

1 Bhutan

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I. Introduction

I.1 History and Background

“Kingdom of Bhutan” is well known for the outside world as happiest country for having guiding philosophy termed as “Gross National Happiness”. Bhutan is a small landlocked country in South Asia at the eastern end of the Himalayas. It is believed that Bhutan was inhabited as early as 2000 B.C. due to the presence of early stone implements discovered in the region. Initially Bonism was the dominant religion in the region that would come to be known as Bhutan. Buddhism was introduced in the 7th century by the Tibetan King Songtsen Gampo and further strengthened by the arrival of Guru Rimpoche, a Buddhist Master that is widely considered to be the Second Buddha.

Bhutan is one of only a few countries which have been independent throughout the history, never conquered, occupied, or governed by an outside power (notwithstanding occasional nominal tributary status). The country was first unified in 17th century by Zhabdrung Ngawang Namgyel. After arriving in Bhutan from Tibet he consolidated his power, defeated three Tibetan invasions and established a comprehensive system of law and governance. His system of rule eroded after his death and the country fell into in-fighting and civil war between the various local rulers. This continued until the Trongsa Poenlop Ugyen Wangchuck was able to gain control and with the support of the people establish himself as Bhutan’s first hereditary King in 1907. His Majesty Ugyen Wangchuck became the first Druk Gyalpo (Dragon King) and set up the Wangchuck Dynasty that still rules today. In 2008 Bhutan enacted its Constitution and instituted a democracy in order to better safeguard the rights of its citizens.

I.2 Concept of Gross National Happiness: How did it emerge in Bhutan?

The concept of “Gross National Happiness” is the guiding philosophy for Bhutan’s development and is “multi-dimensional development approach that seeks to achieve a harmonious between material well-being and the spiritual, emotional and cultural needs of our society”. The Fourth Dragon King Jigme Singye Wangchuck looked at other countries and noticed that most of the government and people strive for economic wealth and those few who achieve these goals usually live a comfortable life. However on the down side, many of them live in misery, poverty or social isolation. Further in the root in search of money, huge part of environments are often destroyed, so he thought such couldn’t be the right path for Bhutan. The concept of GNH has emerged with the primary idea that every human being aspires for happiness and the country’s development should also be measured in terms of citizen’s happiness. The Fourth king challenged figuring out how to balance economic development with the emotional and spiritual wellbeing of the people. Although economic growth can be a goal; a flourishing economy gives the government the funds needed to provide a working healthy and educational systems as well as living standards because being healthy, having opportunities for future and knowing the security as steady income, hosing or well balance time use guarantee is crucial for people the be happy. Further more people get more positive energy from being with others and sharing interest, participating in cultural life and hold up local traditions and cultural heritage led to a strong community feeling. So the healthy family relationship, advocating community activities and religious aspects are factor for achieving happiness and it gives the Bhutanese people a strong sense of value and identity.

The Fourth King reign 34 years basing his decisions on all factors of GNH asking himself “what makes Bhutanese people happy?” so Base on these parameters the four pillar of Gross National Happiness was developed as follows;

- (a) Sustainable and equitable Socio-Economic Development
- (b) Preservation and promotion of Culture

- (c) Conservation of Environment and
- (d) Good Governance

The king himself lived by example leading a very simple life in fact believed so strongly in the concept and even decided to hand over the sovereignty to the people by abdicating his throne at the age of 52 in 2006 and change the course of history. The two years later in 2008, Bhutan elected its first ever representative parliament. Since then the idea of GNH has taken quiet so momentum outside Bhutan with other countries and people around the world thinking about adopting the GNH approach to strive development with values to make a world a happier place to live.

I.3 Geography and Population

Bhutan is located on the southern slopes of the eastern Himalayas with area of 38,394 km sq, landlocked China to the north and the Indian states of Sikkim, West Bengal, Assam and Arunachal Pradesh to the west and south. It lies between latitudes 26°N and 29°N, and longitudes 88°E and 93°E. The land consists mostly of steep and high mountains crisscrossed by a network of swift rivers, which form deep valleys before draining into the Indian plains. Elevation rises from 200 m (660 ft) in the southern foothills to more than 7,000 m (23,000 ft). Bhutan has a population of 745,153 people, with 387,520 men and 357,633 women as of 2014 and is sparsely populated country in the world with population density 19.4 person per sq km as shown below in table 1.

Table 1: Demography

Population by Sex	2012	2013	2014
Male	375,554	381,582	387,520
Female	345,125	351,421	357,633
Both Sex	720,679	733,003	745,153
Population by Age Group			
0 – 14	216,972	224,607	227,254
15 – 64	469,450	471,887	480,347
65+	34,257	36,509	37,553
All Ages	720,679	733,003	745,153
Overall Sex Ratios	108.8	108.6	108.4
Population Density (Person Per Sq. Km)	18.8	19.1	19.4
Median Age of Population (years)	24	24.6	24.7
Ageing Index (elderly per 100 children)	15.8	16.3	15.9
Total Dependency Ratio	53.5	55.3	52.8
Child Dependency Ratio	46.2	47.6	45.5
Old Age dependency Ratio	7.3	7.7	7.3

Source: National Statistics Bureau, Thimphu

I.4 Culture, Religion and Cuisine

Bhutan has a rich and unique cultural heritage that has largely remained intact because of its isolation from the rest of the world until the early 1960s. One of the main attractions for tourists is the country's unique culture and traditions. Bhutanese tradition is deeply steeped in its Buddhist heritage. The government is increasingly making efforts to preserve and sustain the current culture and traditions of the country. Because of its largely unspoiled natural environment and cultural heritage, Bhutan has been referred to as “The Last Shangri-la”. The three quarters of Bhutanese population follow Vajrayana Buddhism, which is also the state religion. Hinduism is the second most dominant religion in Bhutan being most prevalent in the southern regions and less than 1 % that accounts follower of other religion.

Rice (red rice), buckwheat, and increasingly maize, are the staples of Bhutanese cuisine. The local diet also includes pork, beef, yak meat, chicken, and lamb. Soups and stews of meat and dried vegetables spiced with chilies and cheese are prepared. Emadatshi, made very spicy with cheese and chilies, is the most preferred dish by majority for its ubiquity and the pride that Bhutanese have for it. Dairy foods, particularly butter and cheese from yak's and cow's milk, are also popular, and indeed almost all milk is turned into butter and cheese. Popular beverages include butter

tea, black tea, locally brewed ara (rice wine), and beer. Bhutan is the first country in the world to have banned the sale of tobacco under its Tobacco Act of 2010.

I.5 Political Reform and shift to a constitutional Monarch

Bhutan's political system has recently changed from an absolute monarchy to a constitutional monarchy. The fourth King Jigme Singye Wangchuck transferred most of his administrative powers to the Council of Cabinet Ministers and allowing for impeachment of the King by a two-thirds majority of the National Assembly. A new constitution was presented in early 2005. In December 2006, King Jigme Singye Wangchuck abdicated the throne in his son's favor. This was followed by the first national parliamentary elections in December 2007 and March 2008. On November 2008, 28-year-old Jigme Khesar Namgyel Wangchuck, eldest son of King Jigme Singye Wangchuck, was crowned King and he is the world's youngest monarch.

The Druk Gyalpo (Dragon King) is the head of State and the political system grants universal suffrage. It consists of the National Council, an upper house with 25 elected members; and the National Assembly with 47 elected lawmakers from political parties. Executive power is exercised by the Council of Ministers led by the Prime Minister. Legislative power is vested in the National Assembly. Judicial power is vested in the courts of Bhutan. The legal system originates from the semi-theocratic Tsa Yig code; and has been influenced by English Common Law during the 20th century. The Chief Justice is the administrative head of the judiciary. The Parliamentary election, Bhutan's first national election, was held in March 2008, with voter turnout at about 80%. The pro-monarchy Druk Phuensum Tshogpa, translated as the Bhutan Peace and Prosperity Party, won 44 out of 47 seats in Parliament, trouncing the People's Democratic Party. The election marked Bhutan's transition from an absolute monarchy to a democracy. In April, Lyonpo Jigme Thinley, of the Peace and Prosperity Party, became Prime Minister.

I.6 International Affairs

Bhutan has been a member of the United Nations since 1971. It is a founding member of the South Asian Association for Regional Cooperation (SAARC). The country is a member of 150 international organizations, including the World Bank, the IMF, the Group of 77, the Initiative. Bhutan has diplomatic relations with 52 countries and the European Union. Bhutan has its missions in India, Bangladesh, Thailand and Kuwait. It has two UN missions, one in New York and one in Geneva. Only India and Bangladesh have residential embassies in Bhutan, while Thailand has a consulate office in Bhutan. Other countries, such as the United States and the United Kingdom, have no formal diplomatic relations with Bhutan, but maintain informal contact through their respective embassies in New Delhi and Bhutanese honorary consulate in Washington D.C. In terms of developing partners of Bhutan, India is the top most followed by Japan and these two grants aid all financial technical and human resource areas.

II. Over view of Macroeconomic Activity and Fiscal Position

Bhutan is on the UN's list of least developed countries (LDC). In 2013, it embarked on its Eleventh Five-Year Plan (FYP) seeking to maximize what the King termed "Gross National Happiness". Bhutan has adopted a very cautious approach to economic development, putting preservation of the traditional Buddhist culture and the country's spectacular natural environment well ahead of ambitions for economic modernization. The fiscal regime of Bhutan has acquired a number of distinctive features: (a) the size of fiscal operations is exceptionally large by South Asian standards; (b) the large Government budget is sustained to a considerable degree by foreign assistance, primarily from India; and (c) despite a high level of expenditure, budget deficits have been kept within non-inflationary range.

Bhutan's hydropower potential and its attraction for tourists are key resources. The Bhutanese Government has made some progress in expanding the nation's productive base and improving social welfare. Model education, social, and environment programs in Bhutan are underway with support from multilateral development organizations. Each economic program takes into account the government's desire to protect the country's environment and cultural traditions. Bhutan has achieved significant socio-economic progress in the last few decades in terms of health and education indicators, the progress in the real economic sector has not been as impressive. Apart from donor-funded infrastructure works and establishment of hydropower projects, there has been little growth in the manufacturing sector. Rapid social development and population growth coupled with weak growth in the private sector has led to the emergence of new concerns like unemployment, especially youth unemployment, and the need for economic diversification. A major structural problem that Bhutan still faces is its heavy dependence on external assistance.

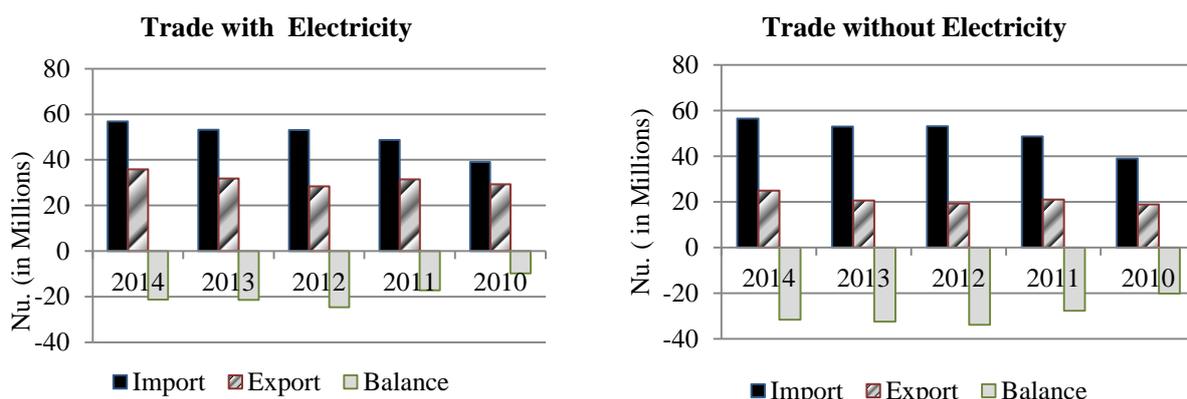
Prior to 1961, the economy was largely based on agro-pastoral subsistence activities and a barter system within village communities. Since the modern banking system was introduced only in 1968, there were no domestic savings to be mobilized for post-1961 development projects. As a result, Bhutan became heavily dependent on external assistance and hence Bhutan's first three Development Plans were largely financed by India. While some progress has been achieved in reducing the role of government in the economy, the public sector contribution was approximately 35 per cent. Bhutan follows a policy of earmarking domestic revenue for current expenditure while external assistance in the form of grant aid and highly concessionary external borrowings is directed to capital projects. While the overall fiscal balance has been in substantial deficit due to government capital spending on the new hydro- power projects, Bhutan's fiscal deficit has been the equivalent of 4 to 10 per cent of GDP in recent years. The net impact of the new hydropower project is critical to Bhutan's medium-term prospect. Moreover, the growing recurrent costs for investments in health, education and general infrastructure are likely to hamper the accumulation of significant fiscal surpluses over the medium term in coming years.

II.1 International Environment

II.1.1 Trade Balance

Bhutan is an import driven country, the overall trade deficit increased by 1.8 percent in FY 2013/14 from the last fiscal year. The trade deficits with both India and Countries other than India (COTI) widened only marginally in the year, by 2.3 percent and less than 0.1 percent, respectively. The imports have been increasing every year for last five years and exports almost remain at constant. The overall balance of trade always remains negative as shown below figure 1 in both situations.

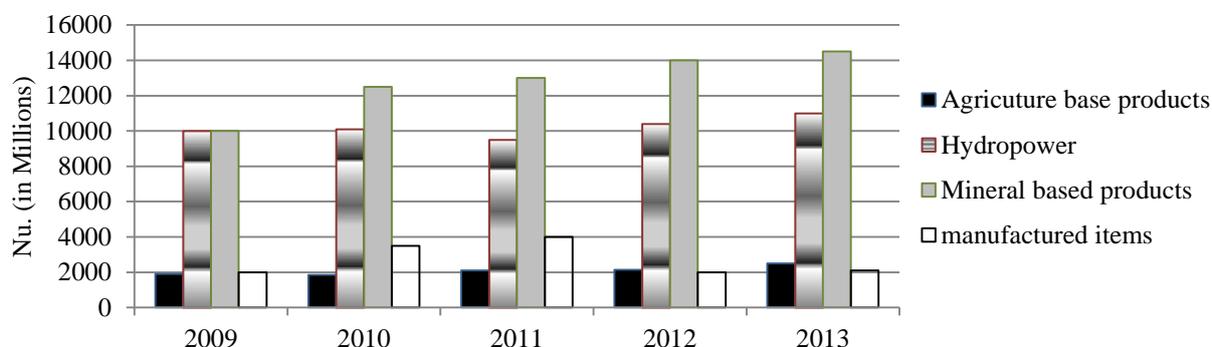
Figure 1: Overall balance of Trade



Source: Bhutan Trade Statistics, DRC

The hydropower continues to remain Bhutan’s largest export, accounting for 35.2 percent of total exports (India plus COTI) in 2013. Figure 2 shows the hydropower exports increased from Nu.10.3 billion in 2012 to Nu.11.2 billion in 2013(Nu stands for Bhutanese currency which is at current exchange rate of 1\$= Nu 65). The export of minerals and mineral based commodities increased to Nu.15.1 billion from Nu.14.8 billion in 2012, accounting for 47.3 percent of total exports. Among other exports, the share of agriculture based exports increased from 8.3 percent in 2012 to 9.7 percent in 2013 (Nu.2.5 billion to Nu.3.1 billion). While exports of cardamoms increased by 50.9 percent from Nu.452.6 million to Nu.656.1 million, exports of apples, potatoes and oranges increased by 30.6 percent, 16.4 percent and 14.7 percent, respectively.

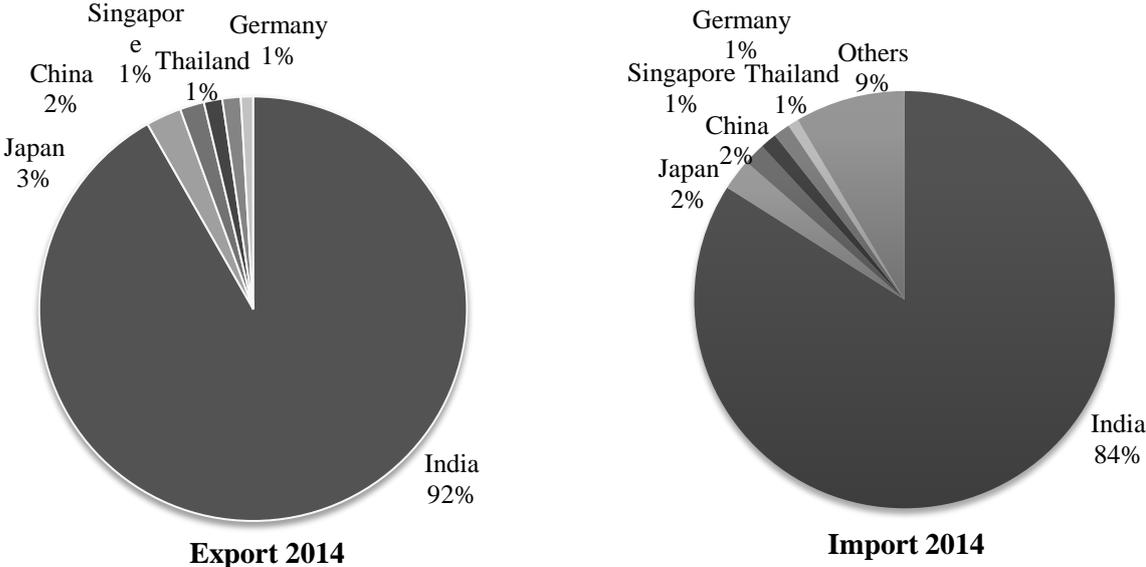
Figure 2: Export Performance



Source: National Statistics Bureau

Top exports to India include hydropower and Ferro alloys. The share of exports to Bangladesh increased to 7 percent from 4 percent in 2012 (major exports include oranges, cardamoms and limestone). Bangladesh was followed by Germany among the top three destinations for exports, with its share increasing to 1.4 percent from 0.1 percent in 2012, mainly due to the increase in export of Ferro alloys. The chart shows the export and import partners for 2014.

Figure 3: Exports and Import Partners of Bhutan



Source: National Statistics Bureau

For imports, the share of import from India increased to 83.5 percent in 2013 from 79.4 percent in 2012. Following India was China with a share of 2.1 percent. Some of the major imports from China were doors, windows, hand tools and crushing and grinding machines. Thailand’s share has increased from 1.4 to 2.1 percent; major imports were polythene and polymers. The share of import from South Korea decreased from 3.1 percent in 2012 (Nu.1.7 billion) to 0.6 percent in 2013 (Nu.280 million). This was mainly due to the decrease in import of copper wire. The pie chart shows the import popular import destination of Bhutan in 2014.

II.1.2 Service and Income Account

The surplus in the secondary income was not sufficient to cover the deficit in the primary income and the services accounts, resulting in a net negative balance in the overall invisibles account. Table 2 depicts that the net deficit increased from Nu.5.5 billion to Nu.6.4 billion in FY 2013/14 driven by the payments made in the services sector. Accrued interest on the Indian Rupee denominated hydropower loans increased by 21.5 percent while the budgetary grants received by the RGOB fell by 11.7 percent during the fiscal year.

Table 2: Overall BOP invisibles

	Nu. (In Millions)			
	2010/11	2011/12	2012/13	2013/14 (R)
Services	(4,283.1)	(4,749.9)	(3,395.8)	(5,380.1)
Services: Credit	3,703.8	5,146.0	6,764.0	8,126.1
Services: Debit	7,986.9	9,896.0	10,160.4	13,506.2
Maintenance and repairs services	-	(14.2)	(2.4)	(195.1)
Transport	(1,441.0)			
Travel	(412.8)	(327.8)	1,080.1	3,086.1
Construction	(1,212.0)	(1,548.3)	(2,805.6)	(2,950.0)
Insurance	(155.0)	(190.4)	(4.8)	(46.8)
Financial services	(3.6)	(6.7)	(12.8)	(5.0)
Charges for the use of intellectual property	(9.4)	(2.5)	(1.3)	(40.7)
Telecommunications, computer and information	(106.9)	(175.5)	(124.9)	(2,778.6)
Other business services (excluding me chanting)	(803.3)	(898.0)	(972.0)	(1,976.7)
Government goods and services	(138.2)	(203.1)	(219.0)	(252.5)
Primary Income	(4,709.7)	(5,922.4)	(9,063.3)	(7,127.6)
Primary Income: Credit	753.6	875.1	965.9	1,164.0
Primary Income: Debit	5,463.3	6,797.5	10,029.1	8,291.8
Compensation of employees	(2,043.2)	(1,898.6)	(2,077.3)	(2,090.2)
Direct investments	(208.7)	(88.1)	(1,089.8)	(110.8)
Interest on deposits	670.5	813.0	856.0	1,081.1
Interest on debt	(3,128.3)	(4,748.8)	(6,752.2)	(6,007.7)
o.w. accrued interest on Indian Rupee hydro	(1,006.9)	(1,979.7)	(2,968.1)	(3,605.4)
Secondary Income	6,206.7	10,778.7	6,997.5	6,103.3
Secondary Income: Credit	8,562.2	12,907.3	8,684.7	7,333.2
Secondary Income: Debit	2,355.5	2,128.6	1,687.1	1,230.0
General Government	7,774.3	11,359.8	7,716.2	5,895.1
Of which: Budgetary grants :Credit	6,540.0	9,020.7	4,716.2	3,856.5
Others Sectors	(1,567.6)	(581.1)	(718.6)	208.1
of which: Workers remittances	(1,651.6)	(935.8)	(468.2)	(64.5)
Total Invisibles	(2,786.1)	106.4	(5,461.6)	(6,404.5)
in percentage of GDP	(3.8)	0.1	(5.6)	(6.1)

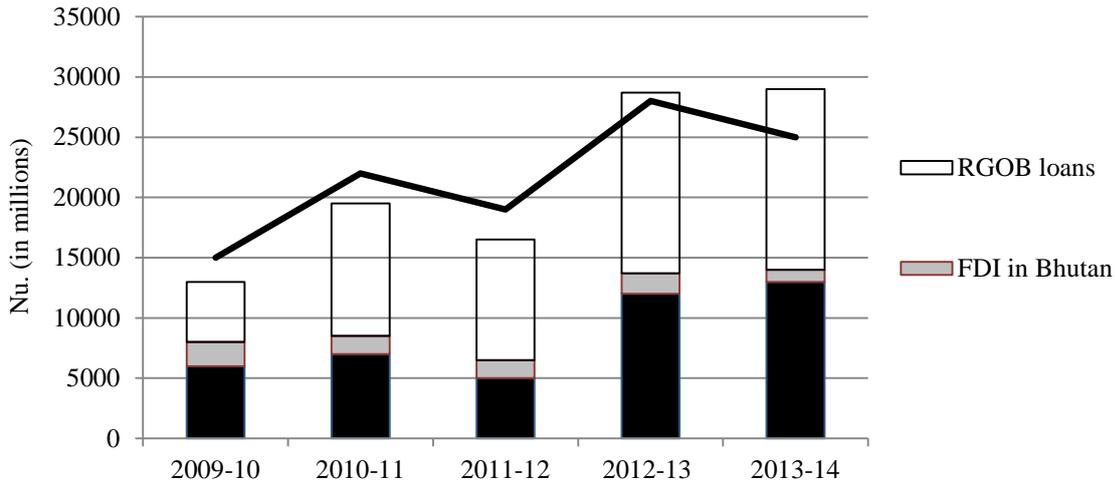
Source: Royal Monetary Authority of Bhutan

The net services account deficit increased by 58.4 percent in the fiscal year. This however was brought about due to expanded data coverage in the services sectors. Within the services account, the net surplus in travel services increased from Nu.1.1 billion to Nu.3.1 billion in 2013/14. Among other major items in travel services, gross receipts from convertible currency paying tourists (Nu.4.1 billion) increased by 16 percent over the last fiscal year, and accounted for 65 percent of the total service credits. The import of construction services (largely from India) increased by 5.1 percent from the last fiscal year to Nu.3.0 billion. These services constituted 21.8 percent of the total services imports for the fiscal year, and were largely related to the development and maintenance of major hydropower projects. The import from other business services increased by over 100 percent in the year to Nu.2.0 billion, also driven by the development of hydropower projects.

II.1.3 Capital and Financial Account

The inflows in the capital account increased by 16.9 percent in FY 2013/14. This was driven largely by increase in budgetary grants received during the year (Nu.4.7 billion to Nu.7.5 billion). The financial account balance for the year was negative at Nu.14.6 billion (implying a net borrower status for the country). The combination of capital and financial account is reducing when compare with last financial year as shown in figure 4. Flows related to direct investment during the year decreased by 81.1 percent from Nu. 2.7 billion to Nu. 512.7 million. Among other investments, total loan liabilities decreased by 24.3 percent during the year owing to a decrease in both the Royal Monetary Authority (RMA) and the Government loan liabilities. After provisioning for net errors and omissions, Bhutan's overall balance (change in reserve assets) was positive at Nu.6.1 billion for the year, since the net surplus in the capital and financial account (Nu.31.5 billion) was more than sufficient to finance the current account deficit (Nu.28.8 billion).

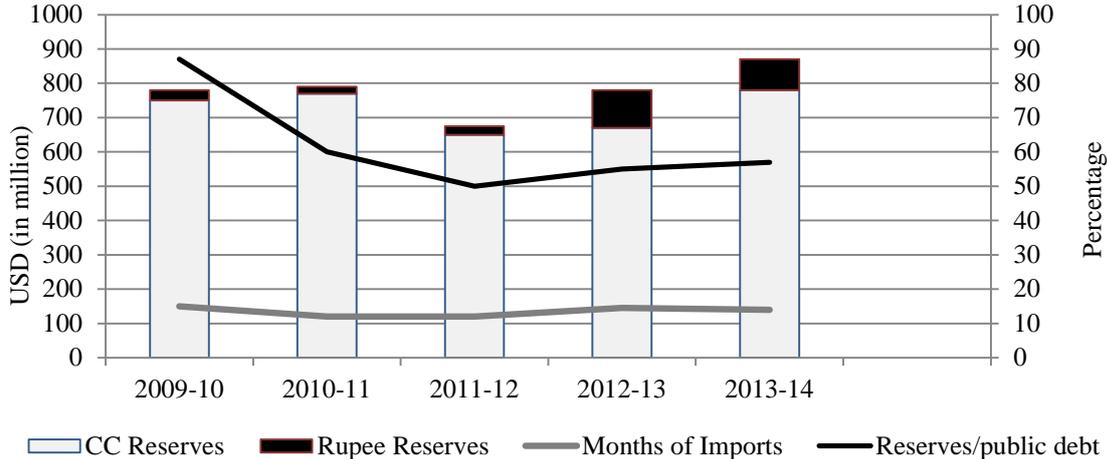
Figure 4: Capital and Financial Accounts



Source: Royal Monetary Authority of Bhutan

Corresponding to this positive overall balance, the country’s gross international reserves increased from an equivalent of USD 916.9 million to USD 997.9 between June 2013 and June 2014. Of the total reserves, USD 829.3 million was convertible currency reserves while 10.1 billion were Indian Rupee reserves. As of the year ending 2013/14, total reserves were adequate to meet 13 months of total merchandise imports (10.5 of imports of goods and services), and 56.7 percent of public external debt outstanding as of June 2014. The Constitution of Bhutan stipulates that “a minimum foreign currency reserve that is adequate to meet the cost of not less than one year’s essential imports must be maintained.” According to estimations by the Indian Rupee Taskforce endorsed by the 127th session of the Cabinet, reserve levels of USD 448.9 million were estimated as being required to meet the Constitutional requirement for the year 2012. As of June 2014, Bhutan’s gross international reserves level of USD 997.9 million are sufficient to finance an estimated 26.7 months of essential imports as shown below in figure 5.

Figure 5: Gross International Reserves



Source: Royal Monetary Authority of Bhutan

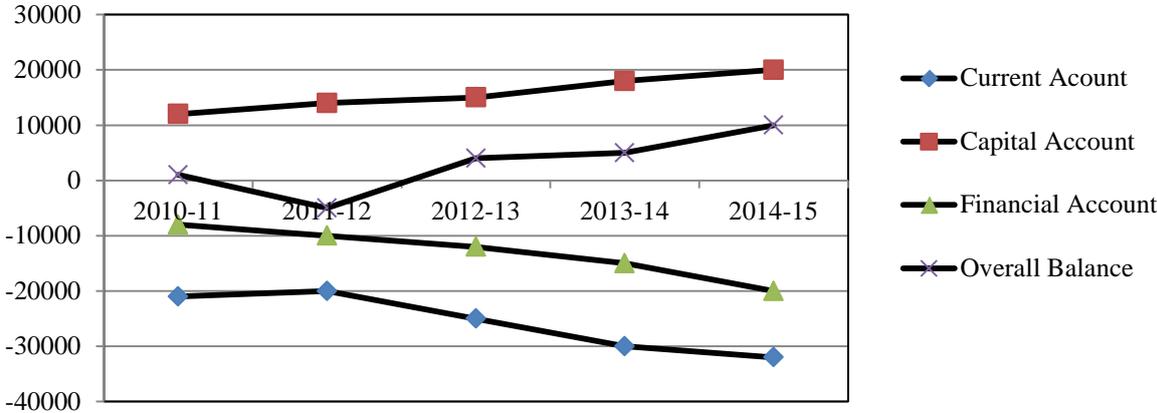
II.1.4 Balance of Payment

Bhutan’s current account continues to remain deficit for the last five years as depicted in figure 6. During the FY 2013-14, current account deficit slightly widened to 25.3% of GDP from 25% in previous year as the export growth was not able to keep pace with imports-particularly consumption and service related imports from India. However, the overall balance of payments remained in surplus due to sizable grants and concessional loan disbursements. Bhutan’s current account deficit with India

continued to remain elevated at 25.7 percent in 2013/14. The trade deficit increased by 2.3 percent from Nu.17.2 billion to Nu.17.6 billion with increases in the import for mineral products (24.7 percent) (notably diesel and petroleum) and base metal products (15.9 percent).

In the income account, budgetary grants increased from 1.5 billion to 2.2 billion. Interest on debt (including accrued interest on hydropower debt) increased slightly from 4.9 billion to 5.1 billion. In the capital and financial account, capital transfers (grants for budget support and for hydropower projects) increased by 39.3 percent, from 11.8 billion to 16.4 billion. A total amount of 5.4 billion on account of the Reserve Bank of India Rupee SWAP was liquidated during the year decreasing the net loan liabilities by 22.7 percent to 11.2 billion. Disbursements for the three ongoing hydropower projects amounted to 14.3 billion. Principal repayments for the external loan of the Dungsam Cement Corporation Ltd. amounted to 288.6 million for the year while 1.5 billion were repaid collectively for the Kurichhu and Tala loans. After provisioning for net errors and omissions, Bhutan’s overall balance with India was negative at Nu.1.2 billion for the FY 2013/14.

Figure 6: Overall Balance of Payment



Source: Royal Monetary Authority of Bhutan

Bhutan’s current account deficit with COTI (Countries other than India) increased by 79.9 percent to Nu.2.0 billion in FY 2013/14. Budgetary grants in the income account fell by 47.5 percent (from Nu.3.2 billion to Nu.1.7 billion). The service account also registered a deficit of Nu.93.2 million during the year. The net surplus in the capital and financial account also decreased from Nu.8.1 billion in 2012/13 to Nu.3.9 billion in 2013/14 driven by a significant decrease (82.0 percent) in budgetary grants. The Disbursements for convertible currency loans also decreased by 25.2 percent during the year. After provisioning for possible errors and omissions, Bhutan had a positive overall balance of Nu.7.3 billion with COTI for 2013/14.

II.1.5 Foreign Direct Investment

The share of FDI in the GDP of Bhutan remains relatively low compared to other developing countries. Geographical factors hold back the region; the country is hemmed in and very mountainous which makes infrastructure construction very difficult and costly. In addition, FDI development is limited by a substantially controlled system and an inadequate policy in the areas of industrial license, trade, work and finance. The shortage of skilled labor is also a hindrance to development. Between 2013 and 2014, Bhutan lost three places in the World Bank’s 2015 Doing Business Report, now ranking 125th (out of 189). This is essentially the result of the deteriorating conditions of contract execution. Further the FDI inward flow and FDI stock has been decreasing for last three years as shown in Table 3. However, the Government has been among the most active in South Asia in terms of introducing reforms, creating a public information and credit register and simplifying the procedures necessary for business establishment. In early 2015, the Government relaxed FDI regulation and foreign investors are now able to buy land and can take money in foreign currency. For several years FDI has been rising steadily.

The hydro-electric energy production sector is to a certain degree threatened by the melting of the glaciers, which represents a growing threat. However, together with the construction sector it remains

the most attractive to investment, which mostly comes from India. Better management of sightseeing tours and better air service benefits the tourism sector, which at the moment contributes only 1% to the GDP, despite its recent growth. Lastly, the agriculture and manufacturing sector receives too little FDI.

Table 3: Foreign Direct Investment Stock

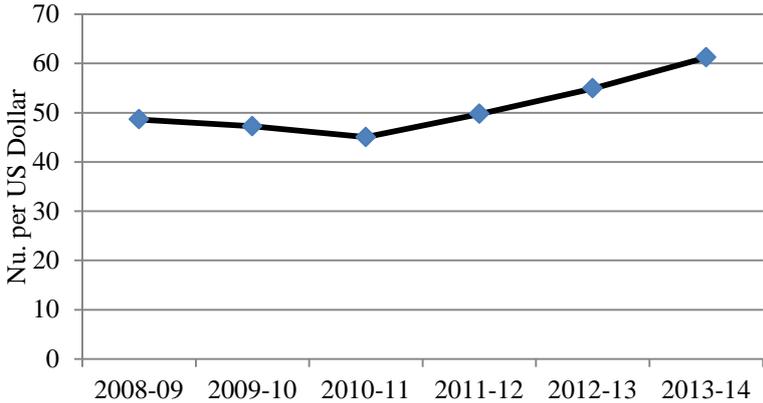
Foreign Direct Investment	2012	2013	2014
FDI Inward Flow (million USD)	51	9	6
FDI Stock (million USD)	141.7	118.8	112.2
Number of Greenfield Investments	1.0	1.0	0.0
FDI Inwards (in % of GFCF)	4.7	0.8	0.5
FDI Stock (in % of GDP)	7.1	6	5.4

Source: United Nations Conference on Trade and Development

II.1.6 Foreign Exchange

In exchange rate developments, the Ngultrum is averaged at Nu. 62.2 per US Dollar in the quarter ending March 2015, depreciating slightly by 0.5 percent from the previous quarter. The Ngultrum however appreciated by 0.7 percent during quarter ending March 2015 against the same quarter in 2014. The Bhutanese currency Ngultrum is pegged 1:1 with Indian Rupee and the exchange rate is mostly determined by the exchange rate of Indian Rupee. Among other major currencies, both the Yen and Euro depreciated against the USD by 9.9 percent and 3.9 respectively between the quarters ending December 2014 and March 2015. The Bhutanese Ngultrum has been weakening since 2010-11 with 61.4 during FY 2013-14 as shown in graph below.

Figure 7: Exchange Rate Ngultrum against Dollar



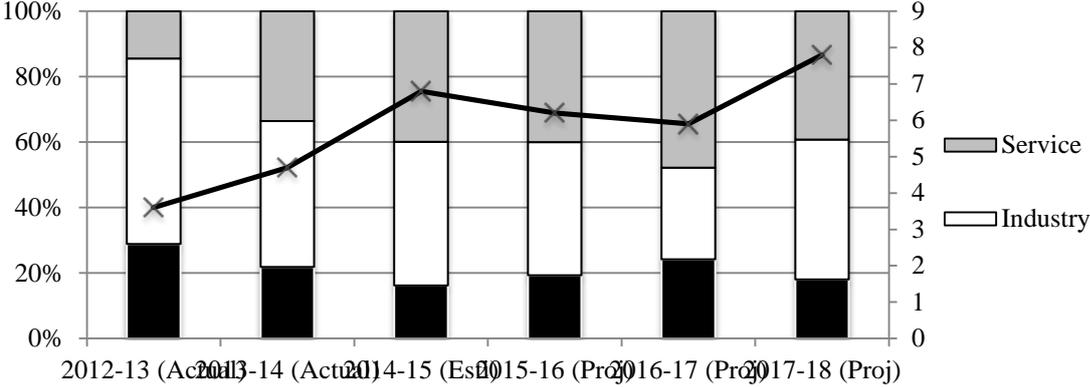
Source: Royal Monetary Authority of Bhutan

II.2 Domestic Environment

II.2.1 Gross Domestic Product (GDP)

During the FY 2013-14, the GDP growth was 4.7% mainly driven by the service sector. In 2014, with the implementation of the fiscal measures, import restrictions were lifted and with the issuance of macro-prudential guidelines by Royal Monetary Authority (RMA), the freeze on lending for housing and transport was removed. The Government’s injection of Nu. 2,100 million under the Economic Stimulus Plan (ESP) into the economy through the financial institutions improved the capital adequacy ratio and financial sector liquidity which facilitated lending and the financial sector growth. During the Financial Year, the agriculture and industry sectors registered a growth of 3% and 6.1% respectively. The growth in industry sector was due to better performance of mining and quarry companies. The MFCC (Mel-frequency cepstral coefficients) estimated the economy to grow at 6.8% in the FY 2014-15 shown in figure 7.

Figure 8: Real GDP Growth Trend



Source: National Statistics Bureau, Bhutan

The growth has been expected to be contributed by service and industry sector which is estimated to grow at 6.9% and 7.6% respectively. The industry sector growth would be on account of construction activities in the hydropower sector. The private constructions also expected to contribute to the growth with the reintroduction of housing loans. Similarly, the growth in manufacturing is also likely to support the growth momentum in the industry sector. The growth in service sector propelled mainly due to increase in developmental activities of the Government and revision of pay and allowances for public servants. The wholesale, retail, hotel and restaurant services along with the tourism sector have also driven the growth of the service sector.

Further in FY 2015-16, the economy is projected to grow at 6.2% mainly on account of the commissioning of Dagachhu Hydropower Project. During the year, agriculture sector is expected to grow at 3.1%. This is with the increasing initiatives taken by the Government towards food self-sufficiency and import substitution with regard to agricultural products. The service sector is projected to have a moderate growth of 6.4%. The hotels and restaurants service is projected to grow by 16.9% during the FY. In the FY 2017-18, the economy is projected to grow by 7.8%. This high growth rate is primarily due to partial commissioning of Punatsangchhu-II and Mangdechhu projects.

II.2.2 Consumption and Investment

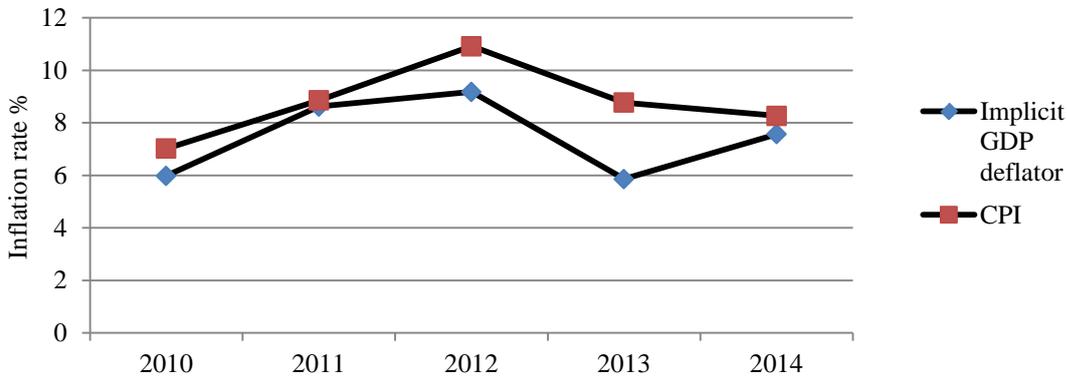
During the FY 2013-14, the gross national savings dropped further to negative 12% from negative 0.17% in the previous year. However, the gross domestic savings during the FY remained at 2.3% which was at the same level of the previous FY. The investment followed a similar trajectory as national savings. The gross capital formation fell to negative 8.7% in FY 2013-14. While both the private and government investment contracted, the contraction was little sharper for the private sector. The saving-investment gap saw some improvement during the FY 2013-14 as compared to the previous FY, which could have been met through foreign financing. However, the consumption level remained at 6.3% mainly driven by the private consumption. In FY 2014-15, consumption grew by 6.9% while investment grew by 10.8% which will be driven by both the government and private investment. The national saving is expected to improve to 12% during the FY 2014-15.

II.2.3 Inflation

The inflation rates fluctuated around an average of 8 to 9 percent in the 1980s and 1990s. However, since 2000, the average inflation rate has been cut almost in half and now stands at less than 8 percent. Low inflation has been achieved not primarily through active monetary or fiscal policy, but through the exchange rate policy that keeps the ngultrum pegged to the Indian rupee. The overall inflation, in general, closely follows the price development in India since major items in the CPI basket are imported from India. For instance, the change in fuel prices in India directly impacts the fuel price in Bhutan among others. Annual inflation was moderated since January 2014, and has reached at 8.27% at the end of 2014 as shown below. With various measures taken by the Government to enhance the domestic agriculture production, the annual inflation rate has dropped as compared to 8.77% in year

2014. This was mainly due to fall in inflation rate for food items by 8.1 percentage points. With regard to non-food items, the inflation rate remained steady at an average of 6.9% during the same period.

Figure 9: Year-on-year inflation (national)



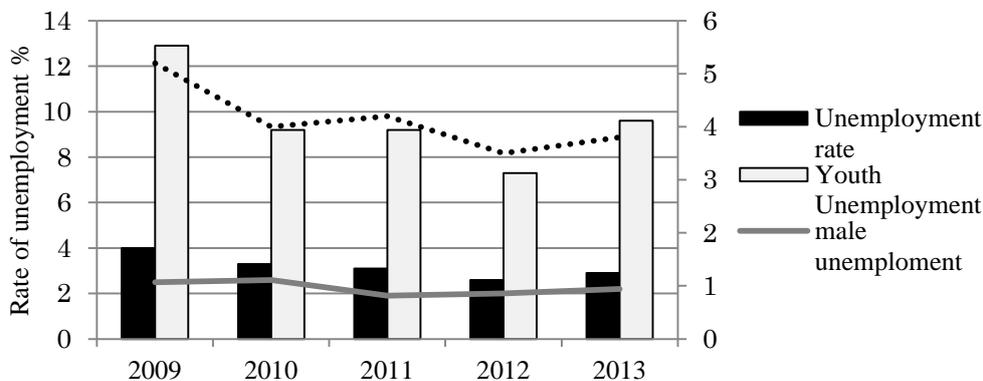
Source: Monthly CPI Bulletin, March, 2015

The prices of domestically produced goods increased by 6.3 percent in March, 2015 as compared to its prices in the same month of the previous year. The prices of imported goods were increased by 6.4 percent during the same period. Within domestic produced goods in the CPI basket, rate of increase in food price was much slower than non-food price. The decreasing trend of annual inflation rate as depicted in the figure 6 and could be attributed to the possible impact of import substitution and export promotion measures initiated by the Government and improved economic situation of India in recent times. In the imported category, food price increased by 5.6 percent and non-food by 6.9 percent in March 2015.

II.2.4 Labor Force and Employment

The Labor Force Participation Rate increased to 65.3 percent in 2013 from 64.4 percent in 2012. This increase in participation rate was due to male with 72.1 percent in 2013 as compared to 65.7 percent in 2012. However, for the women, the rate decreased to 58.9 percent in 2013 from 63.2 percent in 2012. The unemployment rate in country was reported at 2.9 percent (9,916) as compared to 2.1 percent (6,904) in 2012 shown in figure 10. Female unemployment rate was higher (3.7%) compared to that of males (2.2%). It was also reported that more number of people are unemployed in the urban areas than in rural areas. The major cause of unemployment still remains the mismatch of supply and demand of labor in the labor market. Youth Unemployment Rate was 9.6 percent in 2013, an increase from 7.3 percent in 2012. The pattern of high unemployment in the early age groups indicates youths entering into the labor market with certain level of qualification seeking jobs but lacks the required skills needed for immediate employment.

Figure 10: Unemployment Trend

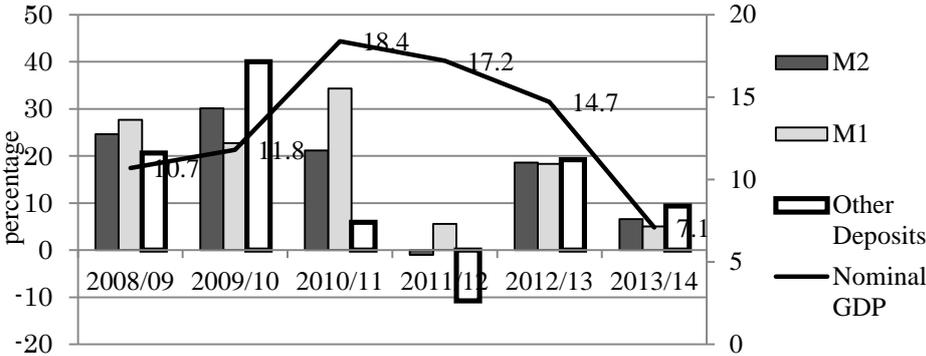


Source: National labor Force Survey, 2013

II.2.5 Monetary and Financial Development

The annual growth of broad money (M2) for the past five years has averaged 18.7 percent, fueled by transferable deposits, which comprises of current deposits and savings deposits of the commercial banks. While on the other hand high domestic credit had contributed to high growth in board money. For the year ending June 2014, M2 recorded growth of 6.6 percent compared to 18.6 percent in the previous year. This lower growth in M2 was mainly contributed by narrow money (M1) and other deposits which grew by 5.0 percent and 9.4 percent as compared to 18.3 percent and 19.2 percent, respectively in 2013 and 2014 as shown in figure 11.

Figure 11: Money Growth



Source: Royal Monetary Authority of Bhutan

Table 4 shows the two major components of M2 comprising of M1 (narrow money) and other deposits. M1 recorded growth of 5.0 percent in June 2014 as compared to 18.3 percent in June 2013. The lower growth in M1 was contributed by slower growth in currency in circulation outside the banks and transferable deposits, which grew by 0.4 percent and 5.9 percent respectively during the FY 2013/14. Transferable deposits comprise of current deposits and saving deposits, of which current deposits recorded an annual growth rate of negative 6.9 percent, a decrease from Nu.18.9 billion to Nu.17.7 billion as of June 2014. Meanwhile, savings deposits grew by 24.3 percent as compared to 15.2 percent in June 2013 and were responsible for fueling the positive growth in M1. Currency in circulation outside the banks increased marginally from Nu.5.6 billion to Nu.5.7 billion during the FY 2013/14. The other major component of M2 i.e. Other deposits, which constitute time deposits and foreign currency deposits, grew by 9.4 percent as compared to 19.2 percent in the previous year. This lower growth of other deposits was on account of slower growth observed in time deposits which grew by 7.7 percent down from 22.4 percent in the previous year as shown in Table 4.

With regard to development in interest rates in the financial sector, the saving rates ranged from 5.0 to 5.5 percent in 2014. Deposit rates ranged from 4.5 to 8.75 percent depending on the maturity of the deposits from three months and less to more than three years. With regard to lending rates, the highest is for the personal loan with 15 to 16 percent and the lowest is 10 to 13 percent for agriculture and livestock sector. The ratio of non-performing loan (NPL) ending June 2014 increased to 12 percent compared to 10.1 percent in 2013. This increase in NPL was due to its increase in trade and commerce, housing and personal loans. For the period ending December, 2014, NPL ratio was 6.3 percent.

Table 4: Selected Monetary Aggregates

Nu. In Million as of June	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
Money Supply, M2	32,114.8	41,778.7	59,639.8	50,122.9	59,451.2	63,387.8
Money Supply, M1	18375	22537.7	30270.3	31960.2	37794.1	39701.8
Counter						
1. Foreign Assets (Net)	32,720.6	34,918.5	35,144.5	35,168.6	48,566.4	53,886.5
O/w: Rupee	-3,258.5	-3,070.8	-7,113.4	-9,550.8	1,492.9	265.2
Convertible Foreign Currency	35,979.1	37,989.2	42,257.9	44,719.4	47,073.5	53,621.2
2. Net Domestic Assets	-605.8	6860.2	15495.3	14954.3	10884.9	9501.3
Domestic Credit	16,259.9	23,136.5	30,705.7	46,465	49,109.2	52,299
Claims on Other Public Sector ¹	-2,211.1	-2,857.4	-2,919.5	2,730.4	2,284.6	4,438.4
Claims on Private Sector ²	18,471.1	25,994	33,625	43,734.6	46,824.6	49,838.7
3. Other Items Net ³	16,865.7	16,276.3	15,210.4	31,510.7	41,547.4	42,797.7
Components						
4. Currency Outside Banks	4,541.8	5,386.5	6,893.7	6,390.7	5,681.2	5,704.6
5. Transferable Deposits	13,833.2	17,151.2	23,376.6	25,569.9	32,112.9	33,997.3
6. Other Deposits	13,739.8	19,241	20,369.5	18,162.7	21,657.1	23,686
O/w Foreign Currency Deposits	1,110.9	1,301.9	2,958.6	1,520	1,283.5	1,733.6
Percent Change over Previous Year						
M2	24.6	30.1	21.2	-1.0	18.6	6.6
M1	27.7	22.7	34.3	5.6	18.3	5.0
1. Foreign Assets (Net)	25.4	6.7	0.6	0.1	38.1	11.0
O/w: Rupee	-265.8	5.8	-131.6	-34.3	115.6	-82.2
Convertible Foreign Currency	33.3	5.6	11.2	5.8	5.3	13.9
2. Domestic Credit	21.7	42.3	32.7	51.3	5.7	6.5
Claims on Other Public Sector ¹	-128.4	-29.2	-2.2	193.5	-16.3	94.3
Claims on Private Sector ²	28.9	40.7	29.4	30.1	7.1	6.4
3. Other Items Net ³	23.3	-3.5	-6.5	107.2	31.9	3.0
4. Currency Outside Banks	24.7	18.6	28.0	-7.3	-11.1	0.4
5. Transferable Deposits	28.6	24.0	36.3	9.4	25.6	5.9
6. Other Deposits	20.6	40.0	5.9	-10.8	19.2	9.4
O/w Foreign Currency Deposits	15.0	17.2	127.2	-48.6	-15.6	35.1

M2= 1 plus 2 minus (Counterpart) and M2= 4 plus 5 minus 6 (Components): M1=4 plus 5.

Corporations.

2. Claims on Private Sectors include Claims on NBFIs.

3. Claims Items (Net) includes markets instruments.

Source: Royal Monetary Authority of Bhutan

II.3 Fiscal Position

Table 5: Fiscal frame Work

Particulars	2013/14	2014/15	2015/16	2016/17	2017/18
	Actual	Revised	Budget	Projected	Projected
Resources	37,819.123	36,400.136	41,017.888	43,780.653	46,557.020
Domestic Revenue	23,244.610	24,900.117	26,145.124	27,042.578	29,434.208
Tax	16,182.774	18,259.128	19,197.949	20,037.995	22,081.746
Non-tax	7,061.836	6,640.989	6,947.175	7,004.583	7,352.462
Grants	14,236.353	11,153.268	14,872.764	16,738.076	17,122.813
India	10,684.430	7,186.202	11,248.657	10,402.856	10,477.856
Others	3,551.923	3,967.066	3,624.107	6,335.220	6,644.957
Project-tied Grants	12,486.660	9,400.768	12,126.764	15,038.076	15,347.813
India	9,059.430	5,486.202	9,548.657	8,702.856	8,702.856
Others	3,427.230	3,914.566	2,578.107	6,335.220	6,644.957
Program Grants	1,749.693	1,752.500	2,746.000	1,700.000	1,775.000
India	1,625.000	1,700.000	1,700.000	1,700.000	1,775.000
Others	124.693	52.500	1,046.000	-	-
Other receipts	338.160	346.751	-	-	-
Outlay	33,522.834	39,211.019	45,504.591	44,831.903	41,902.972
Total Expenditure	34,609.903	40,881.074	47,348.166	46,846.517	43,995.973
Current	17,941.151	22,044.135	23,871.321	25,506.517	27,318.509
Capital	16,668.752	18,836.939	23,476.845	21,340.000	16,677.464
Net Lending (NL)	(1,331.989)	(1,670.055)	(1,843.575)	(2,014.614)	(2,093.001)
Advance/Suspense (Net)	244.920	-	-	-	-
Primary Balance	6,386.678	(659.720)	(2,377.652)	892.300	6,678.175
Fiscal Balance	4,296.289	2,810.883	(4,484.703)	(1,051.249)	4,654.049
Net Borrowings	(1,042.316)	(1,448.734)	396.965	875.370	158.875
Borrowings	1,534.540	1,468.094	3,420.506	3,529.070	2,913.492
Repayments	2,576.856	2,916.828	3,023.541	2,654.070	2,764.615
Resource Gap	3,253.973	(4,259.738)	(4,089.738)	(175.880)	4,813.925

Source: Ministry of Finance, Bhutan

II.3.1 Public Expenditure

Efficient expenditure management is a key economic tool for poverty reduction strategies as it creates adequate fiscal space to reinforce the budget provision for public services like health, education and basic infrastructure in Bhutan. The actual total expenditure outlay for FY 2013/14 grew by 8.2 percent over the 2012/13 outlay to Nu.33.5 billion. In percent of GDP, total expenditure increased from 35.8 percent in 2012/13 to 36.2 percent in 2013/14. The share of capital and current expenditure to total outlay were 51.4 percent and 48.6 percent, respectively. During the year, total current expenditure was budgeted at Nu.19.3 billion, an increase of 6.4 percent over the previous year's current outlay. The increase was due to the incorporation of Economic Stimulus Plan's (ESP) fund of Nu.0.6 billion released to the Business Opportunity and Information Centre (BOIC) and other externally funded activities and adjustment for the previous year's advances. Despite the increase in the current expenditure, the domestic revenue has been able to adequately meet the Constitutional requirement of financing the current expenditure. Current expenditure for the year was Nu.19.3 billion and domestic revenue at Nu.21.9 billion. Correspondingly, capital expenditure stood at Nu.20.4 billion, higher by Nu.1.7 billion from the previous year's outlay mainly on account of the incorporation of ESP fund of Nu.2.1 billion for liquidity injection and Nu.0.06 billion for Pre-employment Support Scheme, besides other external funds received during the year.

Table 6: Highlights of the Budgetary Expenditure: 2009/10 - 2013/14

Sectoral Expenditure	2009/10	2010/11	2011/12	2012/13P	2013/14 R
Social Services	28.5	25.6	23.1	19.2	25.1
Health	8.7	7.1	7.1	5.6	7.0
Education	19.7	18.5	16.1	13.6	17.2
Economics Services	35.3	31.7	27.3	21.9	32.3
General services	15.4	13.0	12.5	10.4	20.0
National Debt Services	11.6	21.1	28.6	41.4	14.0
Others/1	9.2	8.7	8.5	6.9	8.5

Source: Ministry of Finance, Bhutan

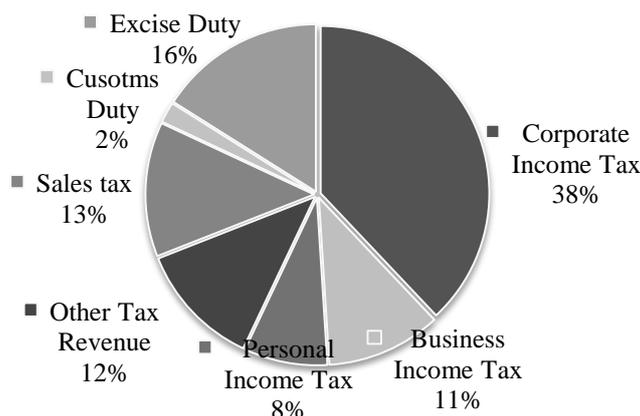
As presented in table 6 above, in terms of the sectoral budget allocation for FY 2013/14, the share of expenditure on economic services (comprised of agriculture, mining and manufacturing industries, roads, housing and community amenities, communications and energy sector) as a percent of total outlay was the highest, increasing from 21.9 percent during 2012/13 to 32.3 percent for the year 2013/14. Similarly, the percentage share of the budget outlay allocated to social services (health and education) increased from 19.2 percent to 25.1 percent during the FY 2013/14.

II.3.2 Resources

Total resources comprises of domestic revenue raised through taxes, fees, charges and grants received from external sources. In the medium term, the total resources are projected to grow at an average of 6.5 percent. The domestic revenue is projected to grow at an annual average of 7 percent in the 11th Five Year Plan (2013-2018) with major increase taking place in the last year of plan with the expected commissioning of new hydropower projects. The realization of revenue projection for the 11th FYP will be dependent on the timely construction of the three ongoing mega hydropower projects. In the medium term, the domestic revenue is projected to cover not only the current expenditure, but will also finance some portion of the capital expenditure. Commissioning of Mangdechhu hydropower project scheduled in 2018 and better growth prospects coupled with automated tax administration is anticipated to enhance domestic revenue performance in the medium term. The table 5 fiscal frame work shows, by FY 2017-18, domestic revenue is expected to reach Nu.29, 434.208 million, which is Nu.3, 289.084 million higher than in FY 2015-16. Domestic revenue as a percentage to nominal GDP is projected to be 18.8 percent for FY 2015-16 as compared to 19.9 percent in the previous FY.

The external grant is aligned with the objectives of sustainable and inclusive green growth, building skills and human development. It is an important source of financing for the Government developmental activities. It constitutes about 36 percent of the total resources in the 11th FYP and is expected to cover about 76 percent of the capital expenditure. As Bhutan is on the threshold of graduating from Least Developed Country status, development partners have decided to gradually phase out from Bhutan which will impact the level of grant assistance in the medium term. The year-on-year growth of grant assistance is estimated to average at 7.4 percent per annum in the medium term. The chart below gives the components of major tax revenue during FY 2013-14.

Figure 12: Composition of Tax Revenue



Source: National Statistics Bureau, Bhutan

The public debt has been increasing for last five year with inception to parliamentary democracy. As show in table 7 the external debt of Bhutan as of 30th June 2014, the external debt stock was Nu.105, 456.913 million (US\$ 1,759.00 million) accounting for 101.3 percent of GDP. Of the total, about 36.2 percent is convertible currency debt and 65 percent is Rupee debt. The Indian Rupee debt also includes project loan for the Dungsam Cement Project (Nu.1, 274.254 million) and Government of India Standby Credit Facility (Nu.10 billion). The growth in debt stock was about 6.97 percent, mainly contributed by disbursements for ongoing hydro power projects. The total principal loan repayment during the year amounted to Nu.2, 576.855 million. The debt service as a percentage of exports of goods and services was maintained at 10.4 percent. Despite the high level of debt stock, as per the Joint World Bank – IMF Debt sustainability Analysis Report 2014, Bhutan is categorized under the moderate risk of debt distress.

As of March 2015 the total outstanding debt stands at USD 1,823.2 million which is 109 percent of the total GDP of a country. Further the total domestic debt as on 30th June 2014 was Nu.2, 913.441 million. Of the total, Nu.350.605 million was the outstanding loan availed for the purchase of aircraft for Drukair in 2004 as Government's equity participation. The balance Nu.2, 562.836 million pertains to short-term borrowings from Bank of Bhutan through overdraft facility for maintaining positive balance in the Consolidated Fund (CF). Over all the debt to GDP ratio has been increasing for last five year and its has crossed 100% sin 2013-14 and even expected to increased in forth coming year till the construction of hydropower project are completed as show in following table.

Table 7: Debt Stock Position

External Debt Indicators	2010/11	2011/12	2012/13	2013/14	Mar' 15
Total Outstanding (USD million)	1,289.3	1,333.7	1,606.8	1,759.0	1,823.2
Convertible Currency (USD million)	527.6	524.7	579.3	629.5	574.7
Indian Rupee (in millions)	34,062.3	45,550.9	61,341.7	67,870.2	78,148.2
Debt/GDP ratio *					
Total	79.5	87.4	98.4	101.3	109.3
Convertible Currency loan	32.5	34.4	35.5	36.2	34.5
Indian Rupee loan	47.0	53.0	62.9	65.0	74.9
Debt service ratio **					
Total	51.7	127.1	229.2	26.8	63.5
Convertible Currency loan	12.4	14.5	15.8	16.8	51.4
Indian Rupee loan	63.5	158.7	285.3	29.7	67.3
Debt service ratio (excluding OD)	12.5	12.9	17.5	26.8	63.5
GDP	72,496.6	85,913.0	97,354.0	104,378.1	104,378.1

Source: Ministry of Finance, Bhutan

III. Tax System

III.1 Organizational Structure.

The vision of the Department of Revenue and Customs of Bhutan is to “contribute to the nation building process through the development of an effective revenue system” and mission with “to ensure that the tax and customs administration has the capacity to collect taxes efficiently and effectively at minimum cost through impartial and consistent enforcement of regulations, and to provide a convenient and honest service to the taxpayers”.

Taxation in Bhutan is collected by the national government and by its subsidiary local governments. All taxation is ultimately overseen by Ministry of Finance, Department of Revenue and Customs. The Ministry of finance carries out the tax laws amendment or regulations and circular through the Department of Revenue and Customs which has five Divisions having different roles as show below in figure 13. All Divisions are under the direct control and supervision of Director, Department of Revenue and Customs which in turn is accountable to Ministry of Finance.

The various functions of the different divisions have been stated as follows:

Tax Administration Division

- a) Implement and monitor the Income Tax Act of the Kingdom of Bhutan, 2001 and the Rules.
- b) Review and advise the Ministry of Finance on all revenue related matters, tax policy and planning.
- c) Revision of legislation, etc. from time to time.

Customs and Excise Division

- a) Implement and monitor the Sale Tax, Custom and Excise Act of Kingdom of Bhutan, 2000 and the Rules.
- b) Review and advise the Ministry of Finance on Custom and Excise policies.
- c) Coordinate with other law enforcement agencies in prevention of the smuggling of restricted and prohibited goods.
- d) Process Excise Duty Refund claim from Government of India.
- e) Liaise with WCO, Regional Custom Administration and other international agencies.

Revenue Audit and Accounts Division

- a) Assessment, collection and deposit of national revenue.
- b) Investigate revenue irregularities.
- c) Advice and interrupt the rules and procedures in revenue matters to revenue agencies.
- d) National revenue forecast on fiscal year basis as well as for the plan period.
- e) Produce the national revenue report.
- f) Process refund from the government revenue account.

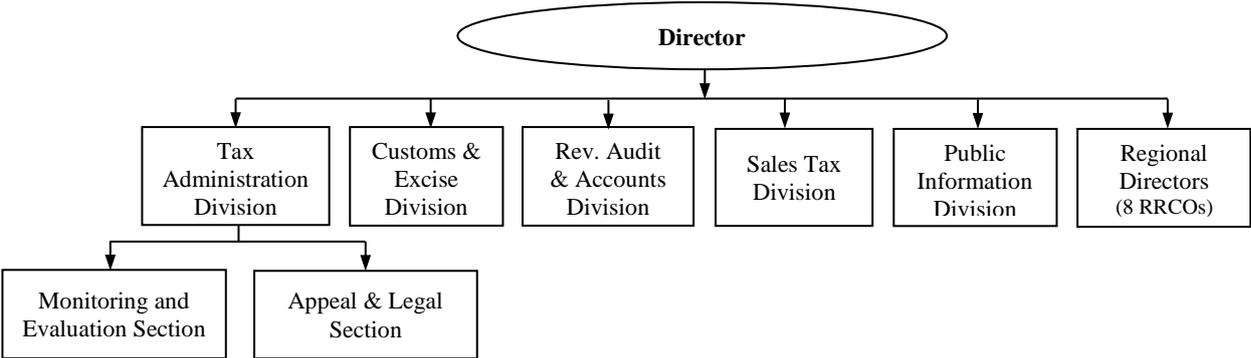
Sales Tax Division

- a) Implement and monitor the Sales Tax, Customs and Excise Act of the Kingdom of Bhutan, 2000 and the Rules.
- b) Review and advise the Ministry of Finance on policy planning and revision of rules/procedures.
- c) Issue and monitor Sales Tax Exemption (STEC) on plants, machinery, spare and raw materials etc.
- d) Refund of Sales Tax.

Public Information Division

- a) Dissemination of direct and indirect tax information, rules and regulation.
- b) Develop and maintain IT systems for effective and efficient management

Figure 13: Organizational Structure



Source: Department of Revenue and Customs

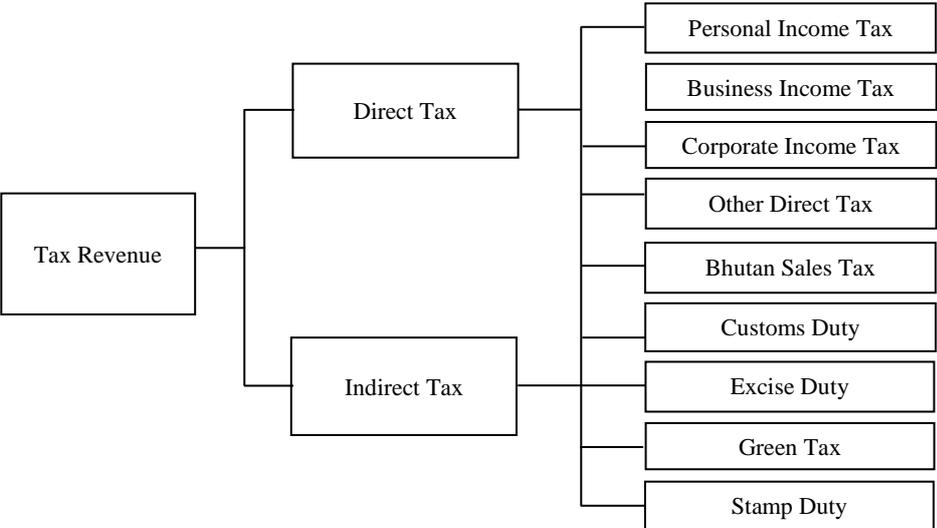
III.2 Tax Administrative Law and Structures

Before 1960, Bhutan didn't have any formal taxation system and the taxes were collected in kind and in form of Labor contribution. The taxes in kind were gradually phased out and replaced by nominal monetized tax on land, property, business income and consumption of goods and services after 1960. The first major tax reform was introduced in 1989 with following purposes;

- a) To take stock of various tax measures.
- b) To develop a coherent and rational tax system.
- c) To establish a system of tax in fair, equitable and efficient manner that minimizes the need for frequent change.
- d) To fully document the system in a way that promotes tax payer awareness.

The main features incorporated during that year was, the Business Income Tax (BIT) on net profit replaced with 2 percent turnover tax and the export income were exempted from tax. The Plant and machinery were also exempted from payment of sales tax and import duty to encourage setting up of industries. Further other nuisance taxes were also abolished during that year. The current tax features is the outcome of the tax reform in 1992 where the tax structure was rationalized and tax based was expanded. Figure 14 shows the restructured Bhutanese taxes which consists basically the direct and indirect taxes.

Figure 14: Tax Structure of Bhutan



Source: Department of Revenue and Customs

The taxation rules in Bhutan is being drafted base on the nature of the taxes and are governed by two tax acts i.e Income Tax Act of Kingdom of Bhutan 2001 for direct taxes and Sales Tax, Customs and Excise Act of Kingdom of Bhutan 2000 for indirect taxes. These two acts are born from the Public Finance Act 2007 and the Bhutanese Constitution which is the mother of all acts. Further these two acts are supported by the two rules namely rules on income tax act 2001 and rules on sales tax, customs and excise act 2000 for the use of tax officials in the field.

III.2.1 Personal Income Tax (PIT)

Resident for Bhutanese taxation means the person whose stay in the Kingdom of Bhutan during the income year is equal to or six months. Income year starts from 1st January to 31st December. For nonresident person the taxation is on source based which means income earned from sources in Bhutan is liable for tax.

Personal Income Tax is the important tax revenue in Bhutan and is the one which has more number of tax payers. It is the tax levied on the balance of the individual taxpayer's income on accrual basis after allowing the deductible expenses as per Income Tax Act of Kingdom of Bhutan 2001 and is applicable to individual, trust and legal heir of the deceased persons. Any person having personal income in excess of Nu. 100,000 per annum shall be liable to be taxed under Personal Income Tax (PIT) as shown in table 8. Personal income means income derived from the following sources:

- a) Salary income from employment and non-licensed consultancy fees.
- b) Rental income from real property.
- c) Dividend income from shareholdings.
- d) Interest income from fixed deposits.
- e) Cash crop income from apple, orange and cardamom orchards.
- f) Income from other sources like hiring of privately owned vehicles and intellectual property right.

All citizens above 18 years of age and residents having personal income from one or more of the sources during an income year should register with the Department and must obtain Tax payer Number (TPN).

Table 8: Personal Income Tax

Sl.No	Net income level between	Tax rates
1	Where income does not exceed Nu. 100,000	Nil
2	Where income is Nu. 100,000 - Nu 250,000.	10%
3	Where income is Nu. 250,000 - Nu 500,000	15%
4	Where income is Nu. 500,000 - Nu 1,000,000	20%
5	Where net income exceed Nu. 1,000,000.	25%

Source: Rules on Income Tax Act 2001, Bhutan

Any religious institution or organization, charitable institution, trust body, trust fund or a body of persons shall be exempt from PIT provided the following conditions are fulfilled as per the Income Tax Act;

- g) Such organizations are approved by the government and established in the Kingdom of Bhutan.
- h) Is not operated or conducted for profit.
- i) Is established exclusively for religious worship or advancement of religion or for charitable purposes and or is in the interest of the general public.
- j) Management and control is done through a board consisting of minimum three members.
- k) Proper books of accounts are maintained.

III.2.2 Business Income Tax (BIT) and Corporate Income Tax (CIT)

The business and companies are segregated into two forms for tax liability as full tax liability and limited tax liability. All companies registered under the companies Act of kingdom of Bhutan are subject to full tax liability on all source of income. Companies or legal entities resident abroad in which none of the participants are personally liable for the company's liabilities, and in which the surplus is distributed according to the ratio of investment from the participants or legal entities resident abroad are liable to corporation tax, if they:

- a) Conduct business in Bhutan through a permanent establishment or participate in business activities conducted through a permanent establishment. The tax liability shall include income from letting such business, payments for consultant services, technical assistance or similar activities, and dividends, royalties or interest that are effectively connected with the permanent establishment. Activities in connection with preliminary survey, exploration or extraction of mineral resources shall be deemed to be conducted through a permanent establishment from the first day;
- b) In the capacity of owner, co-owner or users receive income from immovable property in Bhutan;
- c) Receive income as contractor from sources in Bhutan;
- d) Receive income as consultant, technical adviser, or similar activities from sources in Bhutan;
- e) Receive dividend from sources in Bhutan;
- f) Receive royalties from sources in Bhutan; or

All income including income received either directly or through agencies in Bhutan from bi-lateral/multi-lateral agencies by way of grants or loans shall be deemed to have its source in Bhutan. Where, however, a person, not being a resident of this country, has a permanent establishment in Bhutan, the following income shall be deemed to have its source in Bhutan: -

- a) Interest paid or home on indebtedness in connection with the permanent establishment in Bhutan;
- b) Royalties paid by the permanent establishment in Bhutan for its own use;
- c) Technical services or consultant fees paid by the permanent establishment for services rendered;
- d) Income from immovable property in Bhutan.

Income tax levied on the profits of the business income for all activities carried out on commercial and industries entities as sole traders and partnership in Bhutan after obtaining license from Ministry of Economic Affairs, Bhutan. Those businesses are liable for Business Income Tax (BIT) at the rate of 30 percent of the Net profit. Net profit for the purpose of calculating the tax shall be the Gross income minus the allowable deductions. Deductions shall be allowed under following broad categories;

- a) Direct Costs
- b) Employment Expenses
- c) Overhead Expenses
- d) Sales & Marketing Expenses
- e) Bad debts
- f) Miscellaneous/General Expenses
- g) Fixed Assets & Depreciation
- h) Interest Payment

When taxpayer owns several businesses under the trading sector, each business shall be treated as a separate or independent taxable entity, and the losses incurred in one taxable entity cannot be offset against the profit of another entity. Businesses under the manufacturing and service sector may be treated as one taxable entity irrespective of their geographical locations provided that the following conditions are fulfilled:

- a) Registered as a single tax entity under the same ownership.
- b) Same activity under the manufacturing and service sector.
- c) Consolidated accounts are submitted.

Bhutanese law generally provides for individual and corporate taxation based on income, sales, imports and movable and immovable property. Bhutan has regulated corporations since 1989 most recently under the Companies Act of Bhutan 2000 and these regulations include taxation of corporate income. As of date, Bhutan's Corporate Income Tax (CIT) rate is 30 percent on net profits and is payable by those entities registered under the Company's Act of the Kingdom of Bhutan, 2000. The allowable deduction remains same as in Business Income Tax. CIT is the main contributor to tax revenue with 26.34 percent during financial year 2013-14.

III.2.3 Tax Deducted at Source (TDS)

TDS or withholding tax is a preliminary estimate of tax liability payable on a Pay as You Earn basis. It is not a separate or new form of tax, but a mode of collection on a current income basis, to ease the burden of tax payment at the end of the year. It is deducted at source by a withholding agent and deposited to Regional Offices for adjustment with the final tax liability. All companies that are registered under the Companies Act of Kingdom of Bhutan, 2000 and all those business houses operating under a trade license or permit issued liable for TDS under full tax liability. Whereas those companies not registered under the Companies Act of Kingdom of Bhutan, 2000 but operating a business under temporary license or permit issued by Economics Affairs Ministry, Bhutan through permanent establishment and any business or individual who are resident abroad but receiving from business conducted through a permanent establishment are liable for limited tax liability as show in Table 9.

Table 9: Tax Deducted at Source Rate

Sl No	Income Type	TDS under Full Tax Liability	TDS under Limited Tax Liability
1	Contract income	2% of gross amount	3% of gross amount
2	Consultancy	2% of gross amount	3% of gross amount
3	Royalty	5% of gross amount	5% of gross amount
4	Interest Income	5% of gross amount	5% of gross amount
5	Dividend income	10% of gross amount	10% of gross amount
6	Rental income	5% of gross amount	5% of gross amount
7	Income for leasing, subletting and sub contract business,	2% of gross amount	3% of gross amount
8	Income from other sources	2% of gross amount	5% of gross amount
9	Any other services		3% of gross amount

Source: Tax deducted at source booklet, MOF, Bhutan

III.2.4 Filing of Tax Return and Assessment.

All companies and business with books of accounts must submit their return and make necessary payment of self declared tax on a self-assessed basis to the RRCO of registration before the 31st March following the end of the income year (income year is 1st January to 31st December) and personal income tax before 28th February following the end of income year. However, provisional taxes paid by way of tax deducted at source (TDS) and advance tax shall be paid as per Rules No. 3.2.1, 3.2.2 and 3.2.3 of the General Provisions and will be adjusted during the time of assessment.

The assessment in Bhutanese tax law consists of desk, estimated assessment and field assessment, where assessments are carried when the tax return is submitted or within 90 days thereafter. If the desk assessment is not satisfactory, a field assessment may be carried out within 2 years from the submission of books of accounts. The estimated assessment are carried out if the tax return has not been submitted within the prescribed time limit and no time extension request has been made and approved, a tax return has been rejected during desk assessment, and a valid re-submission has not been received and if a business or company has failed to keep proper accounting records as required under the tax law. Reassessment may be done at any time within five years upon request of the tax payer as part of appeal procedure upon request from the tax authorities where appeal cannot be completed without further investigations and on certain reasonable grounds.

III.3 Indirect Taxes

III.3.1 Sales Tax

The collection under indirect taxes is guided by Sales Tax, Customs and Excise Act of Kingdom of Bhutan 2000. In Bhutan, the sales tax charged to consumers are based on the purchase price of certain goods and services. The benchmark used for the sales tax rate refers to the highest rate. Revenues from the Sales Tax Rate are an important source of income for the government and levied at two points that is point of entry and the point of sale. The sales tax is levied and collected at the point of entry which is valued on free on board (FOB) with the rates varying from 0 to 100 percent based sales tax schedule and customs tariff and the sales tax on point of sale is valued based on selling price of goods and services at the time of sale but excluding discounts. In order to collect the sales tax at the point of sale, all licensed manufacturers; dealers/distributor of beer should register with the Department and are known as sale tax collecting agents. These collecting agents are responsible for collection of sales tax at the point of sale and should deposit the sales tax collected monthly basis on or before 10th of the following month along with monthly schedule of collection reports to the nearest Regional Revenue and Customs Office. Further the sales tax collecting agents should maintain certain set of books of account mentioned the rule.

III.3.2 Customs, Excise Duty and Green Tax.

The Customs duty also is levied at point of entry on the goods imported from Third countries and the tariff rates range from 0 – 100 percent. The specific duty rate is also applied on some of the industrial raw materials. In case of goods imported from SAFTA (South Asian Free Trading Agreement) member countries, the Customs Duty is levied based on the preferential tariff rates as agreed by SAFTA member countries.

Excise duty is levied on certain notified domestically manufactured products. Currently excise duty is levied only on alcoholic beverages. It is levied on ad-valorem basis and the rates are 30, 60 and 75 percent on the ex-factory price. Green tax is levied on import of goods from India as well as from countries other than India. It is levied at the point of entry on motor vehicles, petrol and diesel. The green tax range from 5 to 30 percent and levied on Free on Board (fob) value of imported goods.

III.3.3 Exemptions on Sales Tax (ST), Customs Duty (CD) and Fiscal Incentives.

The tax exemptions are treated as incentives in Bhutan and the general incentives includes incentives to manufacturing companies through issue of exemption certificates on sales tax and customs duties on import of plant and machineries and raw materials. Tax incentives are also given to the locally produced cinemas to encourage and promote entertainment and service industries. These exemptions are given on fulfillment of fiscal incentives 2010 and also sales tax, customs and excise act of kingdom of Bhutan 2000. Excise duties on domestically manufactured products are also exempted from excise duty except for alcohol products. Tax incentives are given by the government in order to protect the domestic manufacturing industries and also to encourage the people to enter into the field of manufacturing business. The above incentives are given until further notice by the ministry of finance, Bhutan.

Further a number of business entities spreading under seven different regional tax bureaus were granted tax holiday among which eight (8) corporations/incorporated companies have applied and availed the tax holidays for the period ranging from three years to five years, seventeen (17) business units have been also granted tax holidays for the period ranging from four years to five years and twenty six (26) more business units dealing in service (hotels) activities were also granted tax incentives for five years by the government of Bhutan.

III.3.4 Payment, Fines and Penalty

All companies, businesses, citizens or residents shall pay income tax on a self-declared basis at the time of filing the tax return. TDS/tax paid half yearly or quarterly shall be adjusted against the tax liability and any payment in excess shall be refunded as per Section 23 of the General Provisions of the Income Tax Act of the Kingdom of Bhutan, 2001.

In general any taxpayer failing to pay their income tax and sales tax within stipulated time and withholding agents failing to deduct or deposit the withholding tax as required will attract penal interest of 24 percent per annum from the due date in addition to tax in arrears. However the various penalties are levied based on the offenses:

- a) A fine equivalent to Nu. 100 per day up to a maximum period of 3 months from the due date ar imposed on late filing of tax return.
- b) A fine at the rate of 100 percent of the gross income shall be imposed on non- filing and non-filing means tax return not files after 3 months from the due date.
- c) A fine ranging from Nu. 100,000 depending on the size of the business for failure to maintain books of accounts, documents and furnish information shall be imposed.
- d) A fine ranging from Nu.500 to Nu.5, 000 for each default shall be imposed for failure to comply with a notice issued by the Department to give evidence and produce books of accounts.
- e) A fine equivalent to twice the tax amount sought to be evaded in addition to tax due shall be imposed on concealment of the particulars of income or furnishing inaccurate particulars of income.
- f) A fine of 50 per cent of the value of the goods in addition to the amount of Sales Tax, Customs and Excise duty shall be imposed for the under invoicing or non declaration, mis-declaration, concealment of goods and for misuse of duty exemptions.

III.3.5 Dispute Settlement and the Appeal.

The appeal system consists of three tier board set up at Regional Office, Head Quarters and Ministry level. A person taxable or business entity including importer can appeal on assessment of tax, sales tax, customs and excise duty or any other decision passed by an officer of the Department. An Appeal Committee at the Regional Office level of the Department consisting of three officers of the Regional Office and chaired by the Regional Director but excluding the assessing officer and at Head quarter level of five members. The appeal board at Ministry level consists of four regular members and one ad hoc member.

The appeal should be filed before appeal committee within 30 days from the date of issue of the demand notice or seizure notice and committee will pass its decision within 30 days from the date of receipt of an appeal. The decision of the appeal committee of Regional office can be appeal to the appeal committee at Headquarters within 30 days from the date a decision has been passed. Likewise the decision of the Headquarters appeal committee can be appealed to the Appeal Board in Ministry within 60 days and further to the Court of Law within 30 days after the decision passed by Ministry level Appeal Board.

IV. Country Specific Issues

Bhutan is admired worldwide for its living spiritual and the rigorous pursuit of Gross National Happiness as the guiding principle of development. However the pursuit of happiness is not achievable without causalities. As modernity and consumerism take hold, Bhutan is facing a host of problems

IV.1 Youth Unemployment

Among many others, the youth unemployment is serious issue. Despite the consistent effort from the government and concerned authorities, the challenging youth problems are on constant rise. According to the UNDP, Bhutan's youth unemployment rate of 7.3 percent is one of the highest in the region. Youth unemployment in Bhutan is mostly concentrated among the educated as a result of the incapability of the poor economy to create new job opportunities sufficient to accommodate the annual increase in the job seeker, which largely composed of young people entering the job market for the first time after obtaining their first stage of higher studies. It is also due to the lack of consistency between the outcomes of the educational system and the needs and demand of the job market in terms of various specialization and skills. In fact, the economic growth over the last decade did not contribute to a growth in youth employment, though there was a vast growth in demand for manual labor. Bhutanese young people are getting educated and do not want to figure out as farmers or labor in the construction industry.

IV.2 Public Debt and Deficit

Bhutan's total external debt today is more than the size of its economy. Bhutan to the path of self reliance, the size of debt has overburdened the country, exceeding the national economy by 12 per cent. According to Royal Monetary Authority (RMA), the Central Bank, the country's debt to GDP ratio stands at 112 per cent. The World Bank projects the debt would increase to 121 percent by 2016-17 fiscal years. Country's GDP is Nu 104 billion while the debt has increased to Nu 114 billion and it was at 108 per cent in September, and more than three quarter of the debts are payable to India in rupees. The hydropower loans accounts for 83.4 per cent of the outstanding rupee loan. The government has cleared about Rs 15.6 billion loan undertaken from various arrangements with India, but owes Rs 10 billion, which was borrowed from Government of India (GoI) line of credit which should be cleared at the earliest. Bhutan does not have any regulations in place regarding the threshold limit for borrowing the loans. The position of Bhutan, as compared with rest of the world, has worsened in 2013 in terms of GDP percentage. Currently it is country number 161 of debt to GDP ratio in debt per capita out of 183 countries.

IV.3 Shortage of Indian Currency

An ongoing and severe shortage of Indian rupees has emerged as a Bhutan's major macroeconomic problems and policy challenges are required. India is Bhutan's largest trading partner and a crucial source of imports, aid and concessional and other loans. Bhutan's currency, the ngultrum, is also pegged to India's rupee. Bhutan's economy is heavily import-dependent and India accounts for the majority of the country's both imports and exports. As the Bhutanese economy grows strongly, imports have also surged. Consequently, the demand for rupees has continued to rise, to support trade, capital and financial transactions. Over the course of fiscal year 2010/11 (July-June) Bhutan's rupee reserves declined from Rs1.4bn (around US\$30m) at the beginning of the year, to Rs774.6m (about US\$17m) at the year's end, (Rs stands for Indian Rupees).

The rupee shortage has become one of the most critical economic constraints in recent years, and requires reassessing the current international reserve management policy and reviewing liquidity management practices. Rapid credit growth and expansionary domestic demand policies in the 2000s have contributed to a surge in imports from India and increased the rupee demand. Addressing the challenge posed by the rupee shortfall and the underlying structural imbalance requires prudent macroeconomic management with a pragmatic monetary policy framework.

IV.4 Economy threat from Climate Change

The Bhutanese are eager to become world leaders in hydropower, but are gradually coming round to learning from regional and international experiences the serious implications and potentially destructive nature of large hydropower dam projects. The risks of climate change include declining flows due to retreating glaciers, which can impact the economic feasibility of Bhutan. The concern of climate change threat is not only worrying Bhutan but the world too is having the same concern. The Bhutan's economy is solely depend on hydropower and is among the intensive producers of hydro power in the world. In terms of share of total electricity generation, virtually all electricity is generated using hydropower. Hydroelectric production is also large relative to the size of the economy; the electricity sector has accounted for 20 percent of real GDP over the recent past. Hydro power potential is estimated at 30,000 MW, of which presently around 1,500 MW has been harnessed, bulk of which is exported to India. The main threat in such an economy is from the global warming where the most of the fast flowing rivers in Bhutan are sourced from high land glacial lakes in the northern part of country. Climate change is a concern for Bhutan and natural disasters like glacial lake outburst floods (GLOF) could be aggravated by it. Northern Bhutan abounds in glaciers and glacial lakes. According to some estimates, there are 677 glaciers and 2,674 glacial lakes in Bhutan. Of these, 25 glacial lakes have been identified as potentially dangerous. The country has already experienced the natural calamities and disaster resulting from glacial lake outburst floods in recent years. Further the disturbances to water sources would definitely impact the production of hydropower and will result in downfall of Bhutanese economy, so the vulnerability of global warming is very high in the mountainous country like Bhutan.

V. Conclusion: Where we stand? Where we go?

Bhutan, located in the eastern Himalayas, is a small landlocked country between the People's Republic of China and India. Despite challenging geography and limited connection to the global markets, the country managed to ignite and sustain strong economic growth with its guiding philosophy called "Gross National Happiness" mainly by unlocking its hydropower potential. Thus, hydropower has been a major engine of growth in Bhutan. The main sources of Bhutan's robust economic performance have been investment in hydropower and growth in hydropower-related construction and services. Heavy dependence on economy to narrowly based growth and limited employment opportunities. Reliance on electricity exports to India as the major source of foreign exchange has also made the economy vulnerable to swings in India's business cycles. In the longer term, jobless growth and dependence on one sector for growth are unsustainable, will lead to income disparities, and will frustrate the efforts of increasing numbers of educated youth seeking gainful employment. The anticipated future decline in external aid and grants has underscored the issue and diversifying the economy. For more broad-based and inclusive growth, Bhutan will need to tap new drivers of growth. A more stable and sustainable growth path and generate productive employment opportunities for the population. How then, should Bhutan better position itself to ensure its economic future? The answer to the question should be addressed by

- (1) Reviewing the economic performance of sectors that are current drivers of growth;
- (2) Outlining new, emerging drivers that can accelerate growth that is sustainable and inclusive;
- (3) Offering policy options to support and advance new growth engines that are sources of new employment.

Unlike other countries, in Bhutan the Gross National Happiness is considered more important than Gross national Product, where GNH is a holistic approach with setting four pillars,

- (1) Sustainable and equitable socio economic development.
- (2) Preservation and promotion of culture
- (3) Conservation of environment
- (4) Good governance

These four pillars are then further classified in nine domains which form the frame work of GNH. Any plans for the development is being aligned with these four pillars.

In three decades, Bhutan has successfully reduced poverty through high growth and improved social programs. The share of the population living below the national poverty line fell from 23.2 percent to 11.5 percent in the 5 years was more substantial in rural than in urban areas, 16.2 percent of rural inhabitants remained poor at the end of the period, while only 1.2 percent of the population in urban areas remained poor. Income inequality widened, however, and income disparity remains high relative to other parts of South Asia. To further its remarkable growth and successful poverty reduction, Bhutan still faces considerable development challenges that the government may wish to consider when preparing its Eleventh Five Year Plan (FYP). Among the most pertinent challenges is economic growth that is hinged on limited productive economic activities outside the hydropower sector, dependence on external aid of gainful employment for an increasing.

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