SATURDAY
KUENSEL
THAT THE PEOPLE SHALL BE INFORMED
FEBRUARY 18, 2017 · Nu 15

Building productive capacity in Bhutan for LDC graduation

The category of least developed country (LDC), introduced in 1971, aims to help attract special support measures for the most disadvantaged economies, which were lagging other developing nations. LDCs are classified as low-income countries which are highly vulnerable to economic and environmental shocks and have low levels of human assets. The Committee for Development Policy (CDP) is the UN agency responsible for reviewing the list of LDCs every three years and making recommendations on the inclusion and graduation of eligible countries. The Committee uses three criteria: income per capita, human assets, economic vulnerability. The latter two criteria are comprised of a number of indicators. 48 countries currently qualify as LDCs.

A country must meet two of these three criteria at two consecutive three-yearly reviews of the CDP in order to be considered for graduation. Alternatively, an LDC may exceed twice the income per capita threshold (currently $1,242) for two consecutive reviews. Four countries have so far left the category: Botswana, Cape Verde, the Maldives and Samoa. Equatorial Guinea will graduate this year. Vanuatu and Angola are also scheduled to leave in 2020 and 2021 respectively.

The LDC category was created to give countries in particular need of assistance exclusive access to certain international support measures, in particular aid and trade. For instance, all LDCs have duty and quota-free access to European markets as well as improved access to other countries under dedicated trading arrangements set up to help LDCs, such as the generalized system of preferences granted by the US and others. Official donors have committed to allocating 0.15 – 0.2 percent of their aid to LDCs. There are several other international support measures for LDCs, including climate change financing, reduced contributions to the UN and WTO (as observers in the case of Bhutan), and help with travel to international meetings.

Bhutan is likely to have met the income-only criterion for LDC graduation (double the current per capita income threshold) at the next triennial review in 2018 and to continue to meet the human assets criterion, rendering it eligible for graduation in coming years, depending on CDP and government discussions.

As such, there is a need to develop the economy further to make development sustainable over the long term, and to understand the implications of the removal of international support measures. The CDP is carrying out a project to help Bhutan understand the implications of a withdrawal of support and to provide some initial ideas about the development of productive capacity. This briefing draws on research conducted on productive capacity and LDC graduation conducted in 2016 for the CDP of the UN Department of Economic and Social Affairs, and a growth identification and facilitation framework (GIFF) study commissioned by the CDP on Bhutan.

Productive capacity and LDC graduation

Productive capacity is the productive resources (natural, human, physical and financial), entrepreneurial and institutional capabilities, and production linkages which together determine the capacity of a country to increase production and to diversify its economy into higher productivity sectors for faster growth and sustainable development. Enhanced productive capacity is not a stand-alone goal but rather a component of broader progress towards sustainable development, and it thus fits well with Bhutan's GNH approach.

Building productive capacity is generally seen as a major challenge for LDCs. The issue is the first priority area in the Istanbul Programme of Action for the LDCs 2011-2020, features strongly in the Sustainable Development Goals, and is the subject of various reports by international organizations dedicated to LDCs. There is also international consensus around the view that LDC graduation should be seen not as an end in itself but as a way point in sustainable development. Productive capacity is thus a critical component of LDC graduation and successful and sustainable development.

There are strong links between expanding productive capacity and making progress towards graduation, but also notable differences. First, increased productive capacity for sustainable development leads to increased production, which in turn increases income. However, production can be increased without expanding productive capacity for sustainable development, in particular by exploiting natural resources through mining activities. Moreover, income can increase without production, for example by increasing proceeds from licenses granted to other countries to exploit natural resources.

In addition, there are clear links between productive capacity and the other two LDC criteria. Building productive capacity in a way that harnesses positive synergies with social outcomes directly increases human assets, moving a country closer to graduation. In principle, increased human assets may not necessarily imply higher productive capacity, if these assets are not harnessed for economic activities, for example due to the lack of complementary physical capital or institutional failure. Generally, though, the link between productive capacity for sustainable development and human assets is clearly positive and two-directional.

The link between expanding productive capacity and reducing the economic vulnerability as measured by the Economic Vulnerability Index (EVI), however, is more complex. Effective industrial and trade policies, supportive macroeconomic and financial policies and international support through preferential market access and other means will lead to increased exports, overall economic diversification and a better integration into the world economy. Reducing export concentration and export instability will result in an improved EVI score.

Raising agricultural productivity, a key ingredient of expanding productive capacity in many LDCs, ultimately reduces economic vulnerability as the share of agriculture in GDP would decline (as labour formerly active in agriculture could move to more productive manufacturing or services sectors) and agricultural instability would fall. However, as in the case of export instability, this may be achieved only after an initial overshooting.

Generally, and after time lags, enhancing productive capacity will in most cases lead to lower EVI scores and move countries closer to graduation. However several components of the EVI reflect structural constraints that are policy-invariant exogenous factors, at least from the perspective of an LDC. Changes in population only marginally change the EVI score (moreover, in most LDCs increasing population growth would not be seen as progress towards sustainable development); remoteness changes over time due to shifts in world trade patterns rather than trade performance of individual LDCs. Consequently, a large part of the EVI score is rather fixed even in the medium term.

Bhutan's progress toward LDC graduation

Some countries have graduated from the LDC category or made progress towards graduation not through progress in all three LDC criteria but by specializing in a few economic activities while at the same time investing in human capital. Bhutan falls within this latter category given that it specializes in natural resource based activities (hydropower generation) and tourism, with some manufacturing.

In line with economic growth and significant investments in social sectors, Bhutan has made rapid progress towards graduation. The country first met the graduation criteria in 2015 and will be considered by the CDP for graduation in 2018. Per capita income has been rising rapidly since the 2000s, almost reaching the 'income only' threshold of $2,484. The HAI score has also rapidly improved and passed the current threshold in 2013, mainly on account of rapid improvement in child mortality and expansion of secondary education.

Generally, Bhutan's progress in improving assets is rooted in the government's active efforts to reduce poverty and maintain equality: the promotion of universal education and the shift of workers into the cash economy has expanded the potential workforce and stimulated demand. Poverty reduction has been faster than in south Asian countries and has fallen to lower levels, whilst equality is higher than in comparable countries (the income Gini coefficient is 38.1, which is low by LDC standards). Economic vulnerability, however, remains high. While the shift of global economic activity towards Asia has reduced the remoteness score and agriculture as lost its role as dominant economic activity, Bhutan remains vulnerable to natural disasters despite undertaking disaster risk reduction measures and export instability is high, largely because each new hydropower plant leads to a sudden increase in export earnings. Agricultural instability has actually worsened, as the increase in production over the last decade has been accompanied with higher volatility.

Growth identification and facilitation

GIFF, developed by former World Bank Chief Economist Justin Lin, is one way of helping identify products which take advantage of a country's latent comparative advantage and the possibilities arising due to catch-up, as well as excluding the improbable. It is designed to help policy makers understand how to use the limited resources available to solve the first mover problem and attract labor intensive industries.

The aim of the GIFF is to identify a shortlist of industries to target as pioneer firms that may be experiencing increased costs due to changes in local factor endowments. Normally, benchmark countries would be identified and possible products chosen, but Bhutan's situation is so unique that no realistic comparator could be found. Once pioneer firms invest and achieve quick wins, their success will demonstrate the potential gains of investment in Bhutan. Whilst the study in Bhutan does not identify an exhaustive list and departs from the conventional approach, it makes suggestions based on the background analysis and on Bhutan's latent comparative advantage.

Continued on INSERT 2

Building productive capacity in Bhutan for LDC graduation

From INSERT 1

Bhutan is likely to face major challenges in diversifying trade, given its binding constraints and the fact that it may soon graduate from LDC status. Nevertheless for at least seven years the country enjoys tariff exemptions on certain exports under the US Generalized System of Preferences (GSP) and the EU Everything but Arms (EBA) program which permits LDCs to export to Europe duty and quota-free. While these preferences do not differentiate among LDCs, the aggregate of two largest markets in the world is big enough for each country to capture a significant share. Although it will be difficult to take advantage of this preferential access Bhutan should not rule out taking advantage it for products with the greatest comparative advantage. These exemptions may be leveraged as an investor incentive while still available. If such a route is taken, first, products could be selected based on their EU trade preferences, which are more meaningful. This large market can provide essentially unlimited demand for products.

The importance of FDI investment pioneers

However it is the attraction of more FDI that will be critical to the development of productive capacity and to sustainable long-term LDC graduation. In 2015 FDI net inflow into Bhutan was only 0.4 percent of GDP, which in South Asia is only higher than Afghanistan and Nepal. Net FDI inflow per capita in Bhutan is even further behind the average level of South Asian countries, LDCs and Asian LDCs.

Between 2006 and 2012 ferro-alloys benefited the most from FDI, distantly followed by hotels and hydropower. Foreign developers are also invited to participate in infrastructure projects under the PPP model. The Thimphu Tech Park attracted the Assetz Property Group of Singapore as a joint developer with an investment of Nu 225 million. However, with respect to attracting more diversified investment, the current FDI scenario suggests that the effectiveness of FDI policies and incentives are secondary to business prospects. This is demonstrated in that agro-based and forest manufacturing are listed as priority sectors, but FDI inflows remain low in these categories.

To capture FDI for key activities, Bhutan needs to re-adjust its policy and link incentives to targeted activities that can diversify its economy. The most convincing evidence of Bhutan's potential will come from compelling pioneer cases. If Bhutan can attract a few successful FDI-driven industries, then they will convince more firms to follow suit. To some extent this is already happening in the case of Thimphu TechPark.

In countries facing infrastructure shortcomings and challenging business environments, Special Economic Zones (SEZs) may be used to overcome barriers to firm entry, attract FDI, and encourage industrial clusters. SEZs enable the allocation of scarce resources on a limited scale in order to create quick wins. These small economic enclaves can prove experimental industrial policies and incentives. Industrial estates allow the government to make desirable improvements in infrastructure and business environment, which will reduce transaction cost and encourage industrial clustering. SEZs take a step further: government can create islands of policy flexibility without changing a broader sea of national policy. Bhutan's 2010 Economic Development Policy makes provision for SEZs.

The success of Thimphu TechPark, launched in 2012, suggests that ICT has a strong potential in the context of economic zones. Despite initial scepticism, after US online photo company Scan Café ramped up its initial 20-strong pilot project in May 2013, 11 others followed from Bangladesh, Switzerland and elsewhere, specializing in telecom, business process outsourcing and online data.

Scan Café showed that Bhutan was a good place to do business. Most of the ingredients were already in place – good education, competitive wages, cheap electricity and low rent – they just hadn't yet been used in ICT. Most Bhutanese are taught English from an early age, and the country scores particularly well on the human assets index that is part of the official LDC category. Bhutan is following a path well-trodden by successful tech exporters: start small and cheap, discover markets through trial and error, and move into more sophisticated activities later on.

In the spirit of the GIFF, these are the pioneer firms which have invested and achieved quick wins, their success demonstrating to other companies the potential benefits from investment in Bhutan. A total of 750 workers are employed at the park, which is an important source of employment for young people in the capital, and more than half the number of people who work at three of the five hydropower plants (although a small proportion of the 350,000 economically-active national workforce). According to the Bhutan Diagnostic Trade Integration Study (DTIS), ICT fits well with the GNH environmental vision. E-commerce and e-government have a low environmental impact because they localize service access and delivery and are more efficient than old, carbon-heavy industries.

Thimphu TechPark is an example of using an SEZ to attract FDI to demonstrate sector potential. Once the potential has been demonstrated, demand increases as more firms follow. SEZs allow policy flexibility, infrastructure and targeted incentives for attracting these pioneer firms. Although industrial estates provide infrastructure, the effects can be amplified with supplementary policy support. By creating manufacturing oriented SEZs, Bhutan can attract FDI and repeat the successes seen in the Phuentsholing Industrial Estate and the Thimphu Tech Park.

The government should compensate pioneer firms with tax incentives for a limited period; direct credits for investments; and/or access to foreign exchange. The incentives provided should seek to drive FDI into sectors consistent with the country's comparative advantage and factor endowments.

The first mover problem is an obstacle based on a lack of information. Initial investors have no previous firms to demonstrate the profitability of foreign firms in the region. Further, after a firm has entered Bhutan, this firm produces information which successive firms can use whether the firm succeeds or not. Pioneer firm incentives compensate for this additional risk.

Bhutan's government enacted the Revised Rules & Regulations on Fiscal Incentives in 2010, attempting to stimulate investment and economic growth. A large proportion of the fiscal incentives targeted firms new to Bhutan. These policies focused on new industries and may be considered Bhutan's pioneer incentives. Further, except for some general incentives, specific sectors were the focus of most of the document. The tourism sector, for instance, is among the sectors that received the most fiscal incentives.

As Bhutan receives industrial transfer, it must be more integrated into the global market. To win competitiveness in the international arena, an efficient custom system must be developed to facilitate export and import. However, Bhutan ranks the lowest efficiency of customs clearance process among South Asia countries, and worse, it takes the longest time to clear exports, according to the Enterprise Survey. Customs clearance is relevant not just to goods exporters but to the ICT services exporters which can be found in EPZs.

Conclusions

The GIFF study, whilst not providing an exhaustive list of future industries into which Bhutan should transfer, argues that the government should play an active role in structural transformation, particularly to help the economy overcome first-mover and externality problems. In a nutshell, the government should facilitate attracting FDI, removing binding constraints and promote SEZs with targeted policies – particularly in services and more specifically ICT. This is by no means to discount the importance of major existing industries such as tourism and hydropower, but diversification is an urgent and pressing task. As industries transfer, Bhutan will become more integrated into the global market and other investors may follow. In addition the learning-by-doing effect may lead to the emergence of local entrepreneur-led firms.

Building productive capacity is critical to successful LDC graduation in that it provides a long-term platform for sustainable social and economic development beyond reliance on international support measures such as trade preferences and aid. Although LDC graduation is an important milestone, it is only a stage in the process and should not be seen as the end-point. In Bhutan's case, it is unlikely to have a major negative impact on the economy given the low utilization of preference rates and donor plans to reduce aid independently of graduation.

Nonetheless there are links between the LDC criteria and productive capacity. Increased productive capacity raises income and can improve human assets, whilst diversification, all other things being equal, improves a country's score on the economic vulnerability index. Diversification is particularly important given Bhutan's increasing reliance on hydropower and its continuing dependence on India.

Bhutan's unique GNH approach is seen as an asset, and something that contributes to prosperity and national wellbeing. GNH has contributed to the relatively effective use of hydropower resources and to the preservation of the natural environment, as well as to ensuring that the benefits of development have been reasonably and equitably shared. Whilst some success has been achieved in diversification, a continued expansionary and stable macroeconomic environment is essential to underpin continued success.

Preliminary research conducted for this report indicates that Bhutan could utilize the current global industrial transfer window to develop new sectors and to build on the success of Thimphu TechPark and others. Establishing SEZs contributes to the alleviation of the costs imposed by hard and soft binding constraints and allows governments with limited resources to focus improvement efforts on a small scale, to encourage FDI. IT-enabled services in particular have potential given Bhutan's remoteness, geography, the availability of power and the lower rent than Bangladeshi or Indian cities. This should enable Bhutan to leverage its relatively low labor costs to encourage firms to transfer to Bhutan, facilitating industrial upgrading, economic transformation, and product and trading partner diversification.

Contributed by
Sonam Tobgay, Consultant
Daniel Gay, Committee for Development Policy
United Nations Department of Economic and Social Affairs