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A Framework of Trade Policy for Bhutan Compatible with the Gross National Happiness

Inkyo Cheong, Taeho Bark, and Hoe Yun Jeong

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Inkyo Cheong is Professor of Economics at Inha University, Republic of Korea. Taeho Bark is Professor, Graduate School of International Studies, at Seoul National University, Republic of Korea. Hoe Yun Jeong is Senior Economist, Regional Cooperation and Operations Coordination Division (SARC), South Asia Department, Asian Development Bank.

Asian Development Bank
6 ADB Avenue, Mandaluyong City
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ABSTRACT

Bhutan highly values psychological aspects of social welfare and well-being by setting requirements for satisfying the threshold of the gross national happiness (GNH) index in making national policy decisions. The GNH index, however, includes factors that are seemingly unfavorable to an active trade policy. One of the most urgent tasks facing Bhutan is to improve general living standards, especially the creation of decent jobs for the young. The country needs to benchmark successful development strategies in other countries, and to recognize that no country can develop an economy without an open trade policy. This paper discusses the relationship between the GNH and trade policy, and tries to analyze trade policy issues of Bhutan: inclusive growth, trade facilitation, incidence of tariffs, and World Trade Organization accession. It explores trade and industry policy that is compatible with the GNH guidelines. It also points out that the structure of the Bhutanese government is less oriented to trade policy than its neighbors, and suggests a new organization for promoting a more active trade policy. It concludes by underlining the importance of an active trade policy for Bhutan.

1. INTRODUCTION

1. Bhutan is a typical landlocked country and heavily trades with a limited number of neighboring countries. Because Bhutan has small domestic market and unfavorable resource endowment for industrialization, majority of its population live on primary sectors and trade issues are not national policy priorities. However, Bhutan has increased trade volumes beginning in the 1990s and thus trade became an indispensable part of its economy. Trade policy is a requisite for all countries. The key issue is how to set up optimal trade policy framework aimed at maximizing economic gains from trade and specialization.

2. Bhutan is renowned for its gross national happiness (GNH) philosophy, but it faces many social and economic issues. One of these issues is the need to raise Bhutan's living standards. Its economic growth has so far been led mainly by hydropower sector development and has not been creating enough jobs especially for the young. Inequality remains high even though Bhutan has been successful in reducing poverty. Bhutan thus needs to ensure a more inclusive and job-generating growth.

3. As a country in the early stages of economic development, Bhutan has tried to improve its business environment since 2008, although it still lags behind its neighbors in this respect.¹ The country faces many challenges in boosting its economy and attracting foreign direct investments (FDIs) to its target sectors in order to improve its people's well-being. Easing regulations favors business activities, but it is just one of the factors investors will consider. Furthermore, investors usually examine the overall competitiveness of the country before investing. Bhutan needs to recognize that its neighbors are competing for FDIs.

4. The Government of Bhutan requires new policies to meet the threshold score of the GNH index. However, the GNH index includes some factors seemingly unfavorable to an active trade policy. Moreover, although the share of trade reached 80% of gross domestic product (GDP) as of 2013, the involvement of the trade authority in the government is very small (the trade authority belongs to only one of 10 departments under the Ministry of Economic Affairs). In most countries, trade policies are administered in the cabinets, such as Ministry of Commerce, Ministry of Trade, or Ministry of Foreign Affairs and Trade. Bhutan is a landlocked country with little economic power, which has resulted in a passive attitude toward international trade.²

¹ Bhutan achieved lower-middle-income status in 2006. Using the World Bank Atlas method, middle-income economies for the current 2015 fiscal year are defined as those with a gross national income (GNI) per capita of more than \$1,045 but less than \$12,746. Lower-middle-income and upper-middle-income economies are separated at a GNI per capita of \$4,125. Countries with a GNI of \$11,905 or less are defined as developing. (Source: <http://data.worldbank.org/about/country-and-lending-groups>) ADB Basic Statistics (2014) estimated Bhutan's per capita GNI at \$2,420 as of 2012.

² Warr (2012, 6) states, "Historically, landlocked countries have generally been pessimistic about the scope for an export-oriented development strategy. They have generally chosen inward-looking development strategies." Hydropower development is one of Bhutan's top priorities. The Indian government is proud of supporting Bhutan in planning and funding the project that largely exports electric services to India.

2. PERFORMANCE OF THE MACROECONOMY AND EXTERNAL SECTOR

2.1 Macroeconomy

5. Although the growth rates in 2012-2014 slowed because of a tight monetary policy in 2012, Bhutan's GDP grew by 6.69% on average during the Tenth Five-Year Plan, 2008–2013, achieving commendable socioeconomic gains. The domestic economy grew 2.05% in real terms in fiscal year (FY) 2013, and 2.10% in FY2014 (Table 1).³ Total budget spending was moderated in FY2014, but the current account deficit remained elevated. (ADB 2014, p.165) It is common for developing countries to have large trade deficits and current account deficits in the early stages of economic development owing to the imports of the capital goods. Bhutan's capital formation contributes to the country's production capacity, and the receipt of foreign exchange from newly built facilities plays an important role in managing the macroeconomy.⁴

Table 1: Macroeconomic Performance of Bhutan

Item	2010	2011	2012	2013	2014
GDP (\$ billion, current) ⁵	1.59	1.82	1.82	1.78	1.70
GDP per capita (\$ billion, current)	2.2-8	2.57	2.53	2.44	2.29
GDP growth (% , in constant prices)	11.73	7.89	5.07	2.05	2.10
Primary	0.85	2.41	2.25	2.94	...
Secondary	12.48	4.06	6.77	3.49	...
Tertiary	15.21	13.89	4.29	0.33	...
Gross domestic capital formation (% of GDP)	62.15	64.43	63.52	40.71	...
Gross domestic savings (% of GDP)	33.42	38.37	43.60	25.24	...
Consumer price index (annual % change)	7.02	8.86	10.92	8.77	8.10
Overall fiscal surplus (deficit) (% of GDP)	1.80	(2.30)	(1.20)	(4.40)	(4.40)
Merchandise trade balance (% of GDP)	(28.70)	(23.10)	(23.40)	(22.60)	(21.50)
Current account balance (% of GDP)	(24.30)	(32.60)	(23.30)	(28.20)	(27.30)
External debt service (% of exports of goods and services)	30.70	51.70	127.10	229.20	26.80
External debt (% of GDP)	66.60	79.50	87.40	98.40	101.30

... = not available, () = negative, GDP = gross domestic product.

Sources: Government of Bhutan, National Statistics Bureau. 2014. *National Accounts Statistics 2014*. Thimphu; Government of Bhutan, Royal Monetary Authority. 2014. *Annual Report 2013/14*. Thimphu.

³ The fiscal year (FY) of the government ends on 30 June. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2013 ends on 30 June 2013.

⁴ Capital-intensive hydropower development contributed 20.9% on average to Bhutan's GDP growth over 2000–2013 (ADB 2014, 166).

⁵ Unless otherwise noted, "\$" refers to US dollars.

6. Bhutan began to record huge trade deficits since 2008, worsening in 2010 and 2011, due to rising imports for building social infrastructure and rising domestic consumption.⁶

7. While the expansion of the hydropower sector has helped propel Bhutan's economic growth and development, the heavy reliance on the sector has had a deleterious effect on the country's current account deficit. The sector's requirements for imported capital equipment and skilled manpower as well as servicing of its short-term debts have swelled the current account deficit and put pressure on international reserves. Rapid growth in the power sector further spilled over into the other sectors of the economy, creating additional demand for imported goods and services from main trading partner, India.

8. The share of the current account deficit to GDP was as high as 32.6% in 2011, but dropped to 28.2% in 2013 owing to a tightened aggregate demand policy when the country faced a shortage of its Indian rupee reserves in 2012. In order to reduce the trade deficit, the government tightened credit constraints on imports and instituted import restrictions, particularly for large-scale construction projects that required rupee payments.⁷ As a result, "The brunt of the downdraft in FY2013 was felt in services. Expansion in transport and communications halved to 5.2% from 10.3%, while growth in retail trade, hotels and restaurants, and other services moderated mainly owing to slower domestic spending, especially on vehicles" (ADB 2014, 164).

2.2 External Sector

9. Bhutan maintains a close relationship with India, politically and economically, based on the geopolitical environment. Traditionally, India has been Bhutan's most important donor country, both for projects and general-purpose grants. Bhutan's currency is pegged to the Indian rupee, and Indian demand accounts for most of Bhutanese exports. Bhutan trades heavily with India (85% of its total trade), and most of the trade deficit is with India. The majority of Bhutanese imports of necessities, including food, come from India. Moreover, India is the only country that imports the electricity produced in the valleys along the western portion of Bhutan.

10. With relatively high trade restrictions and no direct access to international ports, Bhutan's trade with the rest of the world is limited. Being a landlocked country and depending on Indian ports, Bhutan conducts the majority of its cross-border trade with India. Apart from India, Bangladesh and Nepal have traditionally been important trading partners, while more recently Northeast Asian countries such as People's Republic of China (PRC), Japan, and the Republic of Korea have joined Bhutan's trading partners. Bhutan's trade deficit has been recorded since FY2008, and peaked in 2011. Facing a rupee crisis in 2012, the country introduced tight fiscal and monetary policies, after which its trade deficit began to decrease.

⁶ Bhutan's total consumption increased sharply after 1995. The share of final expenditure to GDP was 60% in 1995, growing to 70% in 2000, and to 75% in 2013.

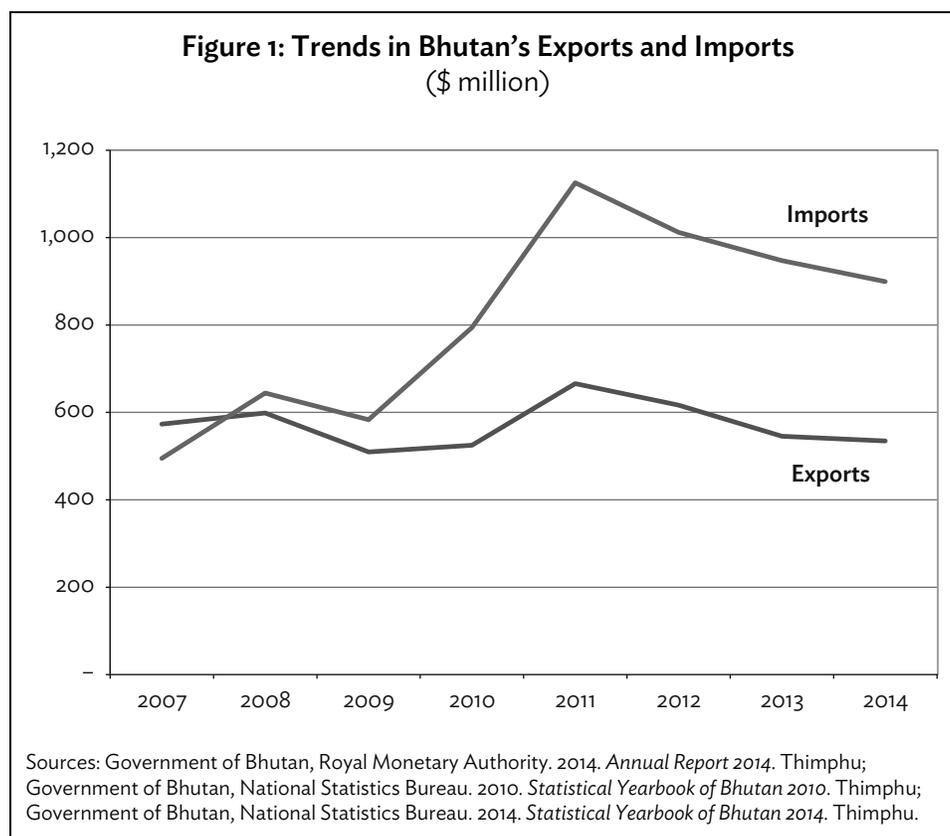
⁷ Imports for hydropower development were exempted from the government's import restrictions.

Table 2: The Trend in Bhutanese External Performance
(\$ million)

Item	2007	2008	2009	2010	2011	2012	2013	2014
Current account	83.9	(111.1)	(76.0)	(318.6)	(521.4)	(393.4)	(500.9)	(463.8)
with India	73.5	(86.6)	(74.4)	(197.5)	(401.1)	(312.0)	(480.8)	(435.9)
Trade balance	78.5	(45.5)	(73.9)	(269.4)	(459.9)	(395.5)	(401.7)	(364.7)
with India	100.7	(0.7)	(12.4)	(125.5)	(334.7)	(254.5)	(313.9)	(286.3)
Exports	573.3	598.7	509.5	524.8	665.8	616.6	545.6	534.6
To India	473.2	538.1	480.0	481.5	562.0	548.0	502.4	486.3
Imports	494.8	644.2	583.3	794.2	1,125.7	1,012.1	947.3	899.3
From India	372.6	538.8	492.5	607.0	896.7	802.5	816.2	772.6
Services	(29.0)	(65.8)	(42.2)	(71.1)	(94.6)	(94.5)	(61.9)	(87.5)
Credit	60.2	54.7	56.5	68.8	81.8	102.4	123.3	132.1
Debit	89.2	120.4	98.7	139.9	176.3	196.9	185.2	219.6

0 = negative.

Sources: Government of Bhutan, Royal Monetary Authority. 2014. *Annual Report 2014*. Thimphu; Government of Bhutan, National Statistics Bureau. 2010. *Statistical Yearbook of Bhutan 2010*. Thimphu; Government of Bhutan, National Statistics Bureau. 2014. *Statistical Yearbook of Bhutan 2014*. Thimphu.



11. Although Bhutan's Economic Development Policy, 2010 has been announced, its trade policy can be changed due to the lack of internationally binding mechanism.⁸ Therefore, it is not clear whether the government should continue its binding commitments to liberalizing the import regime, including a reduction in most favored nation tariffs and non-tariff barriers, other than its South Asian Association for Regional Cooperation (SAARC) commitments.⁹ As a landlocked country, Bhutan had few trading partners, such as India and Bangladesh, even as recently as the 1990s. However, things are changing as Bhutan is gaining more trading partners. India still remains to be an important trading partner, while the number of other trading partners has increased to more than 10 beginning 2008. This implicitly indicates that, overall, the country's trade restriction has gradually been eased.

12. Bhutanese total exports were 29.6 billion ngultrum (Nu) (\$0.53 billion) in 2012, down from Nu31.4 billion (\$0.64 billion) in 2011, although both years showed an increase from the Nu8.2 billion (\$0.18 billion) in 2004. Most trade occurred with geographically adjacent countries, such as India and Bangladesh. In 2012, 98% of Bhutanese exports were sent to India, Bangladesh, and Nepal, and 79% of its total imports were Indian products. As the number of Bhutan's export partners increased to 8–10 countries, the country's export volume jumped in 2004 and 2005. Germany; Hong Kong, China; Italy; Japan; and Nepal became new export destinations, although India and Bangladesh still account for the bulk of the country's exports.

Table 3: Bhutan's Exports by Year and Destination
(Nu million)

	1990	1995	2000	2005	2006	2008	2010	2012	2013
Total	1,221.6	3,350.1	4,615.8	11,386.2	18,771.9	22,590.6	29,324.4	29,618.4	20,625.7
India	1,055.3	3,079.0	4,377.0	9,969.8	14,488.0	21,480.0	26,000.9	27,825.6	17,751.9
Bangladesh	127.8	201.1	164.8	561.8	470.1	632.4	906.1	1,172.2	1,465.0
Germany	n/a	n/a	n/a	n/a	n/a	2.0	0.4	30.3	298.3
Hong Kong, China	n/a	n/a	0.0	685.9	2,866.0	105.3	2,188.3	79.1	234.7
Italy	n/a	n/a	n/a	n/a	n/a	0.0	15.5	125.0	191.1
Netherlands	n/a	n/a	n/a	n/a	n/a	0.1	0.2	70.1	154.7
France	n/a	n/a	n/a	n/a	n/a	0.4	0.6	0.1	152.1
Belgium	n/a	n/a	n/a	n/a	n/a	11.2	-	-	111.5
Nepal	n/a	n/a	n/a	n/a	n/a	195.8	39.7	107.4	87.1
Japan	n/a	n/a	n/a	n/a	n/a	66.0	132.5	113.7	65.7
Singapore	n/a	n/a	0.9	72.8	585.4	n/a	n/a	n/a	n/a
Thailand	n/a	n/a	2.1	32.9	282.4	n/a	n/a	n/a	n/a
Nepal	n/a	n/a	28.4	44.8	57.4	n/a	n/a	n/a	n/a
Others	38.5	70.0	42.6	18.1	22.5	97.6	40.4	94.9	113.6

n/a = not applicable.

Note: An entry of "0.0" indicates a marginal value compared to "-" which indicates no value for that particular item.

Sources: Government of Bhutan, Royal Monetary Authority. 2014. *Annual Report 2014*. Thimphu; and earlier issues of the Annual Report.

⁸ One of the reasons for joining the World Trade Organization (WTO) is the improvement of binding commitments and transparency on trade policy. Non-WTO members bear international duty of keeping their commitments.

⁹ Bhutan has a tariff liberalization plan under an SAARC agreement to gradually reduce peak tariff rates to 5% by end of 2015.

13. Bhutan's major export items--merchandise goods and thus excludes services such as electricity and water utilities--are natural resources or semi-processed ones such as ferro-silicon (HS 720221), semi-finished products of iron or non-alloy steel (720712), carbides of calcium (284910), Portland pozzolana cement (252329), and carbides of silicon (284920). The export of ferro-silicon (containing more than 55% of silicon) represented 37% of Bhutan's total exports of goods.

Table 4: Bhutan's Top 10 Export Goods, 2013
(Nu million)

BTC Code	Commodity Description	Value
7202.21.00	Ferro-silicon containing more than 55% of silicon	7,672
7207.12.00	Semi-finished products of iron or non-alloy steel	1,730
2849.10.00	Carbides of calcium	981
2523.29.30	Portland pozzolana cement	887
2849.20.00	Carbides of silicon	830
7214.30.00	Bars and rods of iron and non-alloy steel	744
0908.31.00	Cardamoms (neither crushed nor ground)	656
2520.10.00	Gypsum; anhydrite	558
0805.10.00	Oranges	519
2518.10.20	Dolomite, not calcined or sintered, chips	513
	Others	5,531
Total		20,626

BTC refers to "Bhutan Trade Classification."

Source: Government of Bhutan, Department of Revenue and Customs, Ministry of Finance. 2013. *Bhutan Trade Statistics 2013*. Thimphu.

14. Imports have increased steadily since 1990, and, although the trade deficit was not large, it showed an increasing trend. Imports jumped in 2004, causing the trade deficit to grow beyond Nu10 billion for the first time. The trade deficit then decreased, until the trade balance became a surplus in 2007. However, in 2010, Bhutan's trade deficit began to increase sharply again, growing by 35% in 2012 due to hydropower development, and exposing the country to a foreign exchange crisis. The bulk of imported goods comes from India. Asian manufacturing powers such as the PRC, Japan, and the Republic of Korea are more recent trade partners, accounting for only 5% of Bhutan's total imports.

15. Unlike exports, imports are spread evenly to several items. The largest imports are petroleum oils constituting about 11% of the total imports, followed by ferrous metals, DC motors and generators, gasoline, brown rice, and hydraulic turbines. Many of top 10 imports are used for building or maintaining hydropower plants. Bhutan has embarked on a major program of building 16 hydropower projects to provide electricity for itself and India. As of 2013, four projects were already producing electricity, and work had started on another four. In 2015, a fifth project (Dagachhu) begins generating electricity, and work is planned on five more projects.

Table 5: Bhutan's Imports by Year and Origin
(Nu million)

Country	1990	1995	2000	2005	2006	2008	2010	2012	2013
Total	1,424.6	3,641.9	7,875.0	17,035.1	19,012.0	23,495.1	39,075.2	52,673.8	52,315.7
India	1,172.5	2,630.2	6,231.3	12,795.1	13,053.9	17,339.5	29,329.1	41,825.6	43,666.4
China, People's Republic of	n/a	n/a	71.8	182.2	281.7	844.7	611.0	1,330.2	1,089.3
Thailand	n/a	n/a	105.8	275.5	257.8	410.8	988.1	740.6	1,080.9
Singapore	14.0	194.0	251.4	447.2	515.1	964.8	903.0	783.5	969.7
Sweden	n/a	n/a	n/a	n/a	n/a	240.7	550.3	609.2	817.0
Austria	n/a	n/a	n/a	n/a	n/a	24.6	78.2	939.7	695.5
Germany	22.8	70.8	28.3	200.4	200.3	285.0	362.0	223.9	304.2
Japan	73.5	412.0	305.2	648.2	395.9	1,098.9	845.1	1,260.7	295.7
Switzerland	n/a	n/a	n/a	n/a	n/a	131.3	176.8	392.7	292.2
Republic of Korea	n/a	n/a	123.9	247.5	459.4	286.7	2,004.7	1,658.9	280.8
Indonesia	n/a	n/a	-	240.0	1,331.3	n/a	n/a	n/a	n/a
Russian Federation	n/a	n/a	-	162.1	874.8	n/a	n/a	n/a	n/a
Malaysia	n/a	n/a	8.1	174.9	351.8	n/a	n/a	n/a	n/a
United States	17.5	12.7	n/a	n/a	n/a	n/a	n/a	n/a	n/a
United Kingdom	8.8	57.5	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Others	115.5	264.7	749.2	1,662.0	1,289.9	1,868.2	3,226.8	2,908.8	2,824.0

Note: An entry of "o.o" indicates a marginal value compared to "-" which indicates no value for that particular item.

Sources: Government of Bhutan, Royal Monetary Authority. 2014. *Annual Report 2014*. Thimphu; and earlier issues of the Annual Report.

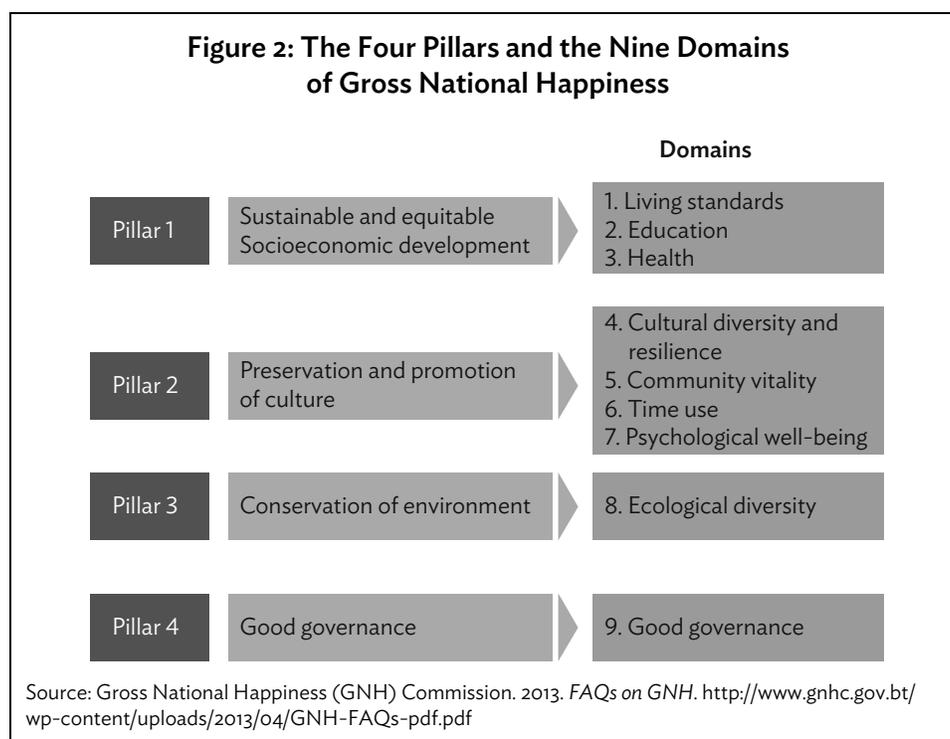
Table 6: Bhutan's Top 10 Imports, 2013
(Nu million)

BTC Code	Commodity Description	Value
2710.19.15	Petroleum oils and oils	5,655
7203.10.00	Ferrous products	1,888
8501.33.00	DC motors, DC generators	1,861
2710.12.10	Motor spirit (gasoline)	1,750
1006.20.10	Husked (brown) rice	1,061
8410.13.00	Hydraulic turbines and water wheels	1,028
2701.19.00	Other coal	1,014
4402.90.00	Wood charcoal	990
2523.29.30	Portland pozzolana cement	825
2704.00.10	Coke and semi-coke	753
	Others	36,220
Total		53,050

Source: Government of Bhutan, Department of Revenue and Customs, Ministry of Finance. 2013. Bhutan Trade Statistics 2013. Thimphu.

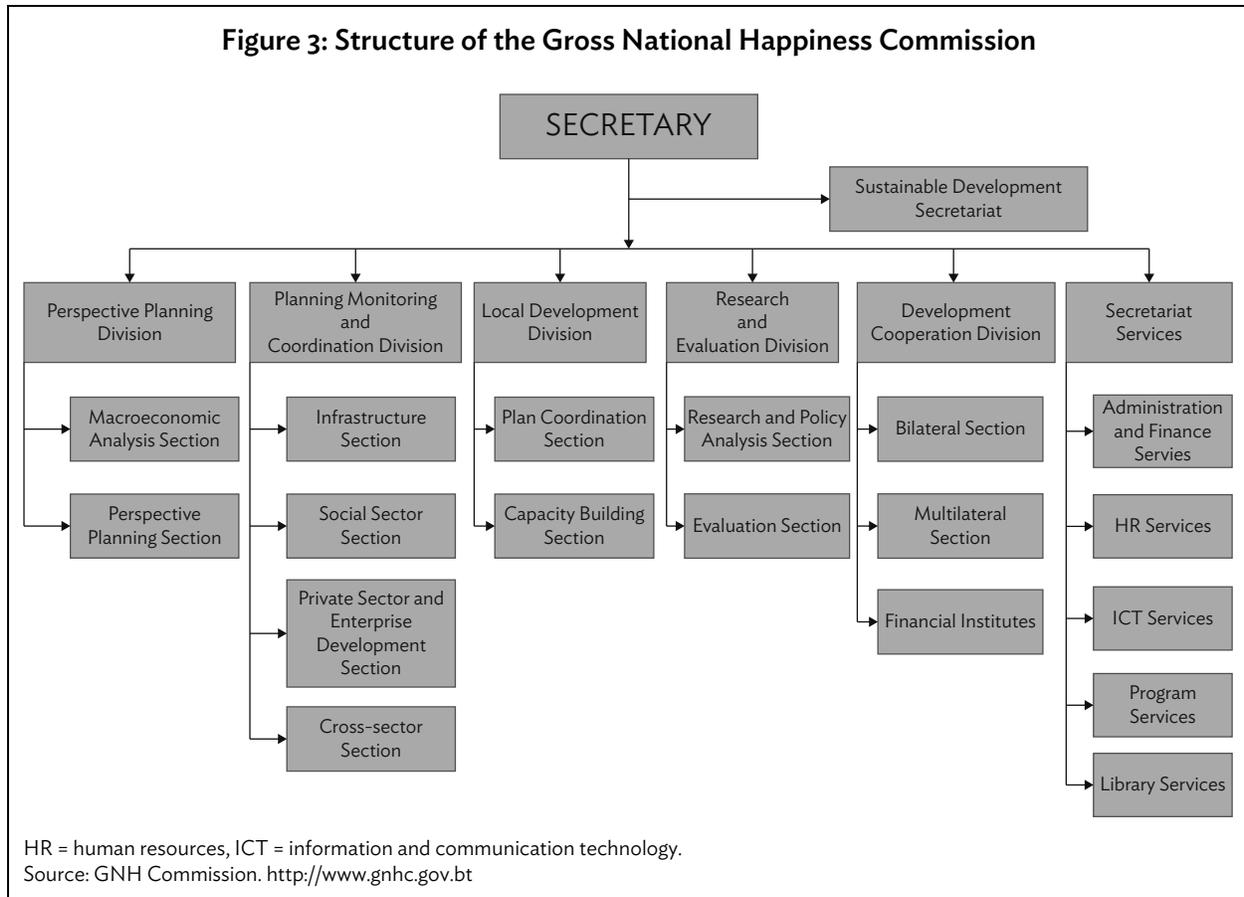
2.3 Elements and Promotion System of Gross National Happiness

16. Bhutan's journey with gross national happiness (GNH) began in the mid-1970s, and initiatives to develop more elaborate and precise metrics to measure GNH have been underway since 2008. GNH is a "multi-dimensional development approach that seeks to achieve a harmonious balance between material well-being and the spiritual, emotional, and cultural needs of our society." (GNH Commission. <http://www.gnhc.gov.bt>)



17. The GNH Commission ensures that the GNH is properly implemented in plans, policies, and programs. It is composed of the Prime Minister as the chairperson; the finance minister as the vice chairperson; and the secretaries to the GNH Commission, Cabinet Secretariat, National Environment Commission, and 10 ministries as members.

18. With several changes to the governance of the GNH, almost all central agencies are now supposed to promote the GNH under the leadership of the Prime Minister. In addition, all new policies should go through evaluation from the viewpoint of the GNH. All relevant dimensions of the GNH are considered in a systematic way while assessing policies and projects. If a policy does not pass the screening test (higher than 66 points across 33 GNH indices is needed to pass), the authorities are required to submit a revised policy following the comments and recommendations of the commission.



3. TRADE POLICY IN THE GROSS NATIONAL HAPPINESS SYSTEM

19. Trade policy, which belongs to Pillar 1 of the GNH, can be approved if it improves living standards and does not damage noneconomic factors. However, active trade policies are not likely to be implemented, as it is difficult for trade authorities to achieve a harmonious balance between economic gains (well-being) and the spiritual factor. This is because the GNH indices are more oriented toward spiritual, emotional, and cultural values.

20. Normally, countries reshuffle their government structure to implement national policy goals. A new ministry tends to be created for dealing with critical task that the current system cannot address properly. The Government of Bhutan comprises 10 ministries, headed by the Prime Minister. The Ministry of Economic Affairs (MOEA) administers trade policy. The MOEA comprises nine departments and one office: the Department of Trade, the Department of Industry, the Department of Intellectual Property, the Department of Geology and Mines, the Department of Hydromet Services, the Department of Renewable Energy, the Department of Hydropower and Power Systems, the Department of Cottage and Small Industry, and the Office of Consumer Protection. About one-tenth or less of the MOEA is dedicated to international trade policy.

21. There are very few countries in which trade policy occupies such a small share of the government structure. Many countries have a ministry of commerce or trade (e.g., the United States and Singapore), while others have joint ministries for trade and industry (e.g., Japan and the Republic

of Korea) or for foreign affairs and trade (e.g., Australia and Canada). Neighboring countries such as Nepal, Bangladesh, and Pakistan have ministries of commerce. Designing and defending trade policies require strong professional staff equipped with a background in international economics and the legal aspects of international trading systems, as well as domestic laws and regulations and business information. There are clear limitations to being promoted as an expert on trade policy under the GNH structure. Thus, Bhutanese government officials are not likely to specialize in trade policy, even though the country needs experts in trade theory and practice.

22. Active trade policy can be one of the most effective tools in improving the GNH. Although Bhutan has limitations in international trade, there is a room for joining global supply chain and expanding trade. Active trade policy can be a basis for improving business climate in services including ecotourism. Bhutan is in transition from a closed country to an open country, and its population is increasing. The country needs to think about how to create quality jobs for its educated young generation. In most countries, youngsters tend to seek modern lifestyle with quality jobs. Active trade policy can create more jobs, which is compatible with the principles of the GNH.

23. In most cases, ministers act like politicians. The ministers of trade in many countries used to make political judgments on sensitive issues. The Bhutanese minister of economic affairs is likely to consider many aspects covered by the ministry when there are conflicts between trade and other policies. Liberalizing trade issues is not a politically popular policy; even the US government sometimes withdraws trade policy agenda during a national election. Rather than being exposed to criticism due to liberalizing trade policy, politicians tend to choose protective measures, although liberalizing trade policy is in the interest of the nation. Thus, many sensitive and important trade policies could be rejected, making binding commitments with regard to an open trade policy unlikely.

24. Trade policy includes political economic aspects, which tend to become political issues. Active (open) trade policies are not likely to be viable without a combination of a strong will for the policy and political support. This is particularly true among emerging economies, where opposition voices can be much louder than those supporting a policy, even though the logic of the policy is correct and the policy is compatible with national interest. In many cases, the discussion on an active trade policy tends to be biased toward the opposition, hence there needs to be a balanced treatment of the policy. In the case of Bhutan, this may be more serious. The trade policy capacity should be reviewed and improved, otherwise issues will not be considered properly and the country will become further marginalized in terms of globalization and regional and global economic integration.

The Way Forward

25. One of the most urgent tasks in Bhutan is to improve general living standards. The authority needs to benchmark successful development strategies in other countries, and to recognize that no country can make economic development without an open trade policy. Equally, an appropriate domestic policy needs to be adopted to minimize excessive socioeconomic costs from open trade policy.

26. Most of the augmented capital was allocated to harnessing hydropower for a decade, which means that productivity growth in the manufacturing sector was limited. The productivity of Bhutanese farmers, who account for 62% of all workers, has not improved, mostly remaining at the subsistence level. Jobs need to be created within the manufacturing sectors for inclusive growth, which will offer employment to rural workers. With the enhancement of an entrepreneurial spirit, the

financial infrastructure should be improved so that small and medium-sized enterprises (SMEs) can have access to credit and financing services.

27. Trade liberalization is not as simple as being classified as “all or nothing” that is either “good” or “bad.” Dynamic processes and the final incidence of a trade policy can be analyzed using an in-depth assessment. As a developing country, Bhutan needs a continuous inflow of foreign capital and economic development to enhance the many factors related to human well-being. No substantial foreign direct investments (FDIs) will be feasible without improving the overall business environment in Bhutan. In addition, there needs to be a balanced evaluation of material and spiritual matters. The current trade authority and trade system should be improved and expanded within the government structure. Introducing a separate ministry could be costly, but to make active trade policy viable and to have balanced policy discussions, the country needs a more powerful trade authority. One idea is for the Department of Trade to establish Center for Trade Policy, which would fall directly under the Prime Minister. This would enable trade policy issues to be discussed with more authority.

4. GLOBAL SUPPLY CHAINS

4.1 Deepening Global Supply Chains

28. Although the world economy has suffered from serious downturns, including the global financial crisis of 2008, the spread of open economic systems and the increase in international trade have been major sources of global economic growth and welfare improvement. The 2008 crisis had hit East Asian economies severely, but their recovery was faster than other regions in the world. East Asian countries’ early recovery from the global financial crisis is largely attributed to high capacity for exports, in addition to expansionary monetary and fiscal policy.

29. Open economic systems have progressed with the development of international economic theory since the publication of Adam Smith’s *The Wealth of Nations* in 1776. David Ricardo’s comparative advantage theory shows that trade liberalization drives the reallocation of production resources and specialization in sectors with a comparative advantage, benefiting all trading parties. Different factor endowments matter in the Heckscher–Ohlin theorem. A country can collect economic gains by specializing in the production of a product with a relatively rich endowed production factor, which is used intensively in producing that product.¹⁰

30. The GNH is consistent with the goal of international trade theory in that both target the maximization of welfare. However, open trade policy brings about adverse side effects on income distribution and could damage the environment, although national income could rise. That is, trade policy could include political economic (pro-and-con) issues. Here, the key is the absolute size of the positive effects versus the negative effects. If the former exceeds the latter, the remaining task should be how to compensate the losers from open trade policy, rather than giving up the opportunity to increase national income just because there are some negative effects. The lesson provided by Adam Smith is still effective in modern days, and the importance of trade in improving national welfare is supported when deliberate domestic policy is considered.

¹⁰ Classical and neoclassical international trade theories were based on interindustry trade, such as the exporting of automobiles or the importing of food.

31. In spite of international trade theory, it is not easy for developing countries to join the international trade market. There is fierce competition for export markets, and the terms of trade tend to count against emerging economies because of higher value added in advanced technology parts and service-based software embedded in the product. A typical example is the assembly of Apple iPhones in the People's Republic of China (PRC), highlighting the importance of recognizing the size of value added in trade rather than trade volume. International economic organizations such as the World Trade Organization (WTO) and the Organisation for Economic Co-operation and Development (OECD) began to pay attention to the statistical illusion provided by traditional trade statistics. Concern for value added is consistent with the principle of the GNH, because it drives policy makers to adopt more welfare-improving policies.

32. The global trade environment has changed substantially since the 1990s as the information and communication technology (ICT) and the transportation system have developed, along with trade liberalization in the mid-1980s. During the 1990s, cross-national FDIs expanded and multinational companies began to increase the outsourcing of intermediate parts. Production has become increasingly fragmented, and subdivided production stages for inputs and parts are now spread across multiple countries along global supply chains (GSCs)¹¹. Joining the GSCs became a basic requirement for a country's industrial development during the time of Baldwin's (2013) "second unbundling."¹² Moreover, the stages of production have expanded and fragmented across national boundaries, a phenomenon known as the global production network (GPN). Both the GSC and GPN imply a "globally organized nexus of interconnected functions and operations" (Henderson et al. 2002). Multinational companies face the task of integrating organizational units for production and distribution, coordinating the flow of materials in each stage, and managing financial flows and the expertise (intellectual property rights) for improving the competitiveness of their products and services.

4.2 Developing Economies Joining Global Supply Chains

33. The world economy has observed fast growing and deepening global value chains in the late 1990s and early 2000s. This provides more opportunities for transition economies to join the international trade, because countries no longer need to build an integrated production facility to execute an entire production. The South-South trade (i.e., trade between developing countries) has grown because of fragmented production processes. The distribution of trade is heavily in favor of emerging countries, such as the BRICS countries (Brazil, Russian Federation, India, PRC, and South Africa). Many developing economies face serious capacity constraints in taking advantage of new business opportunities. This point has changed the role of international institutions, such as the Asian Development Bank (ADB), Economic and Social Commission for Asia and the Pacific (ESCAP), World Bank, WTO, and others.

34. Developing countries have typically pursued two approaches: supporting development and building capacity. In the Doha Development Round, the agenda of development has been a key factor in current multinational trade negotiations led by the WTO. Various international and regional economic institutions and donor countries have supported developing economies, especially in

¹¹ According to Stadler (2005, 5), supply chain management is "the task of integrating organizational units along a [supply chain] SC and coordinating materials, information and financial flows in order to fulfil (ultimate) customer demands with the aim of improving competitiveness of the SC as a whole."

¹² The second unbundling, according to Baldwin, occurred in the post-1985 period when telecommunications became cheap, reliable, and widespread. This made it economical to geographically separate manufacturing stages, which then led to scale economies and the emergence of comparative advantage among countries.

improving the capacity of trade facilitation. “Aid for Trade” became one of the popular topics in conferences on international trade. Here, one of the main challenges of the developing economies is to establish an open trade system that targets the improvement of international competitiveness. This will enhance the capacity of developing economies to absorb knowledge and utilize international assistance strategically, while allowing them to remain open to international trade and not resorting to unnecessarily protective measures.

35. Rather than trade policy alone, a joint policy between industrial development and trade consideration is more desirable in the current situation of deepening GSC. This could provide new momentum for developing economies. According to Baldwin (2013, 1), “Revolutionary transformations of industry and trade occurred from 1985 to the late-1990s—the regionalisation of supply chains. Before 1985, successful industrialization meant building a domestic supply chain. Today, industrializers join supply chains and grow rapidly because offshored production brings elements that took Korea and [Taipei,China] decades to develop domestically.”

36. Prior to the mid-1980s, low wage rates were a primary factor in deciding on factory locations. But during the second unbundling, the competitiveness of the overall business environment is considered along with the merits of wages, since business and transportation costs are critical factors when a part of production stages or tasks are outsourced. While this could be an additional burden for developing countries, it does bring new opportunities. Although massive production facilities are no longer a prerequisite for a developing country to develop its industry and to join international trade, the country needs to find competitive production stages or tasks and improve the competitiveness of its overall business environment.

37. Many developing countries could join global value chains in numerous sectors, reducing the number of poverty-stricken families, contributing to regional economic development, and improving the living standards in the region and country. Lao People’s Democratic Republic and Nepal, for example, have been successful in this regard.¹³

5. BHUTAN’S TRADE POLICY ISSUES

5.1 Trade and Inclusive Growth

38. Trade can act as a powerful engine for economic growth and development, especially in Asia and the Pacific region.¹⁴ Developing countries have long strived for a development strategy that will sustain high economic growth, create employment opportunities, and eliminate poverty. Developing countries are using trade policy as a tool to attain these development objectives.

39. It is possible to draw two extreme assessments on Bhutanese trade policy. First, it can be said that the country has open trade policy in that its overall effective tariff rate is very low; Bhutan freely trades with India, the dominant trading partner representing almost 80% of Bhutan’s total imports. Second, it can also be said that Bhutan heavily depends on a single country in trade; this makes Bhutan pay extra social costs to Indian exporters. The challenge is how to diversify the country’s trade partners by reducing import tariffs and non-tariff barriers.

¹³ As examples of developing countries’ economic development, recent economic performances of Viet Nam, Mongolia, and Ethiopia are described briefly in Appendix A.

¹⁴ This section mainly draws on the article by Ratna et al. (2013).

40. Trade is considered an important tool in the alleviation of poverty. Trade facilitation can reduce poverty by increasing opportunities to trade. Empirical and qualitative studies make clear that the negative impacts of income inequality can be contained when a government implements trade facilitation measures in a step-by-step manner and provides safety nets (e.g., income protection or insurance schemes) to redistribute income during the adjustment process (ESCAP 2013).

41. It is clear that each policy can have both positive and negative effects, and there is no “one-size-fits-all” strategy (Higgins and Prowse 2010) because idiosyncratic factors need to be considered. The government’s role is critical in creating conditions that ensure that the poor do not suffer from the short-term adjustments that trade facilitation measures might entail. Thus, trade policy can lead to inclusive growth when governments introduce income redistribution and a sophisticated domestic adjustment system. In this regard, De and Raychaudhuri (2013) argue that governments need to provide adequate education and capacity building opportunities.

42. Any country cannot stay away from international trade. In order to improve national welfare, trade should be promoted in Bhutan while domestic measures for reducing negative effects from trade should be devised. This will be a trade policy framework which is compatible with the principle of the GNH.

5.2 Trade Facilitation

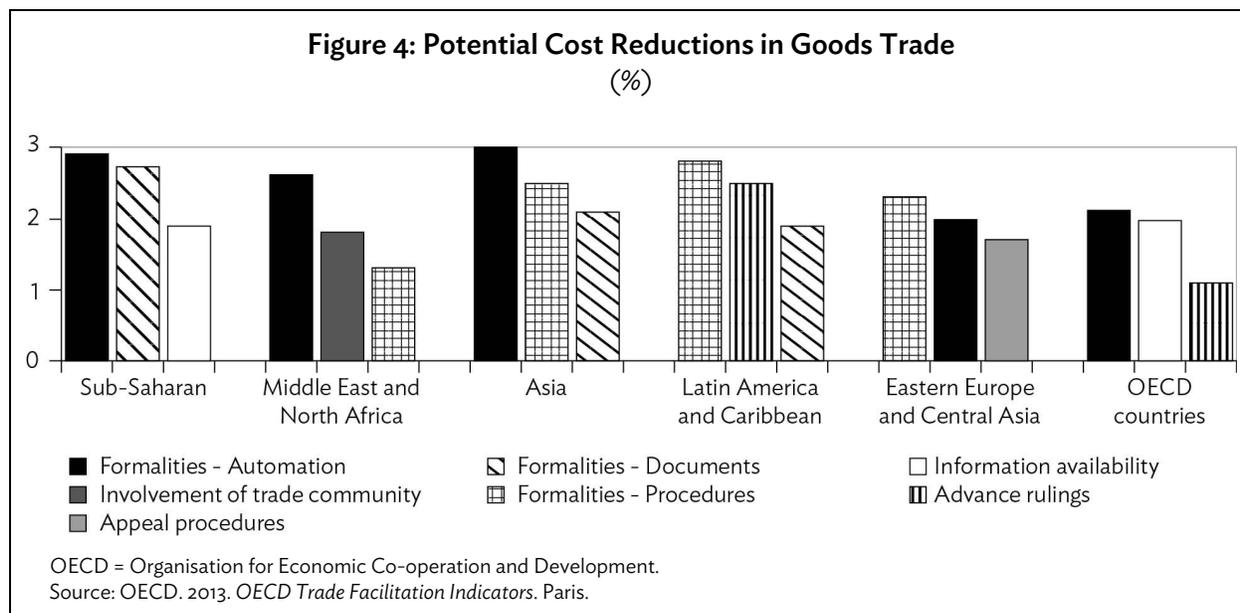
43. The capacity to deliver goods and services in time and at a low cost is the basis for export competitiveness, and plays a favorable role in encouraging the inflow of FDIs. A reduction of transaction costs for international trade is as important as a reduction of traditional trade restrictions such as tariffs and fees. Since the mid-1990s, an increased awareness of these trade-related, cross-border transactions costs has called for multilateral rule-making, under the heading of “trade facilitation,” by international organizations such as the WTO and World Customs Organization. It has also promoted regional or plurilateral coordination, such as among ADB, Asia-Pacific Economic Cooperation, South Asian Association for Regional Cooperation (SAARC), and ESCAP.

44. The definition of trade facilitation can be as broad as an institutional and physical infrastructure, and is indirectly associated with all costs incurred in the cross-border movement of goods and services. The WTO (2015) describes trade facilitation as providing faster and more efficient customs procedures through effective cooperation between customs and other authorities on trade facilitation and customs compliance issues. The definition also contains provisions for technical assistance and capacity building.

45. The primary target of trade facilitation is the reduction or streamlining of the logistics of moving goods through ports and the documentation requirements at a customs post at the border. More precisely, the European Commission defines trade facilitation as the simplification and harmonization of international trade procedures, including import and export procedures. These procedures include “the activities (practices and formalities) involved in collecting, presenting, communicating and processing the data required for the movement of goods in international trade.”(European Commission 2014)

46. According to the OECD (2013), reducing global trade costs by 1% would increase worldwide income by more than \$40 billion, 65% of which would accrue to developing countries. The potential cost reduction from comprehensive trade facilitation reform is about 15% for developing countries. For

example, customs reforms increased Ethiopian imports and exports by 200% and its tax revenues by over 51%.



47. Findings from the OECD trade facilitation indicator analyses show a reduction of trade costs for low-income countries of about 10%. More specifically, trade costs can be reduced by 3% by harmonizing and simplifying trade documents, by 2.3% by automating trade and customs processes, by 1.6% by ensuring the availability of trade-related information, and by 1.5% by advanced rulings on customs matters. Table 7 shows the status of Bhutan in the major indices of trade facilitation. Bhutan’s indices are much worse than Mongolia, which is another land-locked country in Asia.

48. A country’s trade competitiveness also depends on its procedures and infrastructure, such that long delays caused by lengthy procedures in obtaining permits, inadequate infrastructure, and unreliable logistics services would tend to reduce total trade volumes.¹⁵ Small companies in landlocked economies that want to reach the international markets would tend to suffer more from the costly delays.

49. By reducing the time it takes to import by 1 day to 37 days, and by cutting the number of documents to import by one to 11, Bhutan improved its Trading Across Borders ranking by seven notches to 165 in the latest Ease of Doing Business list (Table 8). Bhutan is ahead of two other landlocked economies— Nepal (171) and Mongolia (173). It remains below three South Asian neighbors, Sri Lanka (69), Pakistan (108), and Bangladesh (140).

¹⁵ According to the World Bank (2014), a 10% reduction in the time it takes to move cargo from the production line to the ship increases exports by 4%, all else being equal.

Table 7: Bhutan's Status in Trade Facilitation

Index	Examples of Specific Trade Facilitation Measures	Bhutan's Status	Reference (Mongolia)
Transparency	Information on trade regulations through internet	?	Yes
	Advance rulings in tariff classification and customs valuation	No	Yes
	Mechanism to review decisions, right of appeal	?	Yes
	Digital process of trade data	No	Yes
Simplification	Establishment of a "single window"	No	Yes
	Electronic customs clearance, paperless	No	Some
	Simplification of customs procedures and reduction of documentary requirements	?	Yes
	Simplification of procedures for goods in transit		Yes
	Pre-arrival examination	?	Some
	Reduction of fees and charges in import or export	?	Some
Harmonization	Risk management technique, authorized economic operators	No	Yes
	Harmonization of customs procedures, documents, and customs valuation methods	?	Yes
	International standards with the WCO and the WTO	?	Yes
	Harmonized tariff classification	Yes	Yes
	Recognition of certification and testing facilities of other countries or international organizations	?	Yes

? = ?, WCO = , WTO = World Trade Organization.

Sources: Authors based on interviews in Bhutan; Asia Pacific Institute of Mongolia.

Table 8: Comparative Rankings in Ease of Doing Business and Trading Across Borders

	Bhutan			Mongolia	Nepal	Bangladesh	Pakistan	Sri Lanka
	2014	2015	Change					
Ease of doing business (rank)	141	125	(16)	72	108	173	128	99
Trading across borders (rank)	172	165	(7)	173	171	140	108	69
Documents to export (number)	9	9	-	11	11	6	8	7
Time to export (days)	38	38	-	44	40	28	21	16
Cost to export (\$ per container)	2,230	2,230	-	2,745	2,545	1,281	765	560
Documents to import (number)	12	11	(1)	12	11	9	8	7
Time to import (days)	38	37	(1)	45	39	34	18	13
Cost to import (\$ per container)	2,330	2,330	-	2,950	2,650	1,515	1,005	690

- = no change.

Sources: World Bank. 2013. *Doing Business 2014: Understanding Regulations for Small and Medium-Size Enterprises*. Washington, DC; World Bank. 2014a. *Doing Business 2015: Going Beyond Efficiency*. Washington, DC.

50. Bhutan, in addition, does not fare any better in terms of logistics performance, a requisite to developing a country's external trade since it affects the costs of trading and the potential to integrate with the global market. In the latest rankings of Logistics Performance Index, Bhutan ranked 143rd out of 160 countries, with a low score of 2.29 or 41% of the score of the highest performer.¹⁶ This is the lowest among the landlocked nations, including Mongolia and Nepal, and among neighboring countries, such as Bangladesh, Sri Lanka, and Pakistan.

Table 9: Logistics Performance Index , 2014

Economy	Rank	Score	% of highest performer
Bhutan	143	2.29	41.3
Mongolia	135	2.36	43.4
Nepal	105	2.59	50.9
Bangladesh	108	2.56	50.1
Pakistan	72	2.83	58.5
Sri Lanka	89	2.70	54.3

Source: World Bank. 2014b. Connecting to Compete 2014: Trade Logistics in the Global Economy: The Logistics Performance Index and Its Indicators. Washington, DC.

51. The most urgent task for Bhutan is to upgrade its customs clearance system. As an isolated landlocked country, it takes time and requires large capital to build hardware infrastructures, such as roads, ports, and bridges. While there are many urgent areas in which trade facilitation in the country needs to be enhanced, improving customs clearance has to be done with limited resources and within a short period to break away from one of the worst regions in terms of trade facilitation as assessed in ESCAP's (2014) *Trade Facilitation in Asia and the Pacific*. Since the primary goal of international trade organizations in supporting developing countries is to improve trade facilitation, Bhutan needs to take advantage of the programs offered by international institutions and regional economic cooperation organizations.

5.3 Incidence of Tariffs in Bhutan

52. Bhutan liberalized tariff on imports from India, and has a tariff liberalization plan under the SAARC Agreement that targets a gradual reduction in peak tariff rates to 5% by end of 2015. This is linked to the fact that Bhutan's trade is heavily dependent on India, and its imports from India are traded without tariffs owing to the bilateral free trade arrangement between the two countries. Logistics costs also play a favorable role for Indian products. This implies that Bhutan may not face a substantial increase in imports after it further liberalizes its trade with countries other than India.

¹⁶ Logistics Performance Index is the weighted average of the country scores on six key dimensions: (i) efficiency of the clearance process; (ii) quality of trade- and transport-related infrastructure; (iii) ease of arranging competitively priced shipments; (iv) competence and quality of logistics services; (v) ability to track and trace consignments; and (vi) timeliness of shipments. The scorecards demonstrate comparative performance ranging from 1 (lowest score) to 5 (highest score).

53. Considering the import dependence on a single country and tariff structure, welfare losses owing to trade diversion may arise. If a country lacks capacity in manufacturing and depends on imports, unilateral liberalization is the best policy, as it eliminates economic losses via trade diversion. For example, Chile adopted flat tariff rates for all goods (6% tariff on all imports) and reduced rates gradually, reducing the economic losses from domestic distortion of resource allocation and improving national welfare.¹⁷ Although India is expected to remain a dominant exporter to Bhutan, trade liberalization will lead to the diversification of import sources and stable prices of imported goods. In theory, this gain will spread to all consumers, thus improving the welfare (a part of happiness) of Bhutanese people, which outweighs the loss of government revenue.¹⁸

54. Bhutanese officials are concerned about the farmers, who account for about 56% of the total employment. Most imported agricultural products from India are tariff free. However, two points need to be noted here. First, logistics costs may be critical for agricultural products in general and more so in Bhutan. This implies that India could enjoy a comparative advantage over other exporting countries. Second, many farmers are living at a subsistence level, and Bhutan needs to improve the productivity of agricultural sector. Policies that will improve agricultural productivity do not seem to be viable while maintaining the small amount of farmland per farmer. Therefore, new jobs should be created to absorb marginal farmers. The argument that the current trade system should be maintained to help the poorer farmers might sound reasonable, thus gaining political support, but it is not logical from an economic perspective.. This is an example of an unbalanced treatment of trade policy, ignoring basic economic logic.

5.4 World Trade Organization Accession

55. In principle, economic openness exposes a country to uncertainty and risks. However, this does not necessarily imply that a closed economic system is better. An open trading system is not the goal but a means to improve national welfare. The issue may be the degree of openness. A large economy, which can exercise its market power on world prices, can pursue an optimum liberalization level. For smaller economies, unilateral liberalization is an optimal policy. If a country faces difficulties in reallocating resources across sectors, a gradual approach is desirable, while, at the same time, promoting capacity building to smoothen the structural adjustment. The WTO Agreements have special and differential treatment provisions for developing countries. These special and differential treatment provisions include longer periods for implementing commitments, favorable safeguard measures, support for capacity building, and measures for increasing trading opportunities.

56. Unnecessary trade barriers need to be removed, while gradually lowering average tariffs. It should be noted that the WTO accession implies setting binding tariff rates and that Bhutan has some buffer between effective rates and binding rates. If tariff concession schedule is well adopted, no serious impact will hit Bhutan when it joins the WTO. However, the effects of becoming a WTO member will be substantial, and business sectors will have to adapt to new environment to enhance national competitiveness.

57. In addition, economic logic should be applied to enhance transparency and predictability. Most developing countries lack transparency and policy certainty, and tend to be exposed to political populism. Although they can upgrade their economic system, they tend to go back to older systems

¹⁷ Regarding Chile's economic gains from its unilateral liberalization, refer to Fredriksson (1999).

¹⁸ It is understood that happiness contains material and psychological elements. Since welfare is also set by the level of material satisfaction, welfare is a part of happiness.

when ruling parties change. As a result, foreign investors, uncertain of the political effects of their FDIs, are reluctant to invest in these countries. This is a more serious issue for small domestic markets. Developing countries should recognize this drawback and realize that investors will make unfavorable investment decisions.

58. The WTO accession involves the rights and obligations of new members. WTO members can enjoy equal treatment (the most favored nation principle). Members must abide by the commitments agreed upon during the WTO accession. Regressive changes in laws and rules on trade are not allowed. This works to reduce ad hoc populism that will violate the country's commitments, about which other members can object. In this regard, some Bhutanese officials fear that WTO accession would impair their national sovereignty. International treaties are voluntary agreements for mutual gain, although some of the national sovereignty will be impaired owing to binding elements. This accession has contributed to improving the business environment, leading to growth in international trade volumes and an improvement in welfare. It is not feasible for small countries to confront large economies bilaterally in trade disputes, but the multilateral trading system provides sound legal institutions to solve these problems. That is, even large economies must follow the guidelines laid down for solving trade disputes.

59. Economic reform is not easy, but WTO accession provides a chance to review the overall trading infrastructure systemically. Members are not obliged to accept all the WTO rules, and exceptions are allowed, depending on multilateral or bilateral negotiations. The government should review the gains and costs of WTO accession, and evaluate the net gains and compatibility with the GNH, considering the chance for economic reform. In this regard, short-term costs of structural adjustments can be a plausible pretense for rejecting WTO accession. Rather, these costs should be assessed objectively in comparison with the dynamic gains that will be realized over time. Bhutan's political decision pending the negotiations for WTO accession in 2009 should be reconsidered from the viewpoint of national interest. WTO membership symbolizes transparency and predictability owing to the binding effects. The effects of upgrading regulations should be evaluated properly, rather than just pointing out minor problems. Bhutan should not make a one-sided decision, but should focus on what is best for the country.

6. EXPLORING TRADE AND INDUSTRY POLICY COMPATIBLE WITH CURRENT GROSS NATIONAL HAPPINESS GUIDELINES

60. Despite its commendable socioeconomic gains, Bhutan urgently needs to broaden its economic base and make its growth more inclusive. Poverty has declined, but inequality has remained high. Bhutan's economic growth has generated limited employment opportunities, since it has been driven mainly by the capital-intensive hydropower sector (ADB 2014).

61. Current GNH guidelines permit only Bhutanese business sectors to operate environmentally friendly businesses that inflict little environmental damage, if any. Massive production facilities are not feasible because it is a mountainous and landlocked country and the domestic market is small. The GNH guidelines mandate the government to strategically pursue "high value with a low environmental burden," such as:

- Ecotourism: a clean and healthy natural environment with a rich cultural heritage. As of 2015, Bhutan controls the number of foreign tourists by considering the capacity of the

tourism infrastructure, such as hotels, but the country can promote special ecotourism zones. This could be expanded for human development, education, health, and so on.

- Naturally abundant and competitive sectors: quality perfume, herbal medicine, organic food, mountain tea, minerals, and other products. These sectors can be operated in line with ecotourism.
- Research institutes oriented in line with the GNH components such as health, mind control, medicine, food, aging or anti-aging, environment, and others: Illnesses related with urbanization are on growing trend. Bhutan can be a suitable place for researches of health and food which are compatible with the GNH.
- Processing food and/or medicine rather than exporting raw materials: Bhutan produces valuable herbal medicines, such as *Cordyceps militaris*, which are exported cheaply without processing.
- Commercializing the image of Bhutan: the international community places a high value on the clean and environmentally friendly image of Bhutan. The country can commercialize this image, as well as related products, to companies and/or international organizations. For example, the “Bhutan” brand could be important to automobile companies producing electric or eco-friendly cars.

62. Although Bhutan is endowed with several unique merits for international tourists, tourism needs to be industrialized in the context of services sector. Limited numbers of tourists visit the country at high costs. This is consistent with the government’s tourism policy, which is to promote Bhutan as a high-end tourist destination in accordance with the tenets of GNH—that tourism must be environmentally and ecologically friendly, socially and culturally acceptable and economically viable.. However, two types of tourism can be developed, taking the principle of the GNH into account: the current tourism business and a special tourism zone (STZ). The STZ can be developed for more commercial tourism in a more convenient location with access to international air transportation. Mass tourism may bring burden to the environment, but a part of the income from tourism can be used for building environmentally friendly facilities. The STZ is effectively segregated from the Bhutanese people so that Bhutanese traditional culture and religious customs could remain unaffected.¹⁹ Depending on the evaluation of this project on small-sized STZ, the country may initiate large-scale STZ to create jobs to absorb rising youth unemployment rate. Step-by-step approach will be desirable, noting the concerns of Bhutanese authorities on the GNH and the current social and economic issues regarding youth unemployment. Appendix B provides a brief discussion of an STZ, the Mount Kumgang International Tourist Region, in the Democratic People’s Republic of Korea.

63. Similarly, a special economic zone can be developed for a few selected sectors such as processing food and medicine. ESCAP (2013, 5) reports “there are clear economic benefits of EPZs [Export Processing Zones] with regard to poverty reduction,” although negative impacts such as income distribution take place. Rather than exporting raw materials at low prices, raw materials should be processed for more value-added business. For example, Viet Nam could collect as much as 20 times the value added by exporting roasted coffee rather than dry beans.²⁰ This lesson can be applied to the electric power exported to India. Bhutan needs to find a way to increase its value added using electric power domestically rather than exporting it as a raw material. Ferro-silicon (HS 720221) is

¹⁹ The primary idea is to limit the impact of tourism on the broader population by limiting tourists to the zone, which would feature exclusively designed and constructed tourist attractions and activities. Tours with guides outside the zone would remain available. All in all, these would maximize employment opportunities within and outside the zone for the Bhutanese.

²⁰ Notes reported at the 2014 ARTNet organized by ESCAP in Bangkok, 17 September 2014.

Bhutan's primary exporting goods. A refinery operates on electrical power, and Bhutan has abundant electrical power and rock or soil with rich ferro-silicon. A processing plant will bring more lucrative business to Bhutan.

63. Some projects require substantial capital at the initial stage. Bhutan needs sophisticated systems to promote public-private projects to finance such projects and reduce business risks. In the building of four hydropower plants, Bhutan entirely relied on funds from India for the first plant, and from the Government of Austria and ADB for the other plants. Those power plants are pure government assets with accumulated foreign debt, and have been managed like pure state-owned enterprises. However, the STZs and special economic zones can be constructed with the private investment, in the frame of the public-private project if needed, while reducing national debts.

64. Although there are many factors which determine the inflow of FDIs, overall competitiveness of business environment is critical. Trade liberalization level affects national competitiveness, and Bhutan should liberalize its trade further. The provision of specific incentives is another key factor. Bhutan needs to be more aggressive in providing incentives to specific sectors and industries, not just to the general economy.

65. Most Bhutanese businesses are small and medium-sized enterprises (SMEs). SMEs face a lot of difficulties in payment and settlement regarding exports and imports. This is a universal phenomenon, and Bhutanese SMEs may be treated more severely since even their local banks lack access to international credit facilities. The Bhutanese industries desperately need financial support in mediating export credit and payment settlement, and taking full charge of arranging a medium- to long-term loan on favorable condition. A financial institution such as an export credit agency was introduced in early days of economic development in other countries. In the Republic of Korea, its comprehensive export promotion policy was adopted in 1965 and the establishment of the Export-Import Bank of Korea was officially decided 3 years later. Many developing countries have benchmarked their export credit agencies against Export-Import Bank of Korea, and the bank has assisted many countries in setting up similar financial facilities.

66. Although the size of the population is small, Bhutan should build its human capacity, targeting strategic sectors. In this regard, international support from advanced countries will be invaluable, and Bhutan should improve its capacity to absorb expertise and knowledge. Top priority for education should be young businessmen and government officials, who are more capable in absorbing new knowledge and global practices. It is clear that Bhutan has a limited ability to be competitive internationally in industries based on huge production facilities and large-scale logistics. Based on the value of the clean natural environment, secondary values targeting health, leisure, education, and energy should be promoted. While this will maintain the principle of the GNH, the business environment should also improve. To do so, a WTO accession is a minimum requirement, and, based on this, a gradual approach to improving the business environment needs to be pursued.

7. CONCLUSION

67. Trade theory, which is based on traditional comparative advantage developed in the 19th century, applies to expanding production fragmentation and deepening global supply chains (GSCs). Comparative advantage and specialization are the source of economic gains. Joining a part of GSCs becomes a basic channel to globalization and industrialization for developing economies. This requires

trade liberalization and a reduction in excessive regulations, as well as improved international competitiveness.

68. Although trade liberalization and economic reforms contribute to economic growth, they also require structural adjustments that lead to socioeconomic costs and may widen income inequality. To evaluate the possible consequences of a policy change from a macroeconomic and microeconomic perspective is not an easy task, since the value of the final incidence from a policy change can be viewed differently. In addition, if psychological factors are included as part of policy review guidelines, objective judgment will be more difficult.

69. This paper points out that Bhutanese government structure is less oriented to trade policy, and suggests a new organization for promoting active trade policy. Otherwise, trade policy issues will not be regarded as top priority tasks. Also, top policy makers need to understand trade policies in order to have unbiased evaluation of these policies. For this purpose, the government can organize an international advisory council for its trade policy with eminent trade economists from various countries, and have regular meetings for dealing with international trade issues.

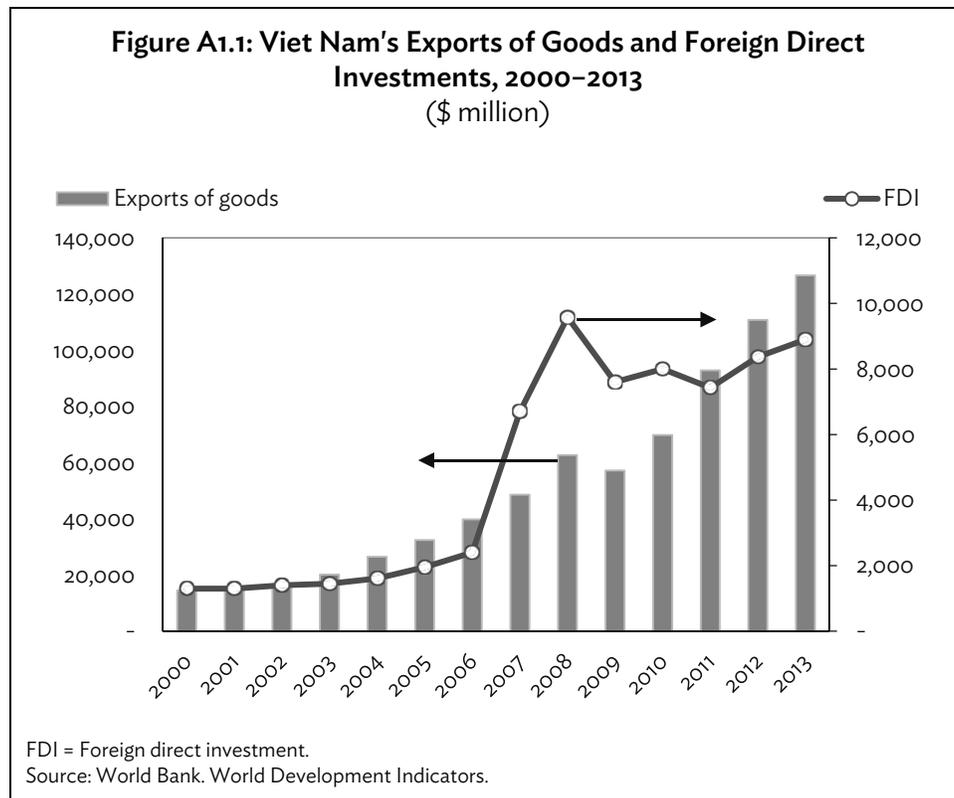
70. Bhutan is not secluded anymore, and it has increased trading partners from neighboring countries. Although it is difficult to overcome the weaknesses in trade due to its geographical location, Bhutan should try to adopt the best package of economic policies including reforms and trade liberalization. Its people have been exposed to global economy, and material well-being has become a key part of their daily life. Bhutan needs trade for better living.

APPENDIX 1

Examples of Recent Economic Development in Developing Economies

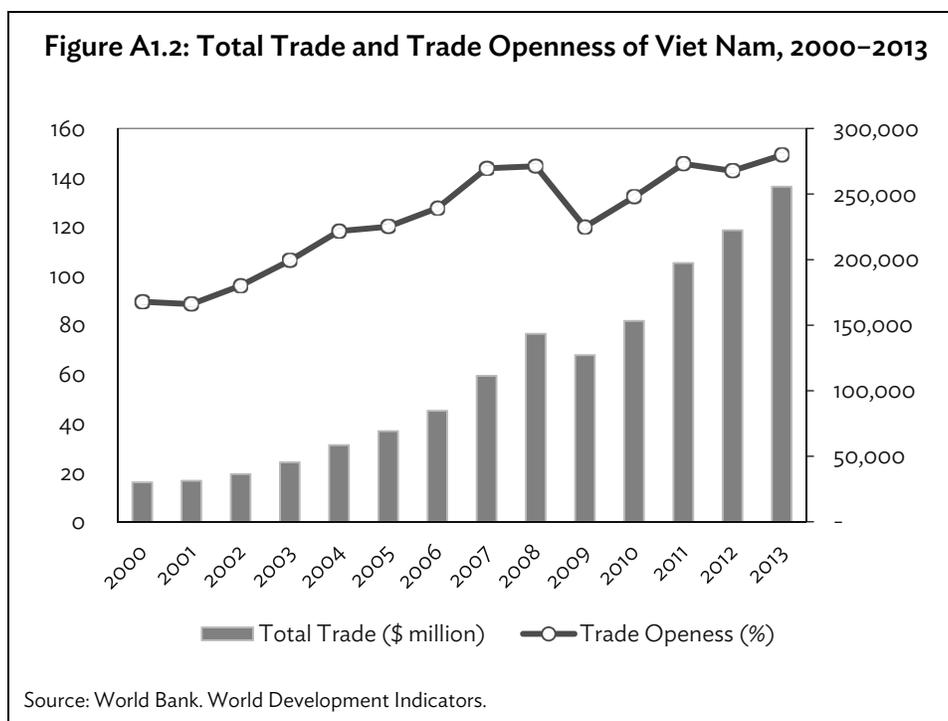
Viet Nam

The Greater Mekong Subregion is one of the fastest growing economic regions in the world. In particular, Viet Nam has sustained robust economic growth amid the global financial crisis, and is now joining global supply chains after several trade and investment reforms. The recent inclusion of Viet Nam into global supply chains is mainly attributable to a surge in foreign direct investment (FDI). During 2000–2013, Viet Nam is catching up with Thailand, the largest FDI recipient in the region, in terms of FDI (Figure A1.1).



It was Viet Nam's unilateral "Doi Moi" (renovation) reforms in 1986 that initiated the opening up of the economy to the world. On top of a significant reduction in tariffs, recent key reform measures included the dismantling of quantitative restrictions, initiatives to expose public sector enterprises to greater market discipline, relaxing restrictions on FDI, lifting restrictions on private-sector participation in foreign trade, and setting up business ventures by private entities (Athukorala 2006, 161). The Government of Viet Nam has also actively pursued engaging in the global economy through regional, bilateral, and multilateral trade liberalization. In 1995, Viet Nam became a member of Association of Southeast Asian Nations. In 2001, it concluded a bilateral trading agreement with the United States. Then, in 2007, it joined the World Trade Organization. Despite the trade collapse in 2008 and 2009,

these trade and investment reforms have helped Viet Nam maintain higher real trade growth than the average trade growth in East Asia. In addition, trade openness has increased above 100% (Figure A1.2).



Mongolia

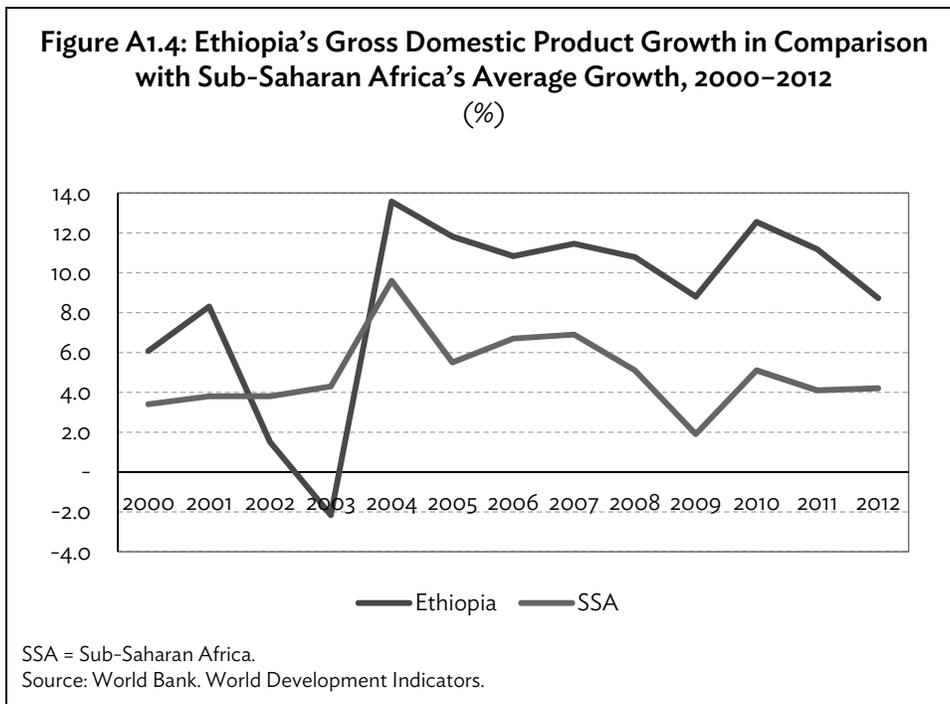
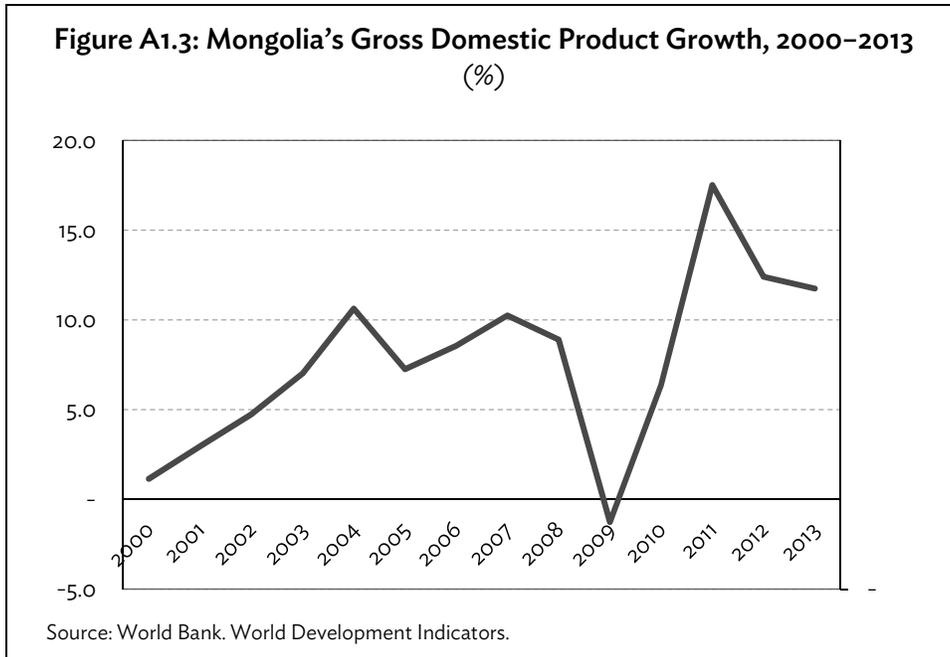
Mongolia, a landlocked country in Northeast Asia, has shown impressive economic performance during 2000–2013. The main driver of this rapid economic expansion has been the development of the mining industry. In the past, Mongolia received little attention from foreign investors due to its low level of economic development, small market size, harsh climate, and geographical disadvantage as a landlocked country. Mongolia experienced negative gross domestic product (GDP) growth in the 1990s, but its economy recovered within a short time, recording an average of about 9% annual GDP growth in the mid-2000s (Figure A1.3).

The global financial crisis in late 2008 hit the Mongolian economy hard, but it took only a year for the economy to rebound with the help of a soaring FDI influx into the mining sector, made possible by the Oyu Tolgoi mining contract. The vast majority of the FDI went to the Oyu Tolgoi mine and its sectors, such as mining machinery and equipment (Lee et al. 2012).

Ethiopia

Ethiopia's GDP grew by 12.6% in 2010, becoming the sixth fastest expanding economy in the world. Despite its geographical difficulties as a landlocked country in Sub-Saharan Africa, the economy has experienced strong and broad-based growth during 2004–2012, averaging 10.9% per year (Figure A1.4). During the same period, the regional average was about 5%. Expansion of the services and agricultural sectors account for most of this growth, while manufacturing sector performance was relatively

modest, according to the World Bank.¹ This growth momentum was expected to continue in 2013 and 2014 (African Economic Outlook, 2014).



¹ <http://www.worldbank.org/en/country/ethiopia/overview>

Ethiopia's economy began to improve when the government embarked on a program of economic reform, including the privatization of state enterprises and the rationalization of government regulation. The Ethiopian government's commitment to economic development has led to its introduction of the "Growth and Transformation Plan," a national five-year plan to transform the country's economy by developing the agricultural sector and raising the share of industry through expanded investment. Ethiopia aims to achieve a GDP growth of 11–15% per year from 2010 to 2015.

APPENDIX 2

Mount Kumgang International Tourist Region, Democratic People's Republic of Korea

The Mount Kumgang International Tourist Region is a special administrative region of the Democratic People's Republic of Korea. It spreads 40 kilometers (km) from east to west and 60 km from north to south, covering an approximate area of 530 square km. Praised by writers and artists, Mount Kumgang (Diamond Mountain) is a national treasure for the Korean people. It is located in the southeast of the country, less than 50 km from the international boundary. The mountain area is famous for its scenic beauty, with waterfalls, springs, lagoons, and Buddhist temples and hermitages.

The Democratic People's Republic of Korea declared the tourist development area as a special autonomous region in 2002. The establishment of the special tourist zone gave an opportunity for tourists, especially from the Republic of Korea (South Korea), to visit Mount Kumgang. The tourism zone provided revenue for the Democratic People's Republic of Korea through business from tourist arrivals and investments.

Mount Kumgang tourist and development project was signed in October 1998 as part of the inter-Korean economic cooperation that seeks to promote trade and investments, tourism, people to people exchanges and partnership between the North and the South. That year, the honorary chairman of the Hyundai conglomerate, Chung Ju Yung, signed an agreement in Pyongyang with Choe Su Gil, president of the Taesong Bank of North Korea. The two agreed in principle to jointly develop the area around Mount Kumgang as a tourist site (Chira 1989).

On 5 February 1999, the conglomerate established Hyundai Asan as its subsidiary that specializes in businesses and exchanges with the Democratic People's Republic of Korea. Under the contract signed by the two parties, development rights were granted to Hyundai Asan. The infrastructure development included the construction of a wharf, enhancement of land routes by restoring railroad and road connectivity, building of family reunion centers, and improvement of amenities in the resort area.

In November 1998, the first batch of tourists arrived in the maiden voyage of the 'Hyundai Kumgang' cruise liner; by September 2003, tourists could travel by road after the overland tour to Mt. Kumgang was launched.

Tourism operation in the area created business opportunities and employment (InSung and Lee 2009).¹ Hyundai Asan employed 1,084 people to handle tours as tourist arrivals were estimated to be about 240,000 annually. From late 1998 through 2008, nearly 1.95 million tourists visited the mountain (InSung and Lee 2009). Tourist purchases also contributed to the increase in inter-Korean trade.

To protect and maintain the cultural domain of the Democratic People's Republic of Korea from outside influence and for the safety of the visitors, the government laid out rules. The government allows only organized tour groups coursed through tour partners; it does not permit any independent

¹ The contract signed in 1998 promised Democratic People's Republic of Korea monthly payments of \$12 million until February 2005 for a total of \$942 million, regardless of the number of tourists. Hyundai further paid \$308 million for the development rights and spent \$104 million in building the facilities. *Editor's note: Reference details moved to the reference section.*

travels. Tourists must always stay with their group when dining and going around the area. The rules further designate the areas where photographs can be taken and where visitors are restricted. There are also restrictions on what guests can bring.

The establishment of the tourist region has contributed to the inter-Korean relations as intended in the inter-Korean economic cooperation. Development in infrastructure and business has also been realized, and the revenues have been a boost to the finances of the Democratic People's Republic of Korea.

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* ADB recognizes "China" as the People's Republic of China.

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A Framework of Trade Policy for Bhutan Compatible with the Gross National Happiness

This paper discusses the win–win relationship between the gross national happiness and trade policy, and attempts to analyze trade policy issues of Bhutan, namely inclusive growth, trade facilitation, incidence of tariffs, and World Trade Organization accession. It explores trade and industry policy that is compatible with the gross national happiness guidelines. It also points out that the structure of the Government of Bhutan is seemingly less oriented to trade policy than its neighbors, and suggests a new organization for promoting a more active and open trade policy. It concludes by underlining the importance of an active trade policy for Bhutan.

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