countries).

A full understanding of the significance of Bhutan's PCI performance and the material change in productive capacities accumulation requires a deeper analysis of the individual trajectories of the eight components of the PCI (Figure 4).

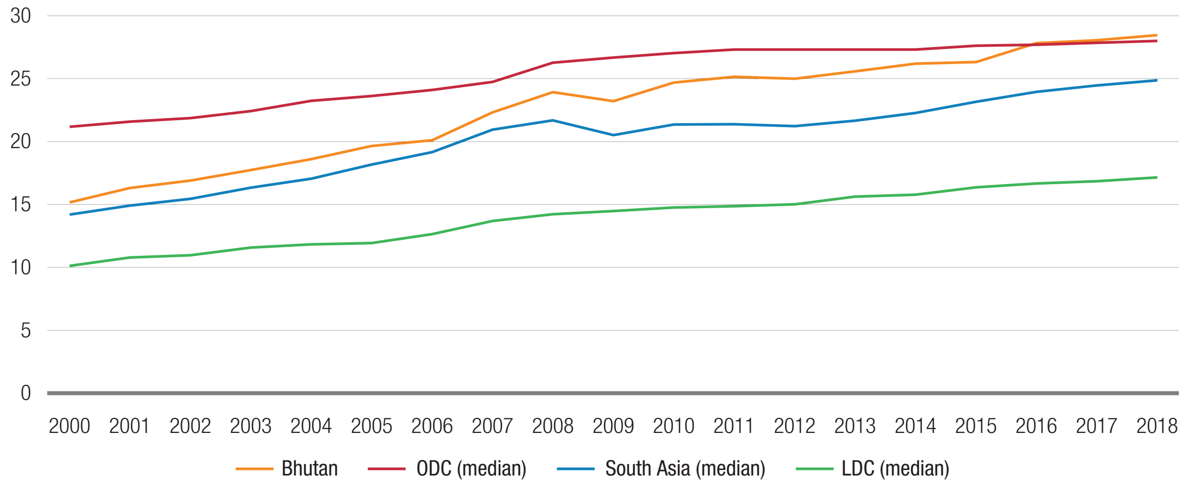
[17] Cottage industries are those having an investment of less than Nu 1 million and employing up to 4 people, while small industries are those that employ between 5 to 9 people, and with an investment ranging from Nu 1 million to Nu 10 million.

[18] The activities are listed in Schedule III of Bhutan's FDI Rules and Regulations 2019 and include agro-based value-added processing, using locally produced products. The priority lists of manufacturing and services sectors are found in Schedule I and Schedule II.

[19] https://openknowledge.worldbank.org/bitstream/handle/10986/32292/Bhutan-Attracting-Foreign-Direct-Investment-Policy-Notes.pdf?sequence=1&isAllowed=y.

Figure 3

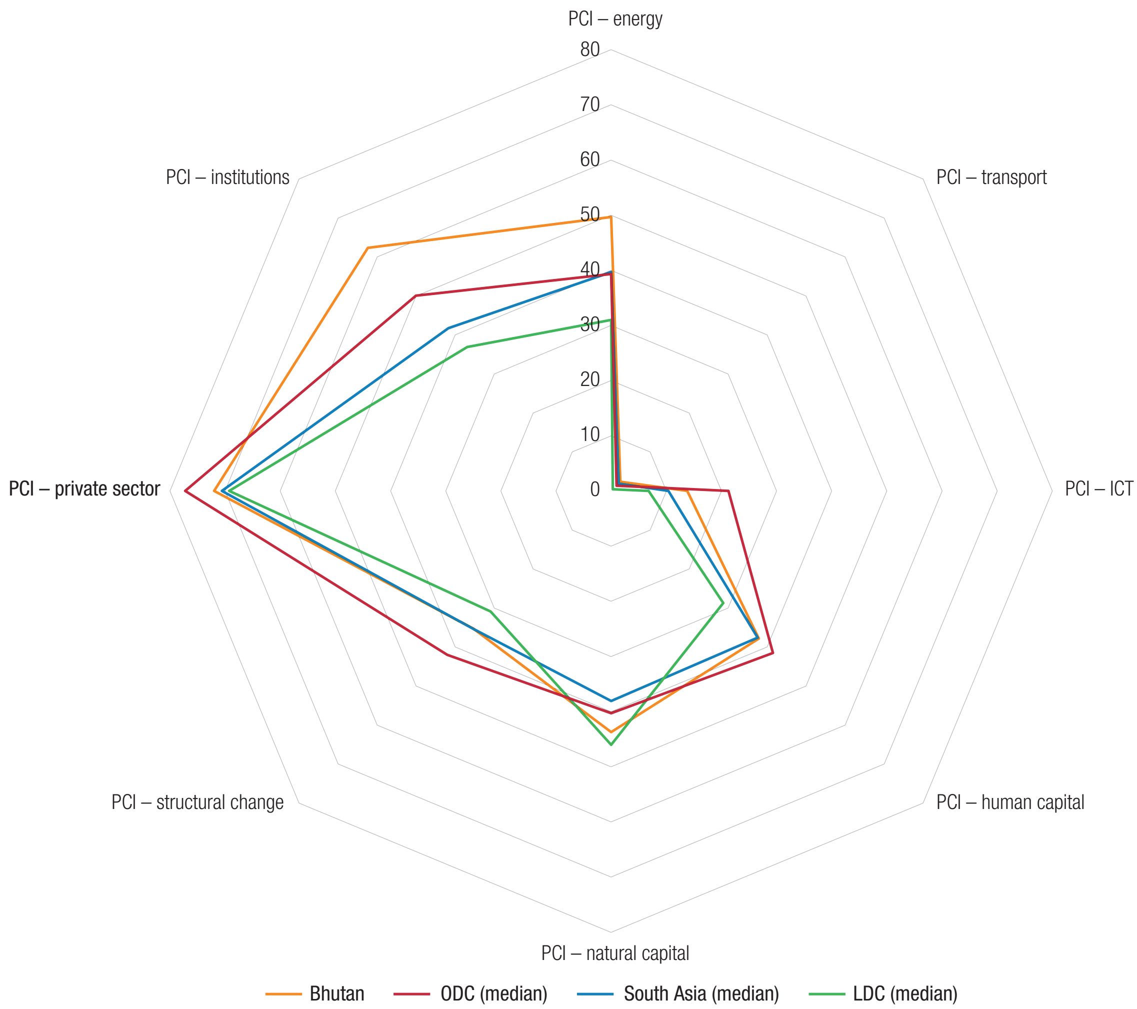
**Productive capacity index for Bhutan and related benchmarks**




*Source:* UNCTAD secretariat calculations, based on data from UNCTAD (UNCTAD, Forthcoming).

Figure 4

**Components of the Productive Capacity Index for Bhutan and related benchmarks, 2018**




*Source:* UNCTAD calculations, based on data from UNCTAD (2020a).

Bhutan outperforms other LDCs, countries in South Asia and other developing countries on energy and institutions, but the country performs weakest in areas such as the private sector. Moreover, the data reveals that regardless of the overall improvement in infrastructural components (ICT, energy and transport), owing to large investments in road and telecommunications networks, deficiencies in links to external and internal markets remain.

Significantly, according to the most recent 2018 World Bank Logistics Performance Index (LPI), Bhutan has one of the weakest logistics performance (second to Afghanistan) — scoring particularly low on the quality of trade and transport related infrastructure — among South Asian countries and showed a marked deterioration in ranking, down from 128 in 2010 to 149.[20] The country records deficits in transport and trade logistics, and physical and digital connectivity between major urban centres and remote areas. These represent fundamental bottlenecks for trade and domestic economic activity, and obstruct the development of value chains, including farm-to-market connectivity. In regard to ICT and IT-related services, progress has been very slow despite an ICT policy and strategy being in place and the recognition of telecommunications and broadband internet connectivity as important contributors to economic growth. Internet use rose from 0.4 per cent in 2000 to 48 per cent of the population in 2017,[21] but Bhutan's ranking slipped from 119 to 121 out of the 176 countries ranked by the International Telecommunications Union's 2017 Global ICT Development Index.[22]

Addressing trade facilitation challenges is especially important for a landlocked country. Bhutan has recognized that to attain a higher growth trajectory, there will be a greater need for regional air connectivity; safer and climate proof roads; and alternative modes of transport to enable both people and goods to travel reliably and efficiently.[23]

Bhutan outperforms the South Asian and LDC median scores on human capital. Fiscal revenues from hydropower have helped finance major investments in human capital and expanded access to basic services,[24] which has significantly improved educational and health outcomes in the country. For example, Bhutan's 2019 Human Development Index (HDI) score (ranked 129 out of 189) is above average for countries in the medium human development group and for countries in South Asia. For example, Maldives and Nepal are ranked 95th and 142nd, respectively.

Dependence on hydropower, however, has resulted in a weak private sector and despite the Government's efforts aimed at developing the private sector, state-owned enterprises (SOEs) remain dominant in viable commercial sectors (manufacturing, energy, natural resources, financial, communication, aviation, trading and real estate).[25] Accordingly, the 12 FYP emphasizes the importance of developing industries other than hydropower, including tourism and the cottage and small industries sector.

### *Employment and poverty*

The lack of meaningful diversification has serious implications for the creation of decent work and addressing rising unemployment, especially among educated youth. For example, according to a World Bank report, youth with bachelor's degrees constituted 67 per cent of total youth unemployment, followed by youth with a middle and higher education degree at 21 per cent. Bhutan's working age population is set to continue to increase in the 2020s, but youth unemployment has remained consistently high, ranging from 7.3 per cent to 15.7 per cent for the period 2010–2019 (World Bank, 2018b). While overall unemployment stood at 3.4 per cent in 2018, youth unemployment was a staggering 15.7 per cent,[26] the highest recorded over that period. In 2019, youth unemployment was estimated at 11.9 per cent, a 3.8 percentage point reduction from the previous year.[27] Rising unemployment

20 2018 Logistics Performance Index, World Bank, Washington, DC.

21 https://www.itu.int/net4/ITU-D/idi/2017/index.html#idi2017rank-tab.

22 https://data.worldbank.org/indicator/IT.NET.USER.ZS?locations=BT.

23 National Transport Policy of Bhutan 2017.

24 Both education and health services are free and are predominantly financed and delivered by the public sector. According to the United Nations Educational, Scientific and Cultural Organization's Institute for Statistics' database, as of 2020, net enrolment in primary education was nearly universal at over 96 percent. Net upper secondary enrolment also expanded rapidly, surpassing 70 per cent in 2018 (from 22 per cent in 2000).

25 https://blogs.worldbank.org/endpovertyinsouthasia/how-diversify-bhutan-s-economy#:~:text=Diversifying%20the%20economy%20is%20touted,low%20productivity%2C%20and%20macroeconomic%20volatility.&text=The%20main%20driver%20of%20Bhutan's,the%20backbone%20of%20its%20economy.

26 2018 Labour Force Survey Report Bhutan.

27 2019 Labour Force Survey Report Bhutan.

among the educated youth poses a major socio-economic challenge for Bhutan. It denotes a failure to capitalize on the realised improvements in human capital, with underlying deficiencies in the education system contributing to a weak impact of economic growth on employment. It also signifies that the supply of education is outpacing the growth in quality jobs as evidenced by the incidence of queuing[28] among educated youth, which points to a manifest preference for public sector jobs. This may have a dampening effect on private sector development and economic diversification.

Agriculture (and allied sectors) is still the largest employer at 57.2 per cent of total employment and contributing 16.5 per cent to GDP. The imbalance between agriculture's share of employment and share of GDP distinguishes the economy as largely agrarian, and requiring further progress on structural economic transformation.

The economic impact of the COVID-19 crisis is hitting the youth the hardest.[29] A slow recovery from COVID-19 will have negative implications for the 12 FYP target of 2.5 per cent overall unemployment and less than 6.5 per cent youth unemployment. It is estimated that more than 5,000 youth laid off in foreign countries returned to Bhutan. Most are beneficiaries of Royal Kidu.[30] As of December 2020, 27 per cent of those registered with the Ministry of Labour and Human Resources as unemployed were laid off due to COVID-19 and about 4 per cent were returned migrants. These numbers likely underestimate the real number of unemployed because they account only for registered job seekers and those permanently laid off, not those who are on reduced pay, leave without pay, leave with partial pay or businesses that are only partly operational.

From 1972, Bhutan has deemed it vital to apply the Gross National Happiness Index based on the notion of Gross National Happiness (GNH)[31] conceived by His Majesty the 4th King. It is at the centre of Bhutan's development vision, and in conjunction with the World Bank poverty line, explains the notion of poverty in Bhutan as much more than a measure of income.[32] Most countries define poverty in incomes terms, making low consumption power and poverty synonymous with people having daily real incomes that are below the World Bank defined US$ 1.90 per day poverty line considered poor. However, the conceptualisation of poverty has changed significantly from the basic needs approach of the 1970s, and while the content of what constitutes poverty is not specific, poverty today is understood as multi-dimensional deprivation (Green, 2006). There is some disagreement about the adequacy of the income-based definition of poverty, in so far as it fails to quantify conditions such as infectious disease or lack of food or clothing that could help explain poverty.

While it is difficult to determine a causal link between the benefits derived from LDC status and changes in poverty status, Bhutan has achieved noticeable improvements: in education, with overall literacy estimated at about 66 per cent in 2018; almost universal provision of electricity nearing 98 per cent in 2017; and basic access to potable water services at about 97 per cent of the population for the same year. Bhutan's HDI score was 0.654 in 2019, above other Asian LDCs and India (0.645). Growth has led to a dramatic fall in the national poverty rate, from 23.2 per cent in 2007 to 8.2 per cent in 2017. However, urban-rural disparities remain marked. Rural poverty decreased from 16.7 per cent in 2012 to 11.9 per cent in 2017. During the same period, urban poverty decreased from 2 per cent to 0.7 per cent.[33] At the start of the implementation of the 12 FYP, the average annual household income of the urban population was 172 per cent higher than that of the rural households, reflecting huge income gaps between urban and rural populations.[34]

Bhutan has a strong track record of reducing poverty, but COVID-19 impacts in 2020 has affected many segments of society, including urban areas, through lay-offs, furloughs, leave without pay or reduced wages, and large increases in the cost of basic

28 Defined as choosing to remain unemployed while waiting for jobs that match their aspirations or expectations.

29 https://undp-ric.medium.com/ethnographic-research-on-youth-unemployment-in-bhutan-looking-beyond-statistics-for-stories-2200ae24e694.

30 Druk Gyalpo's Relief Kidu income support.

31 The GNH seeks to strike an appropriate balance between material well-being and the spiritual, cultural and emotional needs of the Bhutanese society. It captures socio-economic components, such as living standards, health, education and other non-traditional aspects of cultural and psychological well-being — time use, community vitality, and ecological diversity and resilience — to reflect the general well-being of Bhutanese people.

32 For instance, to help determine whether economic growth achieved has trickled down, Mozambique has defined a set of minimum needs. Households whose cost of consumption falls short of the cost of the defined minimum basket of needs are deemed poor (Silva, 2019).

33 From the summary of Poverty Reduction and Social Strategy, written for a project COVID-19 Active Response and Expenditure Support (CARES) Programme.

34 Vol-1, 12 FYP.

goods, triggering spikes in urban poverty. Bhutan is largely dependent on India for imports of most food items. In 2019, agriculture and food accounted for about one-fifth of the deficit of Bhutan's sizable trade imbalance (excluding electricity trade).[35]

While the impacts of COVID-19 have motivated farmers, laid-off youth and others to venture into commercial production and marketing of agriculture goods, many still depend on income from regular and substantial cash remittances by family members in urban centres. These transfers can be expected to have reduced or dried up because of the crisis. Rural off-farm activities have also been adversely affected. Rural handicrafts, which are a major source of off-farm income, were negatively affected by crisis containment and preventive measures. For example, according to the Bhutan Chamber of Commerce and Industry impact study undertaken in May 2020, 90 per cent of handicraft shops were affected by the tourism standstill, experiencing declines in sales of up to 96 per cent. The sector is highly dependent on tourists, with domestic buyers accounting for about 40 per cent of sales. The crisis affected domestic sales, impacting thousands of artisans and suppliers in the value chain, including those in rural clusters.

Disruptions to education and learning at all levels from COVID-19 containment and preventive measures may have a lasting impact on the ability of many to overcome the challenges of poverty, and to capitalise on future opportunities in the job market, while impeding progress on improving human capital and Bhutan's productive capacities. Evidence suggests that students missed out on e-learning programmes availed during the crisis due to access or connectivity issues. Even taking that into account likely underestimates the magnitude of the problem, given that access to e-learning platforms does not guarantee that students' performance remains at the same level as with face-to-face learning. There are reports of children dropping out of school due to the pandemic; some dropout cases are attributable to parents losing their jobs on account of the pandemic crisis (UNESCO and UNICEF, 2021).

### *Environmental vulnerabilities*

Bhutan is the only carbon-negative country in the world, but the country is exposed to climate change and natural disaster risks that impact the availability of water, energy and food security. Situated in seismic zones IV and V, Bhutan is susceptible to seismic and hydro-meteorological hazards, such as landslides, floods, windstorms and forest fires. To show its commitment to addressing these hazards in its pursuit of development, the Government enacted the Disaster Management Act 2013, which provides the legal framework for strengthening the institutional capacity for disaster risk management, mainstreams disaster risk reduction, and integrates and coordinates the approach to disaster management, focusing on community participation and managing incidental matters (RGB, 2013).

## 4. Implications of Graduating and loss of ISMs

LDC-specific international support measures (ISMs) include measures related to international trade, development cooperation, contributions to the funding of the United Nations System, support for travel to official meetings, scholarships and research grants. Ex-ante impact assessments consider the implications of the withdrawal of these support measures that are granted specifically to LDCs upon graduation. The assessments also consider other LDC-specific instruments. While graduation may potentially have benefits, these are not related to specific measures and cannot be assessed ex-ante (CDP, 2018b). An ex-ante impact assessment on the likely effect of the withdrawal of LDC-specific measures for Bhutan was undertaken by the United Nations Department of Economic and Social Affairs (UN DESA) in 2018.[36]

The United Nations recognises the difficulty of relating LDC graduation to specific ISMs. The limited impact and effectiveness of LDC-specific support measures remains a vexing concern. Their effectiveness in enhancing LDCs' exports and promoting integration in the global economic and trading system is limited. Most LDC officials polled by UNCTAD in 2016 considered ISMs insufficient to support the developing challenges in their countries (UNCTAD, 2016). Thus, international support measures constitute neither a recipe for development, nor offer answers to

[35] COVID-19 and Food Security Update, April 30,2020. https://www.food-security.net/wp-content/uploads/2020/06/Regional-Annex-Update-Food-Security_IX_June_04_2020.pdf.

[36] The first time a country is found eligible for graduation, the CDP requests UN DESA to prepare an ex-ante assessment of the expected impacts when the country no longer receives LDC-specific ISMs. UNCTAD is also mandated to prepare a vulnerability profile of the country.

all the development challenges faced by LDCs, such as smallness and landlocked geographical isolation, justifying a need to reconsider their design (Gay, 2019).

## 4.1 Trade and development

The main trade-related support measures to LDCs are: (i) preferential access to export markets; and (ii) special and differential (S&D) treatment in the implementation of WTO commitments and accession to the WTO.

### *Preferential market access*

Bhutan enjoys inclusion in LDC-specific preference schemes granted by developed countries under the Generalised System of Preferences (GSP) scheme, which provides for tariff exceptions, duty-free and quota-free (DFQF) market access and greater product coverage. Several developing countries, such as India and China also provide preferential tariffs to LDCs. Accordingly, Bhutan's exports to the European Union under the Everything But Arms (EBA) programme and to India are governed by the Agreement on Trade, Commerce and Transit, a bilateral free trade agreement that provides levels of preferential market access, regardless of Bhutan's LDC status. Bhutan also trades with Bangladesh under a Preferential Trade Agreement (PTA), which affords duty-free access to over 90 products. In addition, Bhutan receives market access concessions through the South Asian Free Trade Area (SAFTA) and the South Asian Association of Regional Cooperation (SAARC).

Considering that India is the top destination for almost all the main exports of Bhutan, as well as other significant trade relations with Bangladesh, a few European countries and Nepal, Bhutan is unlikely to experience significant trade impacts resulting from graduation. Existing bilateral agreements will continue to govern trade with India, Bangladesh and Nepal. The removal of DFQF market access to the European Union might similarly not have a significant adverse effect on the Bhutan economy given Bhutan's current low utilisation of the European Union's preferences. Some of Bhutan's exports, such as cardamom and cement, will still enter the European Union market duty-free under their standard GSP afforded to developing countries in general. Moreover, some of Bhutan's exports to the European Union, such as ferrosilicon, are unlikely to face a substantial change in tariff after graduation, with the average tariff expected to increase from 0.0 to 2.2 per cent (CDP, 2018a).

However, Bhutan will face a significant increase in tariffs in the European Union, Japan and Thailand for dairy products, vegetables and fruit (CDP, 2018a). The increase in tariffs has implications for the competitiveness of some of Bhutan's products, especially in the light of other developing country competitors that have already established distribution networks and supply chains, using standard GSPs or MFN access. Since Bhutan relies heavily on the Indian market, losing the European Union and Japanese market preferences is of concern, in so far as it will further concentrate Bhutan's major export destinations and heighten Bhutan's exposure to external trade shocks.

The increase in the European Union, Japan and Thailand tariffs for dairy products will also have potentially negative implications for Bhutan's efforts to enhance export and economic diversification, particularly in the agriculture sector as the European Union's tariffs on agricultural products are high. Like most LDCs, Bhutan does not have sufficient productive capacities to take advantage of opportunities created in international markets. However, Bhutan has identified export products[37] with the potential to become major export sectors in the future, but the loss of preferences on these identified sectors, particularly from the European Union, Japan and Thailand will make it difficult for Bhutan to develop productive capacities in the same sectors and diversify its export basket.

Besides, failure to diversify the economy and its export basket will mean continued reliance on electricity generation for growth and exports, which will continue to have environmental consequences. Continued reliance on electricity generation would be contrary to Bhutan's 12 FYP, which focuses on the diversification of the economy to make the country's economic base stronger and addresses some of Bhutan's vulnerability challenges in building a resilient and robust economy. Moreover, although FDI is generally not directly associated with a country's LDC status but can position an LDC to take advantage of LDC-specific market preferences, graduation might affect decisions by such potential investors impacting the flow of FDI to Bhutan and having implications for Bhutan's strategies of developing productive capacities and diversifying the country's economic base. On the

[37] Bhutan's potential export products include: dairy, apiculture, horticulture, potatoes, apples, mandarins, medicinal plants, cordyceps, mineral water, animal feed, plastic film/sheet, particle board, iron ingots and copper wire (CDP, 2018b).

other hand, most countries that provide GSPs, such as the European Union and the United States, have markets big enough for Bhutan to capture a share as a developing country post-graduation. Access to these markets under GSPs may still constitute incentives for FDI keen on exporting to GSP markets (Kuensel, 2017).

### *Implementation of World Trade Organization (WTO) commitments*

Bhutan is not yet a member of the WTO and does not benefit from most of the WTO special and differential treatment (S&D) provisions, nor does the country have WTO obligations to comply with. Nevertheless, as an LDC, Bhutan receives market access to the preferential schemes of WTO developed country members. For example, in 2017, Bhutan benefited from trade-related technical support provided by the European Union and from capacity-building resources provided by Japan under the WTO Trade Facilitation Agreement (TFA) technical assistance programmes.

Bhutan is currently negotiating accession, which makes it difficult to ascertain the impact of the loss of benefiting from the implementation of WTO commitments.[38] Acceding to the WTO after graduation will entail Bhutan the full costs of assuming WTO obligations,[39] unlike LDC members that benefit from several S&D provisions and increased flexibilities in the implementation of rules and disciplines governing multilateral trade, such as extended transitional periods and the provision of technical assistance.

However, should Bhutan accede before graduation, the country could negotiate a preferential transition period and would be eligible for LDC-specific technical assistance and capacity-building for accession and post-accession after its graduation and the smooth transition period.[40]

38 The Royal Government of Bhutan deferred accession and the situation has not changed to date.

39 For example, LDCs are exempted from implementing the TRIPS Agreement until 1 July 2021. As a graduated country, Bhutan would be required to provide intellectual property protection as envisaged under the TRIPS Agreement, and the legislative changes required would depend on the country's accession commitments.

40 In 2002, the WTO General Council adopted Guidelines for the Accessions of LDCs, which was intended to facilitate the accession of LDCs. The Guidelines, which were strengthened in 2012, urged WTO Members to exercise restraint in their demand for concessions from acceding LDCs. The Guidelines will not apply if Bhutan accedes after graduation.

With regards to trade in services, the WTO Services Waiver adopted in 2011 allows WTO members to provide LDCs market preferences in services.[41] The Waiver is relevant to Bhutan's services trade, especially professional services and tourism, which have been identified as potential export sectors. If Bhutan is to accede to the WTO after graduation, the country will lose the opportunity to benefit from the WTO Services Waiver.

## 4.2 Development cooperation

### *Official Development Assistance (ODA)*

It is unlikely that Bhutan will lose foreign aid after graduation. However, Bhutan has been experiencing a decline in ODA, which in the immediate term, poses a challenge for Bhutan's implementation of its 12 FYP (RGB, 2019). Moreover, according to UNCTAD, LDCs stand to lose the most from declining trust in multilateralism, in terms of the availability of financing for development in the medium and longer term (UNCTAD, 2019). While preferential treatment may apply to LDCs in cases where assistance is given in the form of loans, generally, donors do not necessarily use LDC status to guide their allocations despite that many priority countries identified by donors are LDCs (CDP, 2012). Not only do loans increasingly replace grant funding, but aid remains inadequately directed to economic sectors, requiring LDCs themselves to assume the driver's seat in managing and directing official financial flows to prioritize structural transformation (UNCTAD, 2019). The successful implementation of the Istanbul Programme of Action (IPoA) plan and strategy was partly contingent on the donors' commitment to allocate between 0.15 and 0.2 per cent of their GNI as aid to LDCs, on which most donors have fallen short and recent developments show is waning. However, all donors consulted by UNDESA when undertaking the impact assessment for Bhutan proclaimed their intention to continue to support Bhutan to overcome its specific challenges and meet its development objectives after graduation (CDP, 2018b).

41 However, the implementation of the services waiver is still in its early stages, and as of 2018, only 24 WTO members had notified the sectors and modes of supply to which they would grant preferential treatment to LDCs. In addition, LDCs have requested WTO Members to undertake capacity building measures to make it possible for LDC suppliers to take advantage of preferential treatment notified under the LDC Services Waiver. Further steps are also needed to enhance the operationalisation of the waiver.

### *LDC-specific instruments*

#### Aid for Trade

Aid for Trade (AfT) to LDCs is delivered through the Enhanced Integrated Framework (EIF) intended to help LDCs overcome trade-related constraints. Graduation should bring about the phasing out of EIF support provided to Bhutan for analytical work, institutional support, and for developing productive capacities that are vital if Bhutan is to achieve industrial transformation. The EIF provides an automatic transition period of up to 5 years after graduating, with a possibility of an extension of up to two additional years,, decided on a county by country basis.[42] As a beneficiary of the EIF, Bhutan is thus expected to continue to benefit from EIF programmes for some time yet.

#### United Nations Capital Development Fund

The United Nations Capital Development Fund (UNCDF) supports LDCs to unlock private and public funds to reduce poverty and support local economic development. Bhutan stands to continue to benefit from the UNCDF, as the Fund ensures that programmes are funded for an additional three years after graduation and for a further two years thereafter, co-funded with the government on a 50/50 basis.

#### United Nations Framework Convention on Climate Change

While graduation will have negative implications for access to the Least Developed Countries Fund (LDCF)[43] created under the United Nations Framework Convention on Climate Change (UNFCCC), Bhutan will remain eligible for the Green Climate Fund (GCF),[44] Global Environment Facility (GEF) Trust Fund, the Special Climate Fund and the Adaptation Fund. The cessation of access to LDCF — which is vital in Bhutan's effort to mitigate vulnerabilities and build resilience — will harm the country's efforts to address the challenges of vulnerability to natural disasters caused by climate change. However, belonging to the LDC category is not a condition for receiving technical assistance. United Nations organisations and agencies, such as the United Nations Office of the High Representative for the Least Developed Countries, Landlocked Developing Countries and Small Island Developing States (OHRLLS), UNCTAD, United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) and the United Nations World Food Programme (WFP) have indicated their commitment to support Bhutan's smooth transition and to continue support after graduation. Much of this assistance would, however, be technical support.

#### Technology Bank

The Technology Bank for LDCs[45] was officially established in January 2017 and operationalized in September 2017. It is still early in the process to assess its effectiveness and therefore the impacts of loss of access. However, Bhutan would continue to enjoy access to the Bank for a period of five years after graduation.

## 4.3 Contributions to the UN System and Travel Assistance

LDCs benefit from reduced contributions to the United Nations and the WTO, and assistance with travel to international meetings. As such, LDC contributions towards the United Nations regular budgets are capped at 0.01 per cent of the budget, compared to the maximum contribution for other countries of 22 per cent; contributions to peace-keeping operations and the International Criminal Tribunal are based on the United Nations contribution scale, which is based on gross national income, debt-burden, per capita income, among other criteria, but receive a 90 per cent discount. Because Bhutan's contribution of 0.001 per cent is below the LDC ceiling of 0.01 per cent, graduation will not affect Bhutan's contributions to the United Nations regular budget. However, Bhutan is expected to experience immediate changes to its United Nations Peace Keeping budget and its World Intellectual Property Organization's (WIPO) budget (CDP, 2018b).

42 Given the United Nations General Assembly Resolution's (A/RES/59/209) recommendation for the continued implementation of EIF technical assistance programme for a graduated country over a period appropriate to the development situation of that country, the EIF decided to provide an automatic transition period of up to 5 years after graduating.

43 The Least Developed Countries Fund (LDCF) was set up to provide LDCs with climate change financing and will cease to provide new funds on graduation, although ongoing projects will be financed until up to full implementation.

44 However, Bhutan will no longer benefit as a member of the Fund's priority group of countries.

45 The Technology Bank was created as a result of the call in the Istanbul Programme of Action (IPoA) for a "supporting mechanism, dedicated to least developed countries which would help improve LDCs' scientific research and innovation base, promote networking among researchers and research institutions, help LDCs access and utilize critical technologies, and draw together bilateral initiatives and support by multilateral institutions and the private sector, building on the existing international initiatives."

LDCs also benefit from travel assistance provided by the United Nations and some of its agencies to participate in official meetings. For instance, the United Nations offers travel assistance for LDC representatives to attend the regular sessions of the United Nations General Assembly — support that can be extended for up to three years after graduation. The cessation of the travel assistance might affect Bhutan's attendance at critical meetings, such as meetings to discuss issues of vulnerability and building strong and resilient economies.

## 4.4 Graduation, vulnerabilities and building resilience

Bhutan has so far qualified for graduation without meeting the EVI graduation criterion. Significant questions are whether Bhutan can develop the needed capacity to mitigate economic vulnerability and weather the post-graduation environment to sustain development progress and achieve sustainable development. The above discussion highlights the requirement for Bhutan to establish 'graduation with momentum' strategies (UNCTAD, 2016) necessary for the sustainable management of the country's economic vulnerabilities. Table 5 presents a matrix of the implications of situational changes likely to be brought about by graduation for Bhutan on the diversification of both the economy and export basket, building productive capacities, and mitigating natural disasters. Bhutan's limited capacity to address issues of economic and environmental vulnerability will continue to affect Bhutan's ability to address its overall development challenge to deliver greater well-being and happiness to its people and realize the SDGs. This limited capacity provides Bhutan with a compelling reason for requesting a longer phase-out period for specific ISMs to ensure a positive (and sustained) graduation outcome.

Table 5

**Bhutan situational changes and vulnerability status**

| Matrix of Situational Changes and Related Vulnerabilities Implications | |
|---|---|
| **Situation Change** | **Likely Implications for Bhutan's vulnerabilities** |
| Trade | |
| (a) Loss of LDC-specific preferences | • Loss of EBA DFQF preferences will entail export under EU GSP, GSP+ or MFN, impacting on Bhutan products' competitiveness on EU markets with implications for foreign earnings while exposing Bhutan to heightened economic vulnerability.<br>◦ Loss of EU preferences on most agricultural export products would be in the magnitude of more than five per centage points (CDP, 2018b) and will affect the export of products identified as potential candidates for export diversification and building of productive capacities.<br>• Loss of LDC-GSP will mean export under Japan's standard GSP or MFN impacting on the competitiveness of some of Bhutan's agricultural products (dairy, honey, vegetables and fruits) on Japanese markets, exposing Bhutan to economic vulnerability.<br>◦ Loss of Japanese preferences on most agricultural export products would be in the magnitude of more than five per centage points (CDP, 2018b) and will affect the export of products identified as potential candidates for Bhutan's export diversification and building of productive capacities.<br>• Loss of EU and Japanese market preferences will further increase reliance on India as Bhutan's major export destination and thus heighten Bhutan's exposure to external trade shocks.<br>• Narrowed possibilities for export and economic diversification from preference losses imply correspondingly diminished options for developing productive capacities and heightened reliance on electricity generation for growth and development heightening risks of (continued) negative environmental impacts. |
| Development Assistance | |
| (b) Access to LDCF phased out | The phasing out of access to the LDCF has potential implications for Bhutan's capacity and efforts to build resilience and manage vulnerability to natural events. |
| (c) Exclusion from the GCF priority group | The exclusion will have negative implications as prioritised access to GFC is vital for Bhutan's continued effort to mitigate vulnerabilities and build resilience to natural events. |
| Contributions to the UN System and Travel Assistance | |
| Bhutan ceases to be eligible for travel assistance for representatives' travel and participation in international meetings. | Cessation of assistance could affect Bhutan's attendance at critical meetings and benefitting from sharing experiences on critical issues such as vulnerability challenges and building strong and resilient economies. |

# 5. Planning for a smooth transition and adjustment to post-graduation

The economic vulnerabilities outlined in this section have the potential to disrupt Bhutan's pace of development in the lead up to graduation from LDC status. In this regard, it is critical for the smooth transition strategy to mainstream economic and environmental resilience and recovery in its smooth transition strategy.

The aim is to use the transition period to formal graduation to help Bhutan overcome some of the challenges it faces on its development trajectory, as well as to identify and pursue areas for continued international support in accordance with Bhutan's development situation. As such, there is a need to accord special consideration to the challenges that are a potential hindrance to Bhutan adjusting to the loss of LDC associated benefits and continuation of Bhutan's development trajectory.

The crafting of a smooth transition strategy for Bhutan must be situated in the context of Bhutan's unique circumstances, especially related to mitigating Bhutan's economic vulnerabilities and building resilience. In this regard, notable hurdles for continued development include an unstable macroeconomic environment, growing debt burden, lack of technology and human capital, a lack of productive capacities, an insufficiently diversified economic base and export basket that inhibits trade expansion, and marked vulnerability to natural disasters and economic factors — all of which affect Bhutan's capacity to build resilience and weather the post-graduation environment. The strategy must aim to demonstrate how it will achieve a real and sustainable impact on Bhutan's graduation with momentum, build resilience and how it proposes to ensure a graduated Bhutan can adjust to the loss of LDC benefits.

## 5.1 Stabilising the macroeconomic environment

It is vital for Bhutan to ensure that macroeconomic and fiscal instruments help achieve equitable and sustainable growth, job creation and reduction of poverty and inequality. Bhutan's heavy reliance on hydropower for development has created macroeconomic uncertainties and vulnerabilities. Given the country's small economy, large scale hydropower projects have led to large fluctuations in aggregate demand during construction and commissioning phases, and the high import content for the construction projects has contributed to large external balances and high foreign exchange-denominated debt that exceeds 100 per cent of GDP (World Bank, 2018a). In addition, the country has experienced pro-cyclical fiscal pressures, including from an expanded public sector, owing to hydro-related contributions to the budget. Currently, the Government cannot collect much tax from the nascent non-hydro private sector, thereby worsening fiscal pressures. Bhutan is also in its early stages of integrating the SDGs in its 12 FYP. As a result, revenue collection remains insufficient to address the structural fiscal deficit and debt repayments. Fiscal consolidation is expected to remain an essential component to reducing economic vulnerability (IMF, 2018).

Domestic resource mobilisation was a major priority for the 11 FYP. While domestic resource mobilisation has improved, it falls short of Bhutan's developmental needs and Bhutan remains reliant on grant aid in the short to medium term. The increasing scarcity of donor funding, which could constrain development spending and negatively affect future growth and development, means Bhutan requires assistance to identify alternative sources of finance (World Bank, 2018b). Table 6 shows that in recent years, grants from foreign governments and international organisations have continued to contribute significantly to Bhutan's budgetary requirements, second to tax revenue contributions. In 2016 and 2017, revenue from grants contributed 35 per cent and 30 per cent of total revenue, respectively. An abrupt reduction in grants will have severe implications for Bhutan budgetary requirements and on the country maintaining its growth path.

Bhutan continues to accord priority to self-reliance in development financing through developing a comprehensive financial strategy, carefully analysing the costs and benefits of several financing options, including introducing a broad-based goods and services tax (GST) in July 2020.[46] Such efforts are crucial for the mobilization of sufficient resources for the ongoing implementation of Bhutan's 12 FYP, but also for maintaining future development spending. By improving the macroeconomic condition, the RGB will create an environment that is desirable for Bhutan's plans to diversify the economy away from dependence on hydropower (IMF, 2018).

46 https://www.mof.gov.bt/wp-content/uploads/2020/07/NotificationGST.pdf.

Table 6

**Central government fiscal revenues**

(Nu millions)

| | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|
| **Total Revenue** | **30 613.04** | **37 425.45** | **35 022.01** | **42 026.72** | **42 486.84** |
| ***Tax Revenue*** | ***15 151.18*** | ***15 943.70*** | ***16 856.03*** | ***18 632.08*** | ***19 805.06*** |
| Taxes on income, profits & capital | 7 812.79 | 9 349.71 | 9 609.95 | 10 405.24 | 10 404.51 |
| Taxes on income, profits & capital gains: individuals | 1 257.88 | 1 438.39 | 1 536.16 | 1 770.36 | 957.31 |
| Taxes on income, profits & capital gains: corporations | 6 554.91 | 7 911.32 | 8 073.80 | 8 634.88 | 9 447.20 |
| Taxes on property | 0.00 | 0.00 | 0.00 | 0.00 | 3.59 |
| Taxes on Goods and Services | 7 051.66 | 6 285.52 | 6 828.30 | 7 658.79 | 8 817.88 |
| Taxes on international trade & transactions | 286.73 | 308.47 | 447.40 | 597.39 | 562.56 |
| Other taxes n.e.c. | 0.00 | 0.00 | 20.18 | 20.47 | 16.52 |
| ***Social Contributions*** | ***22.61*** | ***24.10*** | ***56.38*** | ***82.42*** | ***-79.92*** |
| ***Grants Revenue*** | ***9 562.64*** | ***14 236.35*** | ***9 955.02*** | ***14 889.61*** | ***12 986.75*** |
| Grants revenue from foreign governments | 6 345.72 | 12 271.09 | 6 593.76 | 10 721.70 | 12 986.75 |
| Grants revenue from international Organisations | 3 216.91 | 1 965.27 | 3 361.26 | 4 167.91 | 0.00 |
| ***Other Revenue*** | ***5 876.60*** | ***7 221.30*** | ***8 154.58*** | ***8 422.61*** | ***9 774.95*** |

*Source:* IMF Data, Macroeconomic and Financial Data.

To attract more resources from Bhutanese abroad, Bhutan launched RemitBhutan, with the view to promoting national savings and building foreign reserves (World Bank, 2018b) to facilitate greater flows of remittances to Bhutan.

The 12 FYP set the target to maintain the average fiscal deficit below 3 per cent of GDP and to fund at least 80 per cent of FYP expenditure through domestic revenue. This target looks increasingly uncertain in the light of the elevated expenditure requirements linked to COVID-19 mitigation and recovery[47] and the downward pressure on non-hydro revenue sources. The 2020/21 fiscal deficit is expected to widen to about 8.4 per cent of GDP and to remain elevated for the medium term, likely necessitating recourse to borrowing on foreign markets should access to grant funding be diminished by COVID-19 impacts on donor countries (Table 7). The public debt projected for FY 2020/21 is 126.5 per cent of GDP, an increase of 8.4 per cent from the previous year – as both external and domestic debt are expected to increase, mainly on account of loan disbursement for the Kholongchu Hydropower Project, and the borrowings from the domestic market through issuance of T-bills and government bonds to meet the resource gap. As of 30 September 2020, total public debt stood at 120.8 per cent of GDP. In addition, the local currency suffered a 5.19 per cent depreciation against the United States dollar in 2020. All these developments place a premium on the establishment of a robust fiscal management plan and have implications for Bhutan graduating with momentum.

Up to 55.65 per cent of the capital budget from front-loading of 12 FYP implementation to the 2020/21 fiscal year, as part of the response to COVID-19 impacts, is projected to be funded through foreign grants (mostly project-tied assistance). Being unpredictable, external fiscal support represents a source of macroeconomic instability for Bhutan.

On the upside, electricity exports remained a reliable source of trade earnings (also offsetting the reduction in the domestic electricity sales, resulting from subdued productive activity, especially energy-intensive industries) and have been boosted by the commissioning of Mangdechhu Hydropower. In addition, subdued imports have been a bonus for macroeconomic health. In the nine months since the start of the COVID crisis, total trade volume dropped by 30 per cent, with non-hydro exports reduced by 43 per cent and imports by 25 per cent. The trade deficit declined by 32 per cent in the first half of 2020 and the current account deficit is expected to narrow from 15.3 per cent of GDP to 7.7 per cent of GDP because of COVID-19. Bhutan's foreign exchange

47 https://www.cabinet.gov.bt/wp-content/uploads/2020/07/PR-Phase-2-fiscal-and-monetary-measured.pdf.

Table 7

**Trends in external fiscal support**

| Fiscal Year | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/20 | 2020/21 |
|---|---|---|---|---|---|---|
| % of foreign grant to total revenue | 35.42 | 30.43 | 28.49 | 19.24 | 26.03 | 37.42 |
| % of foreign grant to capital exp | 68.28 | 54.36 | 51.49 | 46.90 | 47.66 | 55.56 |

*Source:* Extracted from Annual Report 2019, RAMA & NB FY 2020/21.

reserve was $1,2 billion as of December 2020,[48] sufficient to cover more than 21 months of essential imports or more than 15 months of merchandise imports, and well within the country's constitutional requirement. However, due to the impact of COVID-19 on the tourism sector, reserves are expected to fall by around 4 per cent.

## 5.2 Expanding trade

Bhutan faces numerous exogenous and endogenous challenges to trade, including the changing global trading system, restrictive customs procedures, supply constraints and inadequacies of trade-related infrastructure, loss of preferences in specific key markets due to graduation, undiversified export basket and export markets etc. In a world where the big trading countries can resort to international trade tariffs as a lever to promote geopolitical interests, in so far as such tactics can impact opportunities to participate in global supply chains, Bhutan will need to maintain a strategic review of the international trading system, with the view to understanding the ramifications of trade wars on key existing and potential trade partners for Bhutan companies, and the domestic economy that might be impacted.[49] Serious ramifications on Bhutan's major trade partners, including India, the European Union and Japan, could affect Bhutan's economic prospects, as trade wars contribute to a decline in world trade and disrupt supply networks with knock-on effects on manufacturing output, costs and employment.

An understanding of the effects of tariff wars will help options and solutions for mitigating consequences and preserving global markets in the currently uncertain and volatile global trade environment. As such, Bhutan will require to develop capacity in the gathering of accurate data on major trading partners' tariff changes and third-party effects, its use and analysis to determine impacts on domestic producers in the short, medium and long run. Bhutan's limited capacity to collect and use accurate data underlines the need for technical assistance in this area.

Access to international markets by Bhutan's producers is made difficult and costly by inadequate domestic and international transport networks and logistics. Data from both the World Bank's *Doing Business* and the Logistics Performance Index show that the high cost of accessing foreign markets hinders Bhutan's exports. As a landlocked country, trade facilitation is of critical importance to Bhutan. The country needs fluid trade routes to allow for the seamless movement of goods to and from neighbouring countries and the rest of the world. Accordingly, Bhutan is likely to require continued assistance from its trading partners to introduce and implement trade facilitation measures.

To avoid the 'trade shock' from the loss of the European Union and Japanese LDC-related trade preferences, and increased concentration in export destination, the European Union and Japan could consider the gradual phasing out of LDC-specific preferences in line with paragraph 8 of the United Nation's General Assembly Resolution 59/209,[50] and was agreed in the case of the graduation of Cape Verde, Maldives (CDP, 2012). A gradual

48 This information from the Prime Minister's State of The Nation address in the current session of Parliament. https://www.cabinet.gov.bt/wp-content/uploads/2020/12/State-of-the-Nation-2020.pdf.

49 On 1 June 2018, Bloomberg reported that various members of the WTO were moving forward with intentions to retaliate against the United States (US) tariffs on steel and aluminium imports https://www.bna.com/countries-mull-wto-n73014476190/ – increasing the risk of a global trade war. In addition, on 9 October 2019, India's Economic Times reported that IMF Chief, Kristalina Georgieva stated that emerging markets like India and Brazil were experiencing a downturn in 2019-2020. https://economictimes.indiatimes.com/news/economy/indicators/india-slips-10-places-on-global-competitiveness-index-singapore-on-top/articleshow/71498559.cms.

50 The gradual phasing out of preferences will also be in line with SDG 17.11, which calls on all countries and stakeholders to 'significantly increase the exports of developing countries, 'with a view to doubling the least developed countries' share of global exports by 2020.' (Resolution adopted by the General Assembly, A/RES/70/1). Bhutan can cite SDG 17.11 as justification for trade partners to consider extending market preferences as one way for them to meet their international obligations.

phasing out of LDC-specific preferences would help some of Bhutan's export sectors to adjust to the post-graduation environment, as well as allow Bhutan's identified potential export growth sectors to flourish. In addition, for Bhutan to effectively benefit from the phasing out of preferences, trading partners could simultaneously consider providing technical assistance programmes and adjustment facility packages to help the country enhance the competitiveness of export sectors affected by the withdrawal of preferential market access.

Bhutan's continued preferential market access during the smooth transition must also be complemented by other interventions aimed at addressing supply constraints, enhancing capacity to produce at scale and improving product or service quality. A balanced mix of the right domestic policies and international support can help overcome supply-constraints.

To boost trade, sustainable growth and development, it will be vital for Bhutan to continue to take advantage of preferences provided under regional integration initiatives, such the SAFTA and SAARC, and its bilateral preferential agreements with India and Bangladesh. Bhutan's regional trade prospects are unlikely to be negatively impacted by graduation. Regional trade can help reduce Bhutan's vulnerability to external shocks. It also offers alternative markets for domestic products affected by the loss of LDC-specific market preferences and can help Bhutan support the growth of nascent export sectors that are critical for Bhutan's export diversification strategy. In addition, they offer additional investment incentives for FDI that are keen on exporting to the region. However, Bhutan requires effective policies to leverage competitive and comparative advantage to be able to exploit regional markets. In this regard, Bhutan should identify the kind of support it might need to ensure that appropriate policies are developed and implemented during the transition period.

## 5.3 Enhancing productive capacities and economic diversification

UNCTAD maintains that the broadening and full utilization of productive capacities in LDCs remain a central strategy to upgrade economic structure, and bridge development gaps vis-à-vis other countries and underline the role of integrated policies, including industrial policies and the development of technological capabilities to support inclusive development in the 21st century (UNCTAD, 2020a). As argued by UNCTAD (2016) and reiterated by Kuensel (2017), enhancing productive capacitive has strong links to making progress towards graduation having critical links to the HAI through enhancing human capital and the EVI by facilitating economic diversification. To continue its development path, Bhutan must adopt active measures to enhance productive capacities. Enhancing productive capacities will have a positive impact on the achievement of Bhutan's 12 FYP and, in the longer term, GNH and sustainable development. However, building productive capacities and competitiveness takes time, and Bhutan requires assistance in this respect. UNCTAD (2018b and 2020b) outline how by choosing appropriate policies, LDC governments can reduce their external vulnerability and provide actionable policy recommendations and instruments on how LDCs can build new productive capacities and enhance the utilization rates of existing capacities, respectively.

The continued development of the CSI sector is of significant importance to Bhutan and the sector must be cushioned from negative graduation impact by, for example, requesting trading partners for extended phase-out periods for preferences that directly benefit exporting CSIs. COVID-19 impacts led to widespread disruptions of productive activities and may have weakened local industries. Bhutan faces several challenges in raising the quality and capacity of its CSI sector, including the limited size of the domestic market and capacity constraints linked to the development and expansion of domestic productive capacities. For instance, Bhutan's limited supply of skilled labour impedes the development of high value-added products by both CSIs and larger industries. It is equally important for Bhutan to explore ways to support larger industries to ensure balanced industrial development and diversification of the Bhutan economy (UNCTAD, 2018b). Different motivations and sizes mean that the contribution of different enterprises to economic resilience, diversity and structural transformation is differentiated and requires correspondingly differentiated support and entrepreneurship policies (UNCTAD, 2018c). The World Bank reported that, as of 2018, there were more than 30,000 registered CSI in Bhutan, but only a third of them were considered active and operational (World Bank, 2019b). Complementing support to CSIs with strengthening linkages with medium and larger industries will help Bhutan to develop a holistic and practical approach to industrialisation and structural transformation – promoting the shift in factors of production from low productivity to higher value-added industries. As such, it is crucial to support medium and larger industries, particularly in export-oriented sectors. In this context, it will also be vital to find the right balance between attracting FDI and growing local entrepreneurship (i.e., promoting both domestic and foreign investment), including the best-fit FDI to support the latter goal.

Bhutan revised the FDI Rules and Regulations 2012 (amended December 30, 2014), replacing it with the Foreign Direct Investment Rules and Regulations 2019. The revised FDI policy improves investment requirements in some sectors and opens new sectors to foreign investment. For example, 100 per cent of FDI equity investment in infrastructure is now allowable, and FDI is now also permitted in renewable energy. However, the investment climate in Bhutan remains fluid and characterised by policy and administrative challenges (Ministry of Finance, 2019a). Commercially oriented state-owned enterprises (SOEs)[51] involved in the manufacturing, energy, financial and other sectors still dominate and may dampen private investment (World Bank, 2018a).

Also necessary, will be fostering the development of entrepreneurship ecosystem institutions and strengthening the coordination between public agencies, especially the Royal Monetary Authority (RMA) which is entrusted with streamlining and improving institutional coordination and policy support by other relevant parties and interested stakeholders to the infant private sector.

## 5.4 Product space and potential for diversification

Based on Bhutan's current productive capabilities, it is possible to discern the set of upgrading possibilities available to the country.[52] Based on the International Trade Centre's untapped export potential assessment up until 2023, Bhutan's traded products with greatest export potential growth are ferrosilicon (an alloy of iron and silicon with a typical silicon content by weight of 15–90 per cent) products, cardamon and calcium carbides. Ferrosilicon shows the largest absolute difference between potential and actual exports in value terms, leaving room to potentially realize additional exports worth US$ 100.4 million.

Product selection will be an important aspect of the active promotion of export diversification. Products or industries are identifiable based on the feasibility of production (relatedness) and expected profitability or economic gain (product complexity). For 2019, Bhutan's Economic Complexity Index score, which is an indicator of available knowledge and a measure of productive capabilities, is 0. This is higher than Lao PDR (-0.87), Myanmar (-0.99) and Bangladesh (-1.01), but lower than Thailand (1). The order of complexity of Bhutan's export products reveals that machine-tools for shaping metals and electric motors register the highest complexity (2.03 and 0.87, respectively), followed by plastic plate (0.52), and inorganic acids (0.51). Product groups among Bhutan's major exports, which have potentially high diversification opportunities due to high relatedness and above average complexity, are chemical products, plastics and rubber, and transportation (Figure 5). Bhutan's main exports of metals (i.e., ferro-alloys, semi-finished products of iron or non-alloy steel) and mineral products (i.e., dolomite) have on average, a complexity index of -0.16 and -2.45, respectively, associated with lower levels of revenue and economic growth.

Economic gains in terms of the contributions to economic growth will depend on the level of product sophistication. According to Hidalgo et al. (2007), economic growth is driven by products that are more complex, as they provide higher income opportunities. Raising complexity usually occurs in small steps, unless significant investments are mobilized to foster technological progress and build knowledge.[53] Therefore, it might be worthwhile for Bhutan to place emphasis on diversifying into products that show a larger distance from existing capabilities (with a correspondingly higher investment requirement), but also promise strong economic gains.

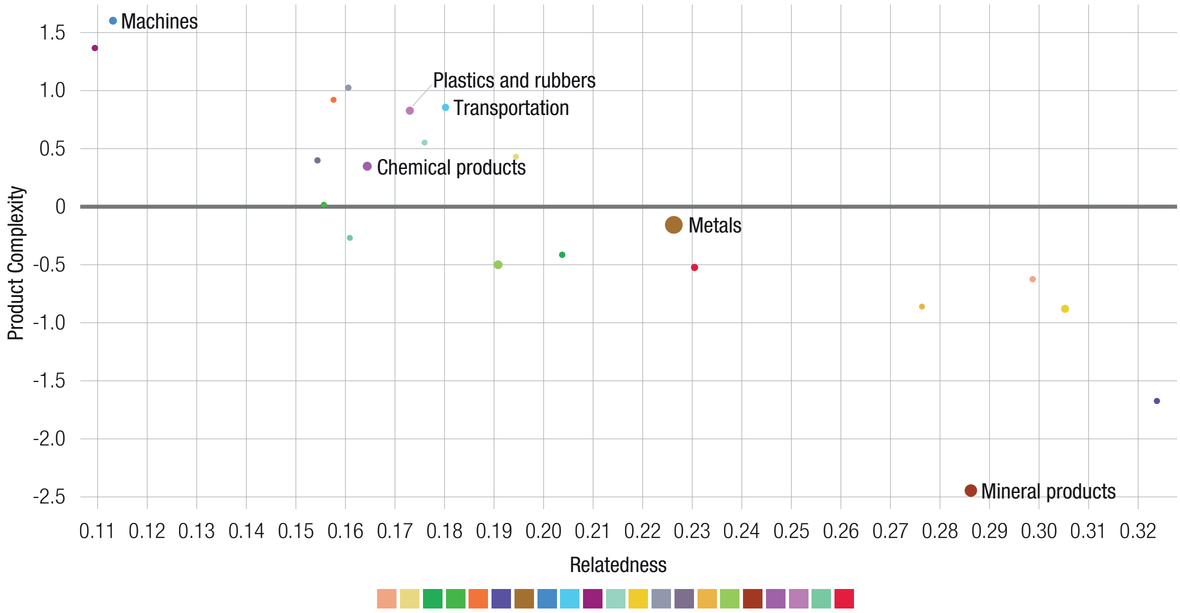
51 There are 38 SOEs in Bhutan, of which 19 are directly under the Ministry of Finance and the remaining 19 SOEs are administered through public owned Druk Holding and Investment (DHI).

52 UNCTAD has undertaken this analysis using data and information obtained from the Observatory of Economic Complexity, complemented by the export potential assessment of the International Trade Centre (ITC). According to the chosen methodology, export growth can be realized at the intensive margin (increasing exports of currently exported products) and the extensive margin (introducing new products and diversifying the export basket).

53 Countries grow by diversifying into new products of increasing complexity. Strategic new products aim to balance: 1) distance to existing capabilities: a lower distance (close to 0) signifies a product is "nearby" to existing knowhow; 2) complexity: more complex products tend to support higher wages; and 3) opportunity gain for future diversification: higher values hold stronger linkages to other high-complexity products, opening more opportunities for continued diversification.

Figure 5

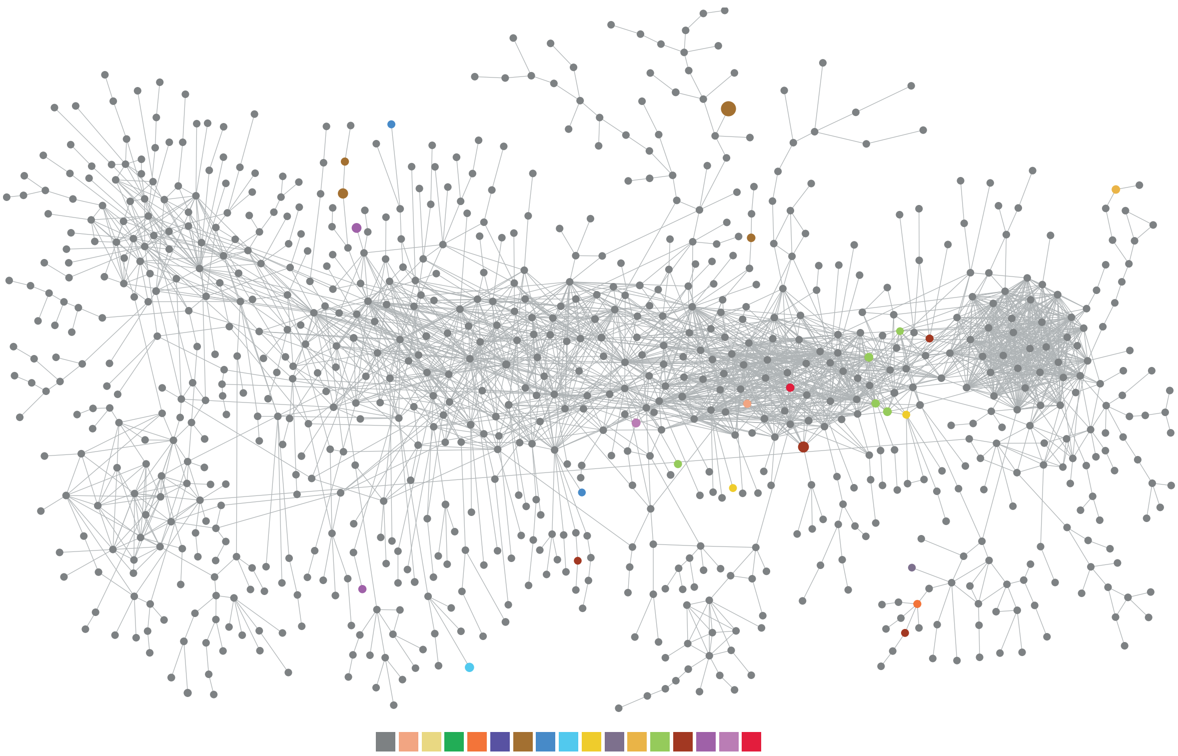
**Bhutan exports' diversification frontier, product complexity and relatedness, 2019**




*Source:* https://oec.world/en/profile/country/btn?depthSelector3=SectionDepth, accessed December 2021.
*Note:* Sections in legend (from left to rights): animal products, paper goods, textiles, footwear and headwear, stone and glass, precious metals, metals, machines, transportation, instruments, weapons, vegetable products, miscellaneous, arts and antiques, animal and vegetable bi-products, foodstuff, mineral products, chemical products, plastics and rubber, animal hides, wood products.

Figure 6

**Product space, 2019**



*Source:* https://oec.world/en/profile/country/btn?depthSelector3=SectionDepth, accessed December 2021.
*Note:* Sections in legend (from left to right): Multiple items, animal products, paper goods, textiles, stone and glass, precious metals, metals, machines, transportation, vegetable products, arts and antiques, animal and vegetable bi-products, foodstuff, mineral products, chemical products, plastics and rubber, wood products.

Bhutan's product space[54] shows that the potential for diversification from metals and mineral products is low because it requires specialized knowledge and technology. Many of the recent export products lie at the outer edge of the product space with few direct linkages.

Clusters in which export diversification is likely to be easiest are sectors such as foodstuff and vegetable products, due to their high relatedness with current productive capacities, which means they will require minimal upgrading effort to produce. Highest relatedness is identified for tropical fruit, wheat flour, spices and raw sugar. According to the International Trade Centre's (ITC) export potential map,[55] the best options for export diversification are, fresh cut flowers and buds.

## 5.5 Maintaining sustainable levels of debt

Weak productive capacities and limited export diversification result in high import content in domestic consumption and production, and persistent current account deficits, leading to aid dependence and the accumulation of significant levels of foreign debt (UNCTAD, 2016). In March 2018, Bhutan's external debt[56] was estimated at US$ 2.6 billion, about 115 per cent of GDP. Though remaining high, it dropped to an estimated 104.4 per cent of GDP by June 2019, but as of 30 September 2020, had risen by 3.7 per cent, mainly due to a loan disbursement for Punatsangchhu-II Hydroelectric Project Authority (RGB, 2020). Total domestic debt also rose in 2020. External debt servicing in FY 2020/21 is expected to increase significantly compared to debt servicing in FY 2019–20, due to the commencement of debt servicing for the Mangdechhu Hydropower Project (MHP) and liquidation of the Standby Credit Facility (SCF) availed by the Government of India (3.3 per cent of the total external debt). The ration of external debt service to exports is thus expected to rise from 6.1 per cent in FY 2019–20 to 19.9 per cent in FY 2020/21.

Despite the World Bank-IMF joint assessment of Bhutan's risk of debt distress as moderate,[57] [58] Bhutan still needs assistance in deploying risk mitigation measures to avoid exposing the country to increased debt vulnerabilities, especially in view of the pressures brought about by the COVID-19 pandemic. The measures should depend on a precise diagnosis of potential sources of debt distress. Bhutan might also require assistance in developing sound debt and deficit policies which should be carefully monitored.

## 5.6 Fostering technological advancement and enhanced human capital development

Technology adoption and technological capabilities development contributes to advancing inclusive development (CDP, 2017; UNCTAD, 2020a). Attracting the right investment from abroad could bring not only the capital and technologies discussed above, but could, under the right conditions, also inject the necessary skills, knowledge and ideas that can help Bhutan move beyond hydropower and CSIs, contributing to the diversification and upgrading of the country's economic base and growth and development. Technology transfer can also play an important role in climate change adaptation and mitigation. For example, climate-related technology transferred through the Clean Development Mechanism (CDM), allows developed countries to meet their emission reduction obligations by financing projects in developing countries using technologies not readily available in the host countries (UNCTAD, 2016 and 2020a).

To stimulate the transfer of new technologies and skills, Bhutan encourages FDI to select small-scale production and manufacturing activities. With the onset of the fourth Industrial Revolution (4IR) and advancements in digital technologies, FDI could be an important source of beneficial 4IR technology and skills for Bhutan. If adequately and strategically leveraged, new

54 Product space is a geometrical representation of products illustrating their proximity based on their production input factors, level of technological sophistication and role of institutions. In other words, two products are related and can be produced in tandem if they require similar institutions, infrastructure, physical factors and technologies.

55 https://exportpotential.intracen.org/en/products/diversification?fromMarker=i&exporter=64&toMarker=w&market=w&whatMarker=k accessed December 2021.

56 Linked mainly to hydropower project loans.

57 As of 25 November 2020 and based on the most recently published data accessed 3 January 2021; https://www.imf.org/external/pubs/ft/dsa/dsalist.pdf.

58 The risk is assessed as moderate because of the FDI-like nature of most of the debt. For example, hydropower projects in Bhutan are virtually all financed by India under the Bhutan-India intergovernmental agreement, which obliges India to purchase the electricity generated in Bhutan on a cost-plus-margin price. This decreases the risk associated with the high level of external debt (IMF, 2018). Some risk may likely to shift to Bhutan once hydropower projects rely on joint ventures.

and digital technologies could boost Bhutan's growth and sustainable development. However, 4IR technologies represent both opportunities and threats to Bhutan's development trajectory because these technologies can rapidly erode the competitiveness of many existing industries, while at the same time boost the prospects and profits of others that are better prepared to absorb them or to develop new business models. Of particular concern are their potential to render certain jobs and skills obsolete. In addition, measures that help tackle concerns around the accessibility, adequacy, affordability and availability of complementary technologies (e.g., electricity, internet connectivity and related technological capabilities and gender divides) are necessary to fully take advantage of the new technologies. This is of concern as much for the effective implementation of the 12 FYP as it is for Bhutan's future growth and development. It is therefore essential for Bhutan to closely monitor the interface between the opportunities and threats of these new technologies. As such, there is a need to develop enabling and mitigating policies and regulations that will ensure Bhutan benefits from the acquisition of 4IR technologies and skills.

As an LDC, bridging the technology divide has been a significant challenge for Bhutan. Bhutan has made some progress in areas, such as strengthening information technology infrastructure, building human capacity on information and communication technology (ICT), and developing appropriate policies and legislation to create an information technology-enabled economy and society guided by the GNH philosophy. However, this progress provides an insufficient basis for the meaningful leveraging of the digital economy. For example, according to World Bank data, challenges remain in terms of coverage, quality and reliability of connectivity, with rural services weaker than in urban centres. As a landlocked country, Bhutan's digital and physical connectivity, remains a challenge as evidenced by the country's Logistics Performance Index ranking (see section 5.2). The current inadequacy of skills and expertise in new technologies, particularly as they relate to the expansion of productive activities, compels Bhutan to develop partnerships at the regional and international levels in, for example, skills development, overcoming the constraints in tapping 4IR technology benefits and strengthening the frameworks for attracting the right kind of FDI. Bhutan also requires assistance in boosting technological innovation and enhancing related infrastructure for industrialisation and structural transformation.

## 5.7 Mitigating vulnerability and building resilience

Bhutan is at high risk from natural disasters and economic vulnerability factors, which pose serious challenges for future growth and development. The Vulnerability Profile of Bhutan (UNCTAD, 2018a) highlights risks from the increased frequency and damaging impacts of natural events experienced by Bhutan over time. Bhutan is especially vulnerable to the effects of climate change because the bulk of the population remains dependent on agriculture, and the economy is reliant on hydropower and tourism. While Bhutan has made some progress in the management of natural disasters and the national Constitution requires at least 60 per cent of the country to be always maintained under forest cover, the country lacks the needed financial resources and technical expertise to adequately manage frequent disasters.

Bhutan requires financial and technical assistance to enhance its disaster management and resilience-building capacity, especially because climate change is expected to increase the probability and severity of natural disasters. The increase in global temperatures due to the rise in greenhouse gases in the atmospheres is suspected of causing an increased risk of drought and increased intensity of storms and cyclones (Earth Observatory, 2005). Other environmental changes caused by global warming are suspected of making storms deadlier and more severe (Thomas et al., 2017). Examining weather-related natural disasters for 228 countries and territories and their monthly weather patterns over 25 years, Acevedo and Novta (2017) found that temperature and precipitation helped explain most disasters, with higher temperatures associated with wilder and fiercer natural events, such as droughts, heatwaves, tropical cyclones and wildfires.

However, in its monitoring of countries that have graduated from the list of LDCs, the United Nations noted that despite high vulnerability to economic and environmental shocks, Samoa still continued to achieve slow but steady development progress (CDP, 2018c). Similarly, Maldives did not experience significant disruption to its development path after graduating in 2011, despite remaining highly vulnerable to economic and environmental shocks. The Maldives experience demonstrates that with tailored support, graduating countries that are highly vulnerable to economic and ecological shocks, such as Bhutan, can still make development progress. In this context, development cooperation directed at building resilience is critical and effective in enhancing disaster management and resilience-building capacity. Bhutan's should similarly focus on its resilience capacity development needs, rather than target isolated interventions. In this regard, Bhutan needs to identify specific support measures, including financial and technical assistance, that will help strengthen its disaster management and resilience-building capacity to be able to mitigate natural events that might disrupt Bhutan's growth and development.

# 6. Conclusion and recommendations

For Bhutan to continue its growth and development trajectory after graduation, there is a need for the country to implement a broad range of complementary policies to address the multiple challenges it faces on its development path. For a small, vulnerable landlocked country that relies on a few commodities for export, Bhutan is still susceptible to economic vulnerabilities, as well as natural disasters. In this regard, the prospects of Bhutan to continue its development path post-graduation is strongly influenced by the process leading to graduation, especially in ensuring a smooth transition that enables Bhutan to overcome vulnerability, including economic diversification, developing productive capacities for structural transformation, and enhancing disaster management and mitigation and build both economic and natural disaster resilience. Critically, the focus for Bhutan's smooth transition strategy should be on devising measures for mitigating the structural challenges faced by the country to enable Bhutan to effectively implement its 12 FYP and develop the resilience needed to operate in the post-LDC status environment. In this regard, less concessionary support from developing partners potentially poses a challenge for Bhutan, given its lack of financial and human resources to mitigate these shocks and build resilience. The annex provides a summary of some of the challenges faced by Bhutan and suggestions on possible mitigating measures for consideration under Bhutan's transition strategy.

Bhutan's 12 FYP outlines several strategies, such as infrastructure development, institutional reforms, economic diversification and human capital development. Considering the key challenges identified, and whose mitigation is critical and vital for the continued growth and development of a graduated Bhutan, several recommendations are put forth for consideration by the RGB and its development and trading partners towards developing Bhutan's smooth transition strategy.

- The experience from graduated countries (such as Cabo Verde) shows the importance of establishing a consultative mechanism to facilitate the development of the smooth transition strategy and to identify related support actions. The establishment of such a consultative mechanism will provide Bhutan with a vital discussion forum, where the RGB and its development partners can mount a coordinated and cooperative effort to addressing the challenges and possible effects of graduation.
- National consultations are necessary to create awareness and understanding on the impacts of graduation, as well as gather data and information that would filter into Bhutan's consultative mechanism. In addition, the design of the smooth transition strategy must outline the specific support measures required by Bhutan during the transition period to ensure the determination of the best mix of supporting actions needed. In this regard, Bhutan is advised to conduct national consultations to determine national requirements for support during the transition period.
- Bhutan remains vulnerable to economic and environmental shocks. Vulnerability to natural disasters and economic shocks are thus the most critical issues deserving of attention when determining the appropriate length of the transitional period and the range and type of support measures that shall be desirable. The transition strategy needs to highlight the necessary support required by Bhutan to mitigate some of its vulnerabilities and needed to build resilience. Such requirements might include technical assistance and capacity-building, advisory services and new forms of development assistance aimed at supporting Bhutan and furthering the country's development progress in line with Bhutan's overall development strategy and its 12 FYP expected achievements.
- If not mitigated, graduation impacts are likely to exacerbate Bhutan's exposure to economic vulnerability shocks, and dilute efforts to diversify the economy and export basket and build productive capacities. Therefore, ideally the manner of phasing down of ISMs in some areas should supports (rather than hinder) Bhutan's development post-graduation. It will be essential for Bhutan to request specific support measures from its developing and trading partners, including transitional DFQF market access for products identified as critical for the diversification of the country's economy Bhutan's potential exports.

- The effective implementation of the 12 FYP and the sustainability of Bhutan's graduation are contingent on the availability of adequate and timely resources. Bhutan must seek confirmation from donors on the levels of support they will continue to provide to Bhutan after graduation. Bhutan must also identify ongoing projects that will require financial assistance from donors beyond graduation to be able to negotiate a targeted smooth transition strategy with its major development partners. This implies the need fora Financial Needs Assessment (FNA) to facilitate the development of a donor resource mobilisation strategy. The FNA could explore areas that require donor assistance in addressing Bhutan's vulnerability challenges such as climate change and natural disasters that might derail successful graduation and development progress post-graduation.
- The RGB must ensure that there is enough capacity and resources for the successful implementation of the smooth transition strategy. The United Nations General Assembly Resolution 71/243[59] requested the United Nations Development System to assist graduating countries in formulating and implementing their national transition strategies and take into account country-specific support for the graduating country for a fixed time frame.
- The development of a monitoring mechanism should be a crucial component of the preparation of Bhutan's smooth transition strategy as measuring progress during transition is a critical aspect of addressing vulnerabilities and building resilience.

59 Resolution adopted by the General Assembly on 21 December 2016, A/RES/71/243, 1 February 2017.

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# Annex

## Summary Table — Guidance on priority elements of a smooth transition strategy

| | Challenge to be mitigated | Proposed mitigating measures for consideration under Bhutan smooth transition strategy |
|---|---|---|
| Securing macroeconomic stability | Bhutan faces budgetary uncertainties exacerbated by the domestic and global impacts of the COVID-19 crisis and in view of the RGB's decision to front load 12 FYP implementation spending to the 2020/21 fiscal year and to introduce several programmes aimed at ensuring macroeconomic stability as part of the national response to mitigate COVID-19 impacts. Moreover, Bhutan's low and dispersed population base, renders the per capita investment cost for public services and infrastructure high. As a result, Bhutan requires more grant aid in the short to medium term. An abrupt reduction in grants and other sources of fiscal revenue could have considerable negative implications for development spending, thus hampering growth and efforts aimed at reducing economic vulnerability with knock-on on the country achieving graduation with momentum. | Bhutan will need to give priority consideration to negotiating with her development partners on continued provision of budgetary grants in short to medium term, including relevant technical assistance in building domestic capacity on the mobilisation of development finance to enable Bhutan to effectively implement the strategies and development programmes envisaged by the 12FYP and for the implementation of the smooth transition strategy. |
| | Bhutan is currently at moderate levels of debt distress. However, the country intends to borrow from multilateral banks to meet part of its recurrent costs and to increase capital expenditure. | Bhutan needs to maintain vigilance on vulnerabilities that arise from increased debt, there is a need for technical assistance in devising risk mitigation measures. |
| Developing Productive Capacity | Producers in Bhutan have a shortage of the skills required to engage in value addition. | Consideration should be given to engaging development and trade partners to encourage their constituencies to invest in the beneficiation of Bhutan raw materials. Consideration should also be given to leveraging regional opportunities to develop measures for the joint development and sharing of skills within a competitive, secure and predictable framework. |
| | The loss of EU and Japanese market preferences, which are essential for the growth of Bhutan's identified potential export products has implications for Bhutan's export diversification and building productive capacity strategies. | The preservation of LDC-specific trade preferences for a longer period will allow identified potential export sectors to grow, contributing to the diversification of the economic base and export basket, while contributing to reduced economic vulnerability. Other interventions aimed at addressing supply constraints and enhancing productive capacities to produce enough to sustain exports must also complement the longer phase-out period. |
| | Bhutan continues to liberalise and strengthen FDI policy to support the expansion and diversification of the country's economic base. | Bhutan will need to give priority consideration to securing technical assistance and support from development and trading partners on policy reforms, including ensuring synergies and coherence between FDI, industrial and entrepreneurship policies. |
| | Bhutan is emphasising the development of its still nascent CSI sector to enhance its contribution to sustainable growth and development. | Securing continued support from sources such as the EIF and AfT can be useful in developing business infrastructure and furthering Bhutan's efforts on the development of its four industrial parks. |
| | The transfer of technology and new skills is crucial to Bhutan to help the country move beyond hydropower and to the diversification of Bhutan's economic base. | For Bhutan to fully take advantage of new technologies and skills, there is need to put in place measures that help tackle concerns around accessibility, affordability and application of technologies, which require technical assistance from Bhutan's development and trading partners. In addition, Bhutan should request its development and trading partners to encourage their constituencies to transfer of technology and technical and management skills. |

| | Challenge to be mitigated | Proposed mitigating measures for consideration under Bhutan smooth transition strategy |
|---|---|---|
| Trade expansion (Trade in Goods) | Bhutan's trade prospects are subject to a volatile and uncertain global trading environment exacerbated by geopolitical tensions at the global level, and at the national level, export product and export market concentration, and low economic diversification. These sources of trade instability have knock-on effects for fiscal health, domestic growth, job creation and general socio-economic well-being. They represent a general threat to achieving graduation with momentum. | Global uncertainty requires Bhutan to adopt a strategic stance informed by analytical capabilities to identify and mitigate threats and leverage opportunities to preserve existing markets or tap new ones as lead producers employ strategies to mitigate risk, build resilience and rebalance global value chains. Bhutan's limited institutional capacity, including in the collection and use of accurate data necessitates the country to secure relevant technical assistance in this area. |
| | Bhutan's reliance on mainly commodity-based exports heightens exposure the country to revenue and economic shocks. | Bhutan must give priority consideration to securing international support measures aimed at accelerating the diversification of the domestic economic base, including its export. In this regard, securing an extended phase-out of trade preferences in key existing markets could directly benefit existing CSI exporters and allow for the emergence of new CSI exporters or sectors identified as having the potential to become significant export sectors. |
| | Some of Bhutan's exports may lose competitiveness due to the phasing out of LDC-specific market preferences. | An extended phase-out period of LDC-specific preferences would help producers to improve or build productive capacities and competitiveness. In addition to securing trade preference prolongation, Bhutan must accord priority consideration to securing complementary assistance, such as technical assistance programmes and adjustment facility packages to help producers to enhance productive capacities, including in the context of industrial policy, technology acquisition, human capital and technological capabilities. |
| | Like most LDCs, Bhutan has limited productive capacity to take advantage of market access opportunities to increase and diversify its exports. | Aid for Trade provided through EIF can be useful in expanding market access, building productive capacity and increase and diversify exports by adding value to raw materials. |
| | Bhutan experiences deficiencies in trade facilitation, including the problem of inefficient customs procedures, which contributes to high trade costs. | Bhutan must consider according priority to securing development finance and technical assistance to improve trade-related infrastructure and enhance trade facilitation to lower the transaction costs faced by domestic economic actors, including through engaging development partners on their WTO trade facilitation commitments and technical assistance that can be availed by UNCTAD.<br><br>Bhutan benefits from WTO Trade Facilitation Agreement technical assistance and Bhutan can request for continued aid from its trading partners to improve its customs clearance processes. |
| Trade expansion (Trade in Services) | Sustainable tourism, agriculture and hydropower generation, are priority sectors in Bhutan's drive for economic diversification and are important drivers of development overall, however, these sectors are increasingly at threat from climate change. Climate hazards can be expected to intensify and socio-economic impacts to grow. | Consideration should be given to identifying special interventions towards natural disaster management and resilience, including securing related technical and financial assistance from development partners. |
| | Bhutan has limited capacity to realise the full potential in trade in services, mainly because of lack of diversification of the services sector. | Assistance in infrastructure development to reach currently inaccessible areas will help create an environment for diversifying services exports. |

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