

1 Bhutan

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I. Introduction

Bhutan is located in between two giant sovereign nations of Southeast Asia and South Asia with China in the North and India in the south. It is a small landlocked country with geographical coverage of 46,500 square kilometers with population size of approximately 774,949 people. It is one of the least populated country in the region of south Asia. The economy of Bhutan, one of the world's smallest and least developed countries, is agriculture and forestry, which provides the main livelihood for more than 60% of the population. Agriculture consists largely of subsistence farming and animal husbandry. Since medieval period, Bhutan like any other countries has also witnessed revolutionary changes politically, socially and economically under the rule of Great religious saints like Guru Rinpoche¹ (746AD), Lam Phajo Drugom zhigpo² (1208-1275), Zhabdrung Ngawang Namgyel³ (1616-1655) and followed by reign of Monarch which began from 1907 and introduction and institution of Parliamentary Democracy system since 2008 to recent.

Before it got its name 'Bhutan', her country and its subjects were known as 'Mon' and people of 'Mon' or it also used to be called as 'Lho Mon' which basically refers to 'Lho' means south and 'Mon' is a derivative of word '*mun*' which is darkness in Tibetan word. This land of '*Mon*' also known as 'Monyul' is believed to have existed between 100 AD and 600 AD. Sometimes this country was also referred by the name 'Lhomon Tshendenjong' that meant '*southern mon sandalwood country*'. Although there is, no precise etymology on how Bhutan got its name but some scholars provide a variation that it is a Sanskrit word 'Bhota-ant' which meant end of Bhot (i.e Tibet). From 17th century onwards, our country was popularly known as 'Druk Yul' (country of Drukpa Lineage or land of Thunder Dragon). Perhaps, Bhutan got this name in 17th century. 17th Century in Bhutan coincides with great advent of one of the famous Buddhist master from Tibet known by its name Zhabdrung Ngawang Namgyel. He introduced the system of 'theocracy' or Dual system of governance in the governance structure of Bhutan. During his reign, many internal strife and foreign aggression was fought and he was able to unify and consolidate central and western part of Bhutan towards east. Zhabdrung was one of the famous religious figure in the culture and Tradition of one of the Buddhist sect known as 'Drukpa Lineage' and because of his reign and rule which lasted for almost (1616-1676) 60 years, the country derived its name from his lineage 'Drukpa Lineage' and the 'Land of Drukyul' or land of Drukpa lineage. All his subjects and the places he visited became his follower and the follower of his Lineage.

Today the country is known by its name 'Kingdom of Bhutan' since Monarch rule (Wangchuk Dynasty) from 1907 until 2007 and still to this day, the country is still referred by this name. The year 1907 marks an important milestone in the History of Bhutan because it was on this day that the country Bhutan remained fully unified under one King (1st King, Gongsu Ugyen Wangchuk on 17th December 1907- 26th August 1926) since the fall of Theocracy system or rule instituted by Zhabdrung Ngawang Namgyel during 17th century. The fall of theocracy system unfolded many internal conflicts and shifts in power in the region and it is the ancestors of our Today's king that country's political situation was brought under the control of Great Monarch. 17th December, 1907 marks the end of long period of internal strife and political instability in our country and our first king got crowned on this day and therefore, December 17th is celebrated as our National Day in Bhutan every Year.

I.1 Bhutan and Parliamentary Democracy system

Two important event unfolds the History of politics and governance in Bhutan. The first one 'the rise of theocracy system' (1616-1907) or Dual system of Governance and the second one 'the reign of

¹ Guru Rinpoche is one of the famous Buddhist saint after Lord Buddha originally known to be from Pakistan.

² Lam Phajo is originally from Tibet and he is the first person who founded Drukpa lineage in Bhutan.

³ Zhabdrung Ngawang Namgyel is a famous Buddhist saint belonging to Drukpa lineage in Tibet.

monarch' (1907-2008). Before 1616 AD, many local leaders and local chieftains ruled our country. The civilization before 1616 AD was not much different from the civilization in west during medieval period. In early period (before 1616 AD), Bhutan was divided into many regions and zones and each regions and zones have its local chieftain whom the people entrust them as their leader of that region. People were subject to labor contribution, taxes including services of different kinds. People generally followed Buddhism but in some pockets of the country, people still followed Bonism⁴. The advent of Bhuddism in Bhutan dates back to 746 AD when one of the famous Buddhist Master (Guru Rinpoche) from Zahore, (presently Pakistan) visited Bhutan. After that, many Buddhist scholar visited the country and the most prominent being Phajo Drugom Zhigpo in 1212 AD until the arrival of Zhabdrung in 1616AD.

In 1616 AD, Zhabdrung Ngawang Namgyel visited Bhutan. He belonged to Tibet and he was a major religious figure in the Drukpa Kagyu Lineage of Buddhism in Tibet. His advent to Bhutan coincides with uprising controversies of his own reincarnation in Tibet, which caused him to abandon Tibet and advent towards south in Bhutan. Since his arrival to Bhutan, he went to preach Buddhism and established many monasteries and fortresses (commonly known as 'Dzongs' in Bhutanese Language) in almost all regions of Bhutan. This has helped him gain people's confidence in seeing him as a religious leader and in fact, Bhutan being a country where many Buddhist scholar preached Buddhism before his arrival made him easier to preach his Buddhism, thereby securing peoples trust and faith in him. He was then popularly named by his subject as 'Zhabdrung' which meant 'to whose feet one submits'.

Under his reign all the divided regions of Bhutan was unified and he went to establish a so called 'choesid system' and 'Desi system' of governance which is also called Dual system of governance. During his reign he was both the head of Choesid system ('Choesid system' pertains to governance of religion) and Desi system ('Desi system' pertains to governance of state and Political affairs). Under this system of governance, selection to both the head of religious and state was made from the fraternity of monk bodies and usually a well-learned/highly attained and respected candidate of monk bodies to the post. The head of the religion was titled 'Je Khenpo' (meaning Chief abbot) and the head of the state 'Druk Desi' (meaning regent). Many administrative, judiciary and cultural reform took place during his reign and several Tibetan invasions and local invasions were fought successfully gaining the invincible fame, which perhaps contributed to consolidation and unification of our Country then. He introduced even the national dress that we wear today, which gives Bhutan its uniqueness in identity and culture.

This system of governance however lasted until 1705⁵ and year after this, Bhutan entered into a decade long of internal instability marked by a continuous civil strife and foreign aggression (especially from Tibet and threat of British Empire). The rule of 'Desi system' has been constantly in crises after 1705 although rule of 'Choesid system' fared well. These periods (1705-1907) characterizes shifts in power from western Bhutan to eastern Bhutan. The local chieftains of the west and east region of Bhutan (known as *penlops*) competed themselves to become Desi of Bhutan through civil war. Amongst them was the Tronsa penlop⁶ Jigme Namgyel who was one of the prominent chieftain born and raised in eastern region of Bhutan and who came to absolute power in east during 1880's. Later, his son (Gongsa Ugyen Wangchuk) succeeded him in maintaining the power base in central of Bhutan (Trongsa Bhutan). Much later in 1907, sir.Ugyen wangchuk was elected as its hereditary Druk Gyalpo (Dragon King) marking the end of Dual system of governance and start of absolute monarchical system in Bhutan. Untill 2008; Bhutan saw a reign of four kings since 1907 and the first one being Gongsa/sir Ugyen wangchuk.

The chronology and their period of reign is shown in below:

1. Gongsa Ugyen Wangchuk, 1st King of Bhutan, (1907-1926)
2. Jigme Wangchuk, 2nd King of Bhutan, (1926-1952)
3. Jigme Dorji Wangchuk, 3rd King of Bhutan (1952-1972)
4. Jigme Singye Wangchuk, 4th King of Bhutan (1972-2006)
5. Jigme Kheser Namgyel Wangchuk, 5th King of Bhutan (2008 and onwards)

⁴ Customary practices of religion before Buddhism, which involves sacrificing of animal in conducting rituals.

⁵ The year marks the Death of Zhabdrung.

⁶ Penlop is a Bhutanese term used to refer to chieftains during that time.

Bhutan achieved another milestone in political history of Bhutan when fourth King of Bhutan (His Majesty Jigme Singye Wangchuk: 1972-2006) announced the Gift of Democracy to the people of Bhutan. This marks the end of the monarchical system of Governance with introduction of Democratic Constitutional Monarchy. Unlike in rest of the world where democracy was a resultant of continuous bloodshed and civil war, Bhutan has been uniquely gifted the gift of Democracy in a so called peaceful transition from hereditary monarchy to democratic constitutional monarchy marked by enthronement of 5th King, His Majesty Jigme Khesar Namgyel Wangchuk in the year 2008.

Today the country has democratically elected Prime Ministers and Ministers who represent the head of government while His Majesty the King is head of state and symbol of unity of Kingdom and people of Bhutan. Since 2008, Bhutan has entered Third phase of electorate process in choosing the ruling government and opposition.

I.2 The geography, culture and economy

a) Geography

At its longest east-west dimension, Bhutan stretches around 300 kilometers; it measures 170 kilometers at its maximum north-south dimension, forming a total of 46,500 square kilometers, an area one-third the size of Nepal. The current population of Bhutan is 774,949 as of Monday, November 23, 2020, based on worldometer elaboration of the latest United Nations data.

Bhutan is geographically located in the Himalayas to the north of India and south of China. The Himalaya Mountains of Bhutan dominate the north of the country, where peaks can easily reach 7,000 meters (22,966 ft); the highest point in Bhutan is 'Gangkhar Puensum', which has the distinction of being the highest unclimbed mountain in the world, at 7,570 meters (24,840 ft). Weather is extreme in the mountains, the high peaks have perpetual snow and the lesser mountains and hewn gorges have high winds all year round, making them barren brown wind tunnels in summer, and frozen wastelands in winter. The blizzards generated in the north each winter often drift southward into the central highlands.

The highlands are the most populous part of the nation and the capital Thimphu lies in the western region. The region is characterized by its many rivers, its isolated valleys that house most of the population and the expansive forests that covers 70% of the nation. The highlands have Eastern Himalayan subalpine conifer forests at higher elevations and Eastern Himalayan broadleaf forests at lower elevations. Winters are cold, summer are hot and the rainy season is accompanied with frequent landslides and roadblocks.

It is bordered for 470 kilometers by Tibet (China's Xizang Autonomous Region) to the north and northwest and for 605 kilometers by India's states of Sikkim to the west, West Bengal to the southwest, Assam to the south and southeast, and Arunachal Pradesh (formerly the North-East Frontier Agency) to the east.

b) Culture

Cradled in the folds of the Himalayas, Bhutan has relied on its geographical isolation to protect itself from outside cultural influences. A sparsely populated country bordered by India to the south, and China to the north, Bhutan has long maintained a policy of strict isolationism, both culturally and economically, with the goal of preserving its cultural heritage and independence. Only during the last decades of the 20th century were foreigners allowed to visit the country, and only then in limited numbers. In this way, Bhutan has successfully preserved many aspects of its culture, which dates directly back to the mid-17th century.

Language

'Dzongkha' is the official language of Bhutan and with opening of Bhutan to rest of the world since 20th century and with growing modern education system in the country, the usages of English language is also prevalent in schools and offices. In fact, most of the official gazettes are documented both in English and in Dzongkha. It is uncommon in Bhutan to find Bhutanese people not speaking English

language which is now a days considered as second language with its growing importance to communicate with people of rest of the world.

Religion

Bhutanese society is centered around the practice of Buddhism, which is the main religion. Religious beliefs are evidenced in all aspects of life. Prayer flags flutter on hillsides, offering up prayers to benefit all nearby sentient beings. Houses each fly a small white flag on the roof indicating the owner has made his offering payments to appease the local god. Each valley or district is dominated by a huge ‘dzong’, or high-walled fortress, which serves the religious and administrative center of the district. Approximately 23% of the population is Hindu. There is a small Muslim population in Bhutan, covering 0.2% of the whole country's population. Overall, 75% of the population is Buddhist, and 0.4% other religions.

Dress Code

Men wear a heavy knee-length robe tied with a belt called a ‘gho’, folded in such a way to form a pocket in front of the stomach. Women wear colorful blouses over which they fold and clasp a large rectangular cloth called a ‘kira’, thereby creating an ankle-length dress. A short silk jacket or ‘toego’ may be worn over the kira. Everyday gho and kira are cotton or wool, according to the season, patterned in simple checks and stripes in earth tones. For special occasions and festivals, colorfully patterned silk kira and, more rarely, gho may be worn. Additional rules of protocol apply when visiting a dzong⁷ or a temple, or when appearing before a high-level official. Male commoners wear a white sash ‘kabney’ from left shoulder to opposite hip. Local and regional elected officials, government ministers, cabinet members, and the King himself each wear their own colored kabney. Women wear a narrow embroidered cloth draped over the left shoulder, a ‘rachu’.

c) Economy

The economy of Bhutan, one of the world's smallest and least developed countries, is based on agriculture and forestry, which provide the main livelihood for more than 60% of the population. Agriculture consists largely of subsistence farming and animal husbandry. Rugged mountains dominate the terrain and make the building of roads and other infrastructure difficult and expensive. Its economy is closely aligned with India's through strong trade and monetary links and dependence on India's financial assistance. The currency of Bhutan is called ‘Ngultrum’ denoted in short by ‘Nu’ and its pegged equal at Indian Currency. Most production in the industrial sector is of the cottage industry type. Most development projects, such as road construction, rely on Indian migrant labour. Each economic program takes into account the government's desire to protect the country's environment and cultural traditions. For example, the government, in its cautious expansion of the tourist sector, encourages visits by upscale, environmentally conscientious tourists. Detailed controls and uncertain policies in areas such as industrial licensing, trade, labour, and finance continue to hamper foreign investment. Hydropower exports to India have boosted Bhutan's overall growth, even though GDP fell in 2008 because of a slowdown in India, which is predominant export market for Bhutan.

Despite confronted with such unfavorable conditions as mountainous topography and being landlocked and susceptible to natural disasters, Bhutan has demonstrated a strong record of accomplishment in sustaining economic growth and reducing poverty over the past two decades or so. Its progress in other socio-economic indicators as reflected in its success in achieving many of the 2000-15 Millennium Development Goal (MDG) targets is also worth noting. It is unique in approaching development by valuing collective happiness as the goal of governance. Bhutan successfully met the least development countries (LDCs) graduation criteria in two United Nations triennial reviews of 2015 and 2018 and is set to graduate from the group of LDCs in 2023.

⁷ ‘Dzong’ is a Bhutanese term for fortresses.

II. Overview of Macroeconomic Activity and Fiscal Position

Broadly, the objective of macroeconomic policies is to maximize the level of national income, providing economic growth to raise the utility and standard of living of participants in the economy. There are also a number of secondary objectives, which are held to lead to the maximization of income over the long run. While there are variations between the objectives of different national and international entities, the details indicated in below shall be touched upon to give the glimpse of macro-economic performances and fiscal position of Bhutan.

- a. Consumer price inflation (annual % change in prices)
- b. Real GDP growth over one or more business cycles
- c. Changes in measured unemployment / employment
- d. Fluctuations in the current account of the balance of payments
- e. Changes in government finances (i.e. the size of the fiscal deficit or surplus)
- f. Volatility of short-term policy interest rates and long-term interest rates such as the yield on government bonds
- g. Stability of the exchange rate in currency markets

II.1 Macroeconomic Activity

a) Consumer price inflation (annual % change in prices)

The Consumer Price Index (CPI) is a measure of average price changes in the basket of goods and services purchased by households over time. It shows how much, on average, prices of goods and services have increased or decreased from a particular reference period, commonly known as the Index reference.

Consumer prices rose sharply from March to May in the wake of the Covid-19 pandemic, according to the Consumer Price Index (CPI) published recently by the National Statistics Bureau (NSB). The average inflation rate during the six months before the country detected its first Covid-19 case on March 5 had remained slightly over 2%.

The year-on-year CPI for the month of September increased by 8.02% compared to the same month of previous year. This rate is an increase of 0.58% point as compared to the year-on-year increase recorded in August month, which was 7.44%. The higher rate is associated with increase in prices of food and non-alcoholic beverages by 16.69% and alcoholic beverages and betel nuts by 12.77%. Prices of vegetables recorded the highest monthly increase of 7.31% followed by beer with 6.76% over the previous month of August.

Non-food prices decreased by 0.30% compared to previous month, however it recorded an increase of 1.36% in the past one year (compared to September 2019). The drop in the year-on-year rate as compared to August month is due to decrease in communication by 12.50%. The month-on-month decrease in price of non-food is mainly due to decrease in communication and kerosene price.

The purchasing power of Bhutanese Currency⁸ as measured by CPI is Nu.67 as of September 2020 compared to December 2012. This means, Nu.100 in September 2020 is worth only Nu.67 at December 2012 prices. The PPN has dropped by 7.43% in the past 12 months (from September 2019 to September 2020) due to price increase in the economy.

b) Real GDP growth

Real Economic Growth Rate is the rate at which a nation's Gross Domestic product (GDP) changes/grows from one year to another. GDP is the market value of all the goods and services produced in a country in a particular time-period.

⁸ Ngultrum is the Currency of Bhutan often denoted by Nu.

Pre-Covid GDP growth rate:

The Bhutanese economy recorded a Gross Domestic Product (GDP) growth of 5.46% in the year 2019 as against the 3.03% growth in the year 2018. This was an expansion of the economy by 2.41% in 2019.

Sectoral analysis indicates that the main sectors that helped the economy rebound were education and health; mining and quarrying; and transport and communication, which grew by 51.09%, 33.1%, 13.2% respectively. Another major contributor was electricity, grew by 12.12%. The NSB (National Statistical Bureau) adds that the government final consumption expenditure and private final consumption expenditure were the main contributors in 2019, with the growth of 10.80% and 6.13% respectively. The year 2019 also recorded an increase in national savings; however, gross national savings could not meet the investment requirements of the economy. It reports that nominal investment in 2019 was estimated to around Nu.67.637 billion as against the gross national savings of Nu.36.467 billion which is a growth of 2.34% of gross national savings in 2019 from 2018. This record of an increase in terms of Ngultrum was approximately around 1.432 billion.

Post Covid GDP growth rate:

In its latest “South Asia Economic Focus, Spring 2020”, the World Bank estimates that Bhutan’s Real GDP growth in the fiscal year 2020 will decelerate in the range of 2.2 to 2.9% depending on how long the pandemic lasts. Before the pandemic, the country’s growth projection for the year was at 6.5%. The World Bank predicts that the pandemic will adversely affect agriculture, construction, and export sectors due to disruptions on the supply side such as labour shortages and lower external demand. The trend is likely to continue until the end of 2021. Because of strong linkage of Bhutan’s economy to its neighbor country (India), growth slowdown in India is expected to dampen external demand in Bhutan and particularly for non-hydro goods and services from Bhutan. As a response to this dampening effect, the government has to initiate various measures to minimize its effect on economy. However, government has already initiated its measures and among many of its measures, the government plans to frontload some of the 12th Plan projects. However, the country’s current account deficit is likely to persist given the country’s dependence on essential imports, both for consumption and investment. It also indicates that domestic production of electricity is likely to decline. Over the medium-term, the external deficit is likely to narrow with the increase in electricity exports from two mega powerhouse of Bhutan (Mangdechhu and Punatsangchhu II). Because Bhutan is a net electricity exporter whose prices are set with India independently of oil prices, there is likelihood of Gain from export of electricity due to lower prices on import of fuel prices as indicated by World Bank.

Other risks that Bhutan faces include possible delays in hydropower project completion and lower-than-expected rainfall due to global warming, which would negatively affect growth and reduce exports. The fiscal deficit is expected to widen to 3.4% in the fiscal year 2020 due to a pickup in current spending in response to the Covid-19, and an increase in salaries and wages (for employees affected by pandemic).

On the other hand, reduction of the government’s discretionary spending is expected to lead to a decrease in capital expenditure. The non-hydro revenues could also decline with the slowdown in the services sector. However, hydropower revenues could increase due to the one-off profit transfer from the commissioning of the Mangdechhu hydropower plant.

The World Bank suggests that improvements in tax policy and administration and the implementation of the Goods and Services Tax (GST) will be critical to increase revenues over the medium-term. GST in Bhutan will become effective from July, 2021 with levy of 7% on the all goods and service purchased and it will also replace the Bhutan sales tax system which is levied for only hotels and services at the rate of 10%. According to world bank “Slower than expected implementation of the GST would also affect fiscal outcomes, because of the discontinuation of excise duty refunds and lower levels of grant financing from India,”.

The projections on Poverty reduction by World Bank estimates that poverty reduction will continue at a modest pace due to Covid-19 as most of the poor work in subsistence agriculture. The poverty headcount rate at USD 3.20 per day is projected to gradually decline to 9.8% in 2020 and 8.8% in 2021. Reduced demand for agricultural products could lower export and hurt agribusinesses. The World Bank says that the risks from weaknesses in the non-banking financial sector needs to be monitored. The World Bank reasons, “The banking sector has adequate cushions to absorb potential losses, given sufficient capital adequacy, but some of the non-bank financial institutions are fragile, particularly in

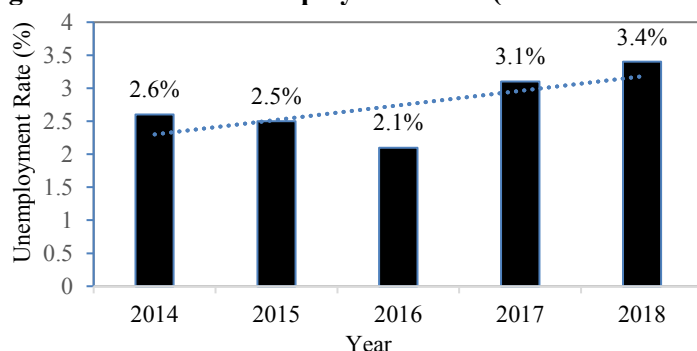
the insurance sector.” The Non-Performing Loan (NPL) ratio in the financial sector rose to 18.4 % in September 2019, up from 12.8% in September 2018.

Although the public debt in Bhutan is over 100% of GDP, this is not a sustainability concern because most of it is contractually linked to hydropower project loans from India. Hydropower output should generate substantial export revenue soon, it says. The report states that although the current account deficit remains high in Bhutan, its deficit is largely financed by India’s investment in hydroelectric capacity, which should turn into a net income once operational.

c) Changes in measured unemployment / employment

The International Labor Organization (ILO) defines unemployed as those aged 15 years and above without a job, seeking a job in the last four weeks prior to an interview and available for work if given the opportunity.

Figure 1: Bhutan’s Unemployment Rate (Labor Force Survey Report of 2018)



Source: Labor force survey report of 2018, National Statistical Bureau.

Bhutan’s unemployment rate stands at 3.4% as per the Labor Force Survey Report of 2018. This means nearly 10,500 people were without work during the reference period, actively seeking and available for work. The figure is an increase from 3.1% in 2017. The unemployment rate over the five years has remained below 4%. The highest unemployment rate is reported in 2018 and lowest in 2016 with 2.1%. According to the report, the unemployment rate for females is higher than males. In addition, unemployment is more of an urban phenomenon with 71% which is four times higher than that of the rural areas.

On the other hand, the employment rate over the five years has remained above 95%. The highest employment rate was observed in 2016 and lowest in 2018. The overall youth unemployment rate is estimated at 15.7% which is an increase from 12.3% in 2017. Youth unemployment covers those unemployed aged between 15 to 24 years. The increase in youth unemployment is due to the fact of declining youth population and increase in inactive youth population over the years. Not getting a job, lack of adequate qualification and lack of experience as the major reasons for people being unemployed.

In addition to the growing unemployment problem, the pandemic has taken its toll in this already growing problem. Like in many other countries, the pandemic has affected employment and displaced majority of productive people working in tourism/aviation and hospitality sectors in particular. It has affected other sectors as well but the magnitude of its effect is lesser compared to the former one. Unemployment is already one of the biggest social problems in our country. The youth unemployment rate is far worse off which stands at 15.7%, higher than 12.3% in 2017.

Despite its need of policy attention to come over these challenges, the pandemic has caused government to divert its attention to activities and plans to fight Covid-19, which leaves the activities and plans to address employment in the country shelved. As those who had jobs before are becoming jobless, the problems of unemployment is further expected to increase.

d) Fluctuations in the current account of the balance of payments

The recent commissioning of Mangdecehu Hydro-project (MHP) in Bhutan since 2019 has improved the goods and services balance as electricity exports significantly increased and imports

related to MHP ceased (MHP is one of the hydro-power project with 720 megawatt water run power house which is one of the main assets that generates sales revenue from sale of electricity to India). The list of total powerhouse in the country along with its capacity is displayed in below table.

Table: 1: Hydropower Stations in Bhutan

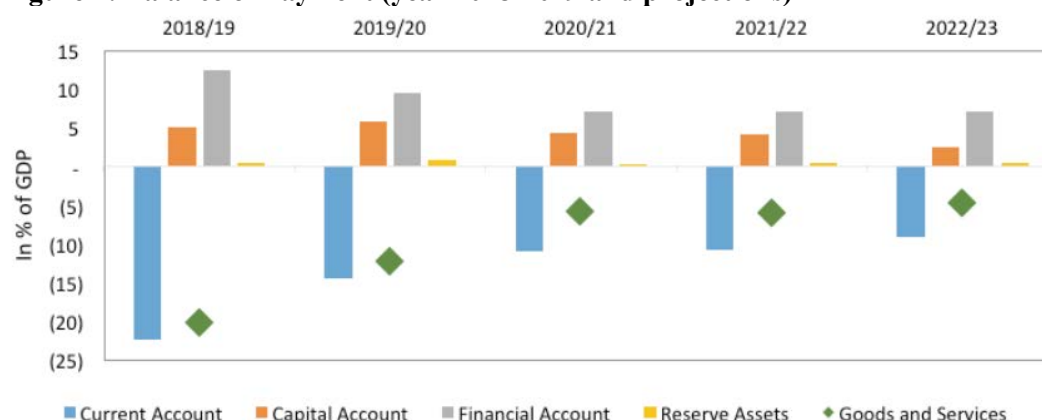
Sl. No	Power Station	Year of Construction (Completed)	Capacity (Megawatt)
1	Chukha Hydro Power Station	1986	336
2	Kurichchu Hydro Power Station	2001	60
3	Basochhu Hydro Power Station	2002	24
4	Basochhu Hydro Power Station	2004	40
5	Tala Hydro Power Station	2006	1020
6	Mangdechu Hydro power station	2019	720
7	Total		2200

Source: Druk Green Power Corporation of Bhutan (list number 6 is the latest energy plant, which is not updated in the source).

Bhutan is still in the initial stages of developing its hydropower potential, with around 2,200 megawatt(s) (MW) of installed capacity, constituting 9.2% of the total techno-economically exploitable potential of 23,760 MW. Existing hydro-projects have been developed with foreign aid, primarily from India (Four projects) and Austria (Two projects).

Further, imports of goods and services are also expected to fall and as a result, the goods and services balance as a % of GDP is estimated to improve from a deficit of 20.4% in financial year 2018-19 to a deficit of 12.4% in financial year 2019-20. This is further projected to narrow down to a deficit of 6% in financial year 2020-21. As Bhutan's current account balance (CAB) is largely driven by goods and services balance, the improvement in goods and services balance is expected to improve the current account balance from -22.5 % of GDP in financial year 2018-19 to -14.4 % of GDP in FY 2019-20. The balance is projected to further improve to -11.0 % of GDP in FY 2020-21 and -10.8 % of GDP in FY 2021-22. Financial inflows in the form of hydro-power loans and capital inflows of budgetary and hydro-power grants are estimated to remain positive and sufficient to finance the current account deficit. The overall balance of payment is estimated to remain positive, resulting in a marginal accumulation of reserves during FY 2019-20 to FY 2022-23 as shown in figure below.

Figure 2: Balance of Payment (year 2018-2019 and projections)



Source: National Budget Report 2017-18, Ministry of Finance.

e) Changes in government finances (i.e. the size of the fiscal deficit or surplus)

Pre-Covid scenario (FY 2017-2018, 2019-2020)

In Financial year⁹ 2017-18, the actual outlay was Nu.52,658.670 million against the resources of Nu.52,113.168 million resulting in fiscal deficit of Nu.545.502 million and the resource gap of Nu.647.252 million. The fiscal deficit was 0.3% of Gross Domestic Product (GDP), which is less than the original fiscal deficit projection by 2.2% points of GDP and less than revised budget by 1.86% points. The original total expenditure for FY 2017-18 was Nu.57,915.710 million with resources of

⁹ Financial year in Bhutan starts from July and ends in June of succeeding year.

Nu.51,402.893 million. The expenditure was revised to Nu. 62,643.611 million and the resources was revised to Nu.56,772.785 million. The positive actual outcome of FY 2017-18 was achieved through increased mobilization of resources and rationalized spending.

During the FY, the actual external borrowing was about 10 % higher than the original estimates and 16 % less than the revised estimates, while the actual repayment of debt remained same as the estimates. With repayment of Nu.2,802.356 million and borrowing of Nu. 2,718.332 million, the net borrowings during the FY was negative, implying that there was more external repayment than borrowings. The positive outcome of the fiscal balance reduced the resource gap, which was significantly lower than the original estimates. The actual resource gap was 87% less than the original estimates and less by 81% compared to revised estimates. The resource gap of Nu.647.525 million was financed through the issuance of Treasury Bills (T-Bills). The principal amount of T-Bills outstanding at the end of the FY was Nu.7,967.066 million. The Government fund position at the close of the FY stood at negative Nu. 39.776 million.

Table 2: Fiscal Performance for the FY 2017-18

Fiscal Performance for the FY 2017-18							
Sl.No	Particulars	Nu in Million			% in Variance		
		Original Budget	Revised Budget	Actual Outcomes	Original vs Revised	Revised vs Actual	Original vs Actual
A	RESOURCES	51,402.89	56,772.79	52,113.17	10.4%	-8.2%	1.4%
1	Domestic Revenue	34,700.36	36,178.37	36,871.37	4.3%	1.9%	6.3%
2	Other Receipts (Net)		1,055.27	394.73		-62.6%	
3	Grants	16,702.54	19,539.14	14,847.07	18.9%	-26.3%	-12.4%
B	OUTLAY	55,850.26	60,549.83	52,658.67	8.4%	-13.0%	-5.7%
1	Total Expenditure	57,915.71	62,643.61	56,331.36	8.2%	-10.1%	-2.7%
2	Net Lending	(2,065.45)	(2,093.78)	(2,077.88)	1.4%	-0.8%	0.6%
3	Advance/ Suspense (Net)			(1,594.81)			
C	FISCAL BALANCE	(4,447.37)	(3,777.05)	(545.50)	15.1%	4.8%	-87.7%
D	FINANCING	4,447.37	3,777.05	545.50	-15.1%	-85.6%	-87.7%
1	Net Borrowing	(348.24)	404.10	(102.02)	-216.0%	-125.2%	-70.7%
2	Resources (Gap)/Surplus	(4,795.61)	(3,372.95)	(647.53)	-29.7%	-80.8%	-86.5%

Sources: National Budget Report 2017-2018, Ministry of Finance of Bhutan.

For FY 2018-2019 the approved total appropriation was Nu.47,698.129 million with a fiscal deficit of Nu.5,234.324 million which is 2.69% of GDP. During the year, the total appropriation has been revised to Nu.49,325.539 million, which is about 3.4% increase from the approved total appropriation. The increase in the appropriation is mainly on account of increased total expenditure due to incorporation of donor-funded projects. The total expenditure has been revised from Nu.45,128.177 million to Nu.46,724.585 million. The increase in donor funded activities has also increased resources from Nu.39,893.853 million to Nu.42,949.113 million.

The increase in resources is mainly on account of increase in grants and tax revenue. With these revisions, the fiscal deficit is expected to improve from Nu.5,234.324 million to Nu.3,775.472 million, which is about 2% of GDP. The improved fiscal deficit will reduce pressure on the financing requirement thereby reducing net borrowings. While the net external borrowing is estimated to increase from Nu.961.245 million to Nu.986.304 million, the net domestic borrowing is estimated to reduce significantly from Nu.2,839.917 million to Nu.1,399.490 million. The net lending has reduced mainly because of incorporation of on- lending of Rural Renewable Energy Development Project for Nu.31.002 million while the recoveries reduced slightly.

Table 3: Budget Summary for FY 2018-2019

Revised Budget summary for FY 2018-19 as of 31st March 2019				
Sl.No	Particulars	approved Budget (June 2018)	Approved Budget Estimate (Jan 2019)	Revised (31st March, 2019)
A	RESOURCES	38,600.39	39,893.85	42,949.11
1	Domestic Revenue	35,855.00	33,943.97	34,321.82
2	Other Receipts (Net)	10	20	40.99
3	Grants	2,411.95	5,606.44	8,262.86
4	Internal Grants	323.445	323.445	323.445
B	Total Expenditure	34,461.33	45,128.18	46,724.59
C	FISCAL BALANCE	4,139.06	-5,234.32	-3,775.47
D	FINANCING	-4,139.06	5,234.32	3,775.47
1	Net Lending	1,554.41	1,433.16	1,389.68
2	Net External Borrowings	-1,210.84	961.245	986.304
3	Net Domestic Borrowings	-4,482.64	2,839.92	1,399.49
	Fiscal Balance as a % of GDP	2.00%	-2.69%	-1.96%

Source: National Budget Report 2018-19, Ministry of Finance of Bhutan.

f) Volatility of short-term policy interest rates and long-term interest rates such as the yield on government bonds

Interest rate in Bhutan has evolved with major policy reforms to promote competition and flexibility. Originally, the Royal Monetary Authority¹⁰ (RMA) administered interest rates in Bhutan. However, with deregulation and liberalization in the 1990s, in both advanced and emerging market economies, the RMA also liberalized interest rates to be determined by market forces of demand for and supply of funds.

With the rigidity and high spreads of interest between deposits and lending, the RMA started issuing policy guidelines, however, leaving the actual interest rate to be determined by market forces of demand for and supply of funds. Thus, the Base Rate System was introduced in 2012, specifically to promote transparency in pricing of loans. However, the application of the base rate system revealed structural problems and poor transparency during the review study. To address the shortcomings and to have a more forward-looking interest rate policy mechanism entailing greater competition, transparency and professionalism amongst the lending institutions, the Minimum Lending Rate (MLR) was introduced in 2016.

Taking into account the marginal cost of funds, the negative carry charges on the cash reserve ratio (CRR) and the operating costs, the RMA computes a single common MLR by averaging the MLR of individual banks. On the common MLR, the financial institutions derive their product-specific final lending rates by adding components such as credit risk, tenor premium and the bank's business strategy cost to the MLR. The RMA reviews the MLR on a semi-annual basis and monitors its implementation based on the financial institution's financial accounts. Financial institutions cannot lend below the MLR except for selected sectors such as priority sector loans identified by RMA from time-to-time, advances to depositors against their own deposits, loans for liquidity management of less than 90 days maturity and strategic consortium loans approved by the Royal Government of Bhutan.

While Bhutan's financial sector is not immune to global developments it is mostly driven by domestic factors. Saving rates for banks ranged from 5.0-5.8% as of June 2019, while the interest rate on term deposit varied depending on the maturity and amount of the deposits. Overall interest rate deposits remained unchanged from that of 2018.

On the lending front, lending rates across sectors have declined in the range of 15-250 basis points (bps). The largest decline was observed in the manufacturing industry sector from 10% in 2018 to 8.0% in 2019. The decline in lending rates was also attributed to the fall in the minimum lending rate by 0.3% points in June 2019 from 7.0% in December 2018.

g) Stability of the exchange rate in currency markets

The exchange rate is considered a key financial variable affecting the decision of investors, policy makers and businesses. Exchange rate fluctuations affect the value of international investment portfolios, trade competitiveness, international reserve position, value of debt payments and cost to tourists in terms

¹⁰ Royal Monetary Authority is a Central Bank of Bhutan.

of value of their currency. It is therefore imperative to closely watch the movement of exchange rates and understand their potential implications on the economy's business cycle, trade and capital flows.

It is almost 50 years since the Ngultrum was pegged at par with Indian Rupee (INR) in 1974, around the same period when floating exchange rate became increasingly the preferred regime in most western economies. Given the close economic and financial integration with India, the current conventional peg exchange rate arrangement has served the economic interest of Bhutan, mainly by reducing trade uncertainties, anchoring prices, promoting investments and tourism. Not only does it serve as the nominal anchor of monetary policy and eliminates exchange rate risks, the free convertibility of India Rupee to Bhutanese Ngultrum has also helped reduce transaction costs for individuals and businesses.

More importantly, the peg has enabled Bhutan to benefit from the low inflation conditions in India, which has also helped to maintain lower inflationary expectations, making it conducive for overall macroeconomic stability. Studies have shown that Bhutan's economic characteristic support the optimum currency criteria, meaning that the existing pegged regime is optimal for Bhutan under the current economic conditions. However, the key impediment of the existing peg regime is that the RMA as the Central Bank, has limited monetary autonomy as it needs to closely follow the monetary policy of the Reserve Bank of India to support the peg.

In terms of nominal exchange rate on FY basis, Ngultrum depreciated by 8.4% from Nu 65.09 against the US dollar(USD) in FY 2017/18 to Nu 70.58 in FY 2018/19. On month-month comparison, the Ngultrum depreciated by 2.4% from Nu 67.79 against the USD in June 2018 to Nu 69.44 in June 2019.

Historical trend of nominal exchange rate of Ngultrum (Nu) against USD since 2010 shows that Nu has been depreciating. It has depreciated from Nu 45.93 per USD in the beginning of 2010 to around Nu 70.43 in the third quarter of 2019, replicating movement of INR against USD. India has experienced several currency volatilities, with INR hitting all-time high in 2018, especially in the third quarter at INR 72.07 per USD on average, making it one of the Asia's worst performing currency. Although INR appreciated to 70.48 and 69.55 in first and second quarter of 2019 respectively, it fell back to 70.43 in third quarter. This currency volatility has been largely attributed to rising trade protectionism and slowing global trade and output. Besides direct impact of exchange rate fluctuation on Bhutan's debt outstanding, investment and fiscal flows, there is pass-through effect of inflationary pressure on the domestic economy. According to the RBI, an appreciation of the INR by 5% could moderate Indian inflation by around 20 bps and GDP growth by around 15 bps.

II.1.1 International Environment

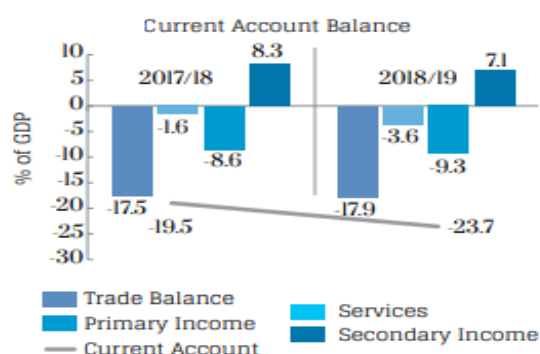
The external sector is the portion of a country's economy that interacts with the economies of other countries. In the goods market, the external sector involves exports and imports. In the financial market, it involves capital flows.

II.1.2 External Sector:

The Bhutan's external imbalance continues to reflect weak underlying economic fundamentals of high dependency on imports (including a large expatriate labor force), grant-aid driven investment and persistent high stock of external debt.

The *current account* deficit expanded in Financial Year (FY) 2018/19 to 23.7% of GDP from 19.5% in FY 2017/18. The main contributor to such widening deficit was increased trade imbalance, net service payments, followed by decline in net primary and secondary income receipts.

Figure 3: Current Account Balance

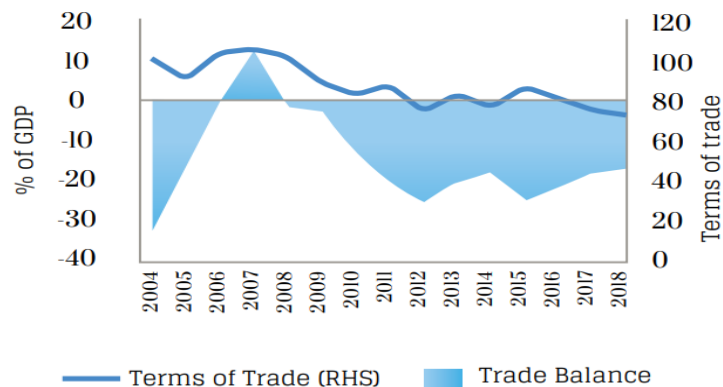


Source: Annual Report of Royal Monetary Authority of Bhutan, 2019.

On the *trade account*, trade deficit increased by 6.9% mainly due to decline in merchandise exports by 2.7% and increase in imports by 1.3% in FY 2018/19. The primary income account declined with an increase in interest payments on foreign however; there was a slight increase in interest receipts. Similarly, the secondary income account declined with an increase in other current transfers outflow and a slight fall in inflow.

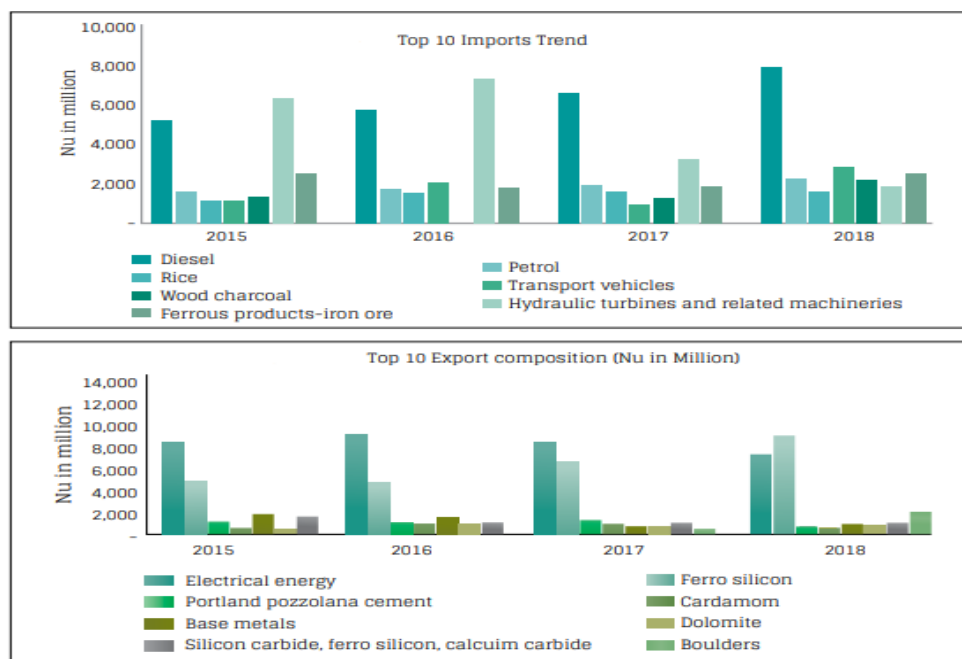
Overall, the trade balance recorded a deficit of Nu 29.88 billion in FY 2018/19 as compared to deficit of Nu 27.96 billion in FY 2017/18. This was attributed to higher import, recording at Nu 68.05 billion against merchandise exports of Nu 38.17 billion. On a bilateral basis, notable record is an increase in trade deficit with India, even Bhutan's trade deficit with Countries Other Than India (COTI) improved significantly during the review period.

Figure 4: Trade Balance



Sources: Annual Report of Royal Monetary Authority of Bhutan, 2019

Figure 5: Import and Export Commodities (Top 10 list)



Sources: Annual Report of Royal Monetary of Bhutan, 2019.

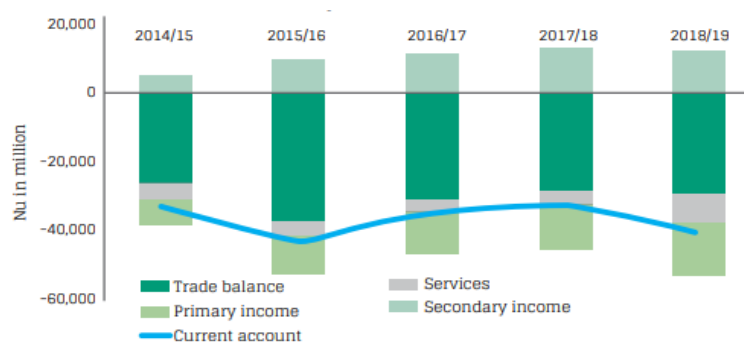
II.1.3 Services Accounts

In the services account, the net payments recorded an increase from Nu 2.59 billion to Nu 6.05 billion. Therefore, the services account deficit surged significantly due to substantial fall in export of services by 27.5%, though 0.3% rise in imports was recorded during the review period. This expansion mainly came from an increase in net payment of transport and fall in receipts from net travel services. On the receipts side, total services receipt was recorded at Nu 8.90 billion during 2018/19 as against Nu 12.26 billion in the previous year. Travel receipts, which accounted for 62.9% of total services receipt, declined by 22.3% due to lower business and personal travel receipts during the review period. Receipts from transport services also decreased to 42%, largely attributed to fall in airport services to foreign travelers. On the other hand, total payments on services was recorded at Nu 14.90 billion during the review period. This total payment was higher by 0.3% from the previous year, which was triggered by an increase in payments for financial, telecommunication, computer and information, other technical and trade related, and diplomatic bodies spending on goods and services abroad. The acceleration in this expenditure was also because of increase in reinsurance related services, from Nu 135.84 million in FY 2017/18 to Nu 252.63 million in FY 2018/19.

II.1.4 Primary Income Account:

The primary income account was dominated by outflows related to interest payments (79.1% of all outflows), particularly on hydro related debt, which increased by 6.6% during FY 2018/19. Hence, primary income deficit widened by 12.9% to Nu 15.58 billion from the previous year. This increase can be attributed to increase in net compensation outflows by 34.3%, amounting to Nu 922.94 million. Another driver was increase in net payments of investment income arising from direct investment outflows relating to repatriation of dividend and re-invested earnings from the FDI companies.

Figure 6: Components of Current Account Balance (Primary Balance)



Source: Annual Report of Royal Monetary Authority of Bhutan, 2019.

II.2.5 Secondary Income Account:

Net receipts in the secondary income account decreased by 10.3% in FY 2018/19, due to increase in net other current transfer outflows amounting to Nu 170.3 million, while inward budgetary and worker remittances recorded a marginal increase.

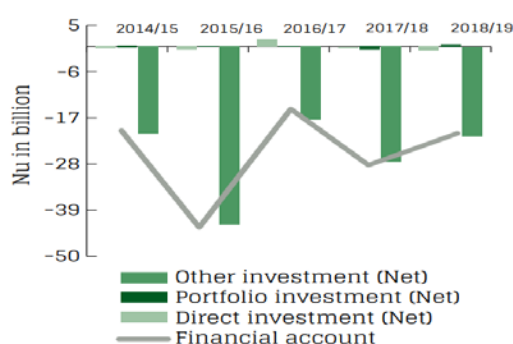
II.2.6 Capital Account:

Similarly, the capital account also contracted by 26.2%, amounting to Nu 8,769.14 million in FY 2018/19 as against Nu 11,884.03 million in FY 2017/18, particularly because of reduction in budgetary grants inflow for investments.

II.2.6 Financial Account:

The financial account continued to register net inflows of Nu 21.88 billion, which is a decline of 23.2% from FY 2017/18. However, on the foreign equity front, the inflows increased by 79.8% from the previous year.

Figure 7: Financial Account



Source: Annual Report of Royal Monetary Authority of Bhutan, 2019.

II.2.7 Direct Investment Account:

Net inflows (FDI inflows position) related to direct investment during FY 2018/19 increased to Nu 920.65 million from Nu 274.03 million in the previous year. This was mainly due to foreign equity inflows amounting to Nu 754.35 million from Nu 419.66 million in FY 2017/18. Of the total equity inflows, Nu 38.99 million was from India, and Nu 715.38 million was from COTI (Countries other than India). The capital infusion during the year was channeled to hospitality, financial, manufacturing and agriculture sectors. These were sourced mostly from Thailand, British Virgin Island, India, Canada,

France and Hong Kong. Net inter-company debt totaled Nu 29.19 million, entirely availed from COTI. It is anticipated that the revised FDI policy 2019 will encourage more inward investment including investment in the Cottage & Small Industries. The revision of FDI policy was initiated to further promote FDI with the aim of building a resilient, more diversified and sustainable economy.

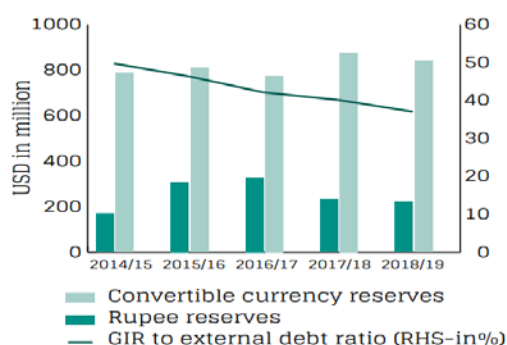
II.2.8 Other Investment Account;

The other investment account recorded a net outflow of Nu 21.33 billion in FY 2018/19 as compared to Nu 27.45 billion in the previous year. This development was because of increase in net acquisition of financial assets, amounting to Nu 1.72 billion and decrease in net incurrence of liabilities by Nu 5.48 billion.

II.2.9 Portfolio Investment Account:

Net portfolio investment revived to Nu 366.27 million in FY 2018/19, mainly because of increase in net acquisition of financial assets. As the current account deficit was larger than the inflows in the capital and financial account, the gross international reserves depleted to Nu 73.38 billion (USD 1,064.77 million) in June 2019 from Nu 76.21 billion (USD 1.11 billion) in the same month of the previous year. Nonetheless, the reserves continued to remain adequate to cover 12.9 months of merchandise imports and 22 months of essential imports, thereby meeting the constitutional requirement of minimum 12 months of essential import coverage. The ratio of international reserves to external debt stood at 38.3%. After accounting for other financial flows and net errors and omission, Bhutan's overall balance (change in reserve assets) stood at Nu 621.94 million.

Figure 8: Gross International Reserve (GIR)



Source: Annual Report of Royal Monetary Authority of Bhutan, 2019.

II.2.10 External Debt and Balance of Payment:

Total outstanding external debt was recorded at USD 2.73 billion in FY 2018/19, higher by 3.3% from USD 2.64 billion in FY 2017/18, mainly contributed by increase in hydropower loan and convertible currency loans from multilateral institutions. Of the total outstanding external debt, rupee debt constituted 73.6% (INR 138, 409.37 million) and the remaining 26.4% (USD 720.12 million) in the convertible currencies. Within the rupee debt, about 89.9% comprises self-liquidating hydropower debt and the remaining 10.1% were incurred to meet balance of payments deficit with India. From the total convertible currency debt, the concessional public debt constitutes 95.1%.

As of June 2019, the volume of total external financial assets amounted to USD 1.23 billion, an increase by 6.8% from the previous year. Majority of assets (USD 1.08 billion) represents the reserve assets followed by trade credit, and currency and deposits amounting to USD 84.10 million and USD 66.61 million respectively. Total external financial liabilities increased by 13.4% to USD 4,082.09 million as of June 2019. The increase in financial liabilities is mainly driven by loans, comprising 86.9% of total financial liabilities. The external loan increased to USD 3,545.29 million from USD 3,321.85 million of the previous year.

Table 4: Percentage of Total Debt

Items	Rupee/Ngultrum Million					USD Million				
	2014/15	2015/16	2016/17	2017/18	2018/19	2014/15	2015/16	2016/17	2017/18	2018/19
1. Convertible Currency Debt	37055.0	41178.5	42759.0	47990.2	49629.3	581.2	609.0	663.2	699.8	720.1
Public	37010.2	40502.3	40824.9	45932.9	47643.5	580.5	599.0	633.2	669.8	691.3
World Bank	10542.5	12507.2	13475.7	17058.7	18936.3	165.4	185.0	209.0	248.8	274.8
IFAD	2304.6	2442.7	2276.0	2491.4	2464.5	36.1	36.1	35.3	36.3	35.8
ADB	16523.2	17115.1	17700.5	18997.0	19869.2	259.2	253.1	274.5	277.0	288.3
Govt of Austria	5163.4	4918.1	4315.5	4139.7	3497.2	81.0	72.7	66.9	60.4	50.7
Govt. of Denmark	139.2	48.8	0.0	0.0	0.0	2.2	0.7	0.0	0.0	0.0
JICA	2337.3	2997.5	2593.7	2742.6	2876.3	36.7	44.3	40.2	40.0	41.7
Private	44.8	676.2	1934.1	2057.3	1985.8	0.7	10.0	30.0	30.0	28.8
2. Rupee Debt	81183.6	115393.8	118770.1	133190.7	138409.4	1273.4	1706.6	1842.2	1942.3	2008.3
Hydropower debt	73196.3	101677.0	111770.1	119452.8	124432.8	1148.1	1503.7	1733.6	1741.9	1805.5
Chukha	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Kurichhu	186.7	0.0	0.0	0.0	0.0	2.9	0.0	0.0	0.0	0.0
Tala	4699.1	3356.5	2013.9	671.3	0.0	73.7	49.6	31.2	9.8	0.0
Punatsangchhu-I	31423.7	42543.7	44543.7	46043.7	46673.7	492.9	629.2	690.9	671.4	677.2
Punatsangchhu-II	20984.3	27487.5	35982.2	39182.2	41804.5	329.1	406.5	558.1	571.4	606.6
Mangdechhu	15902.5	28289.3	29230.3	32706.6	34397.0	249.4	418.4	453.4	476.9	499.1
Nikachhu Project(SBI)				849.1	1557.6				12.4	22.6
Other										0.0
GOI Line of Credit	7000.0	7000.0	7000.0	7000.0	7000.0	109.8	103.5	108.6	102.1	101.6
RBI Swap	0.0	6716.8	0.0	6737.9	6976.6	0.0	99.3	0.0	98.3	101.2
Total (CC + Rupee)	118238.7	156572.3	161529.1	181180.9	188038.7	1854.6	2315.6	2505.4	2642.1	2728.4
Convertible Currency Debt As a % of Total Debt										
Rupee Debt As a % of Total Debt	68.7	73.7	73.5	73.5	73.6	31.3	26.3	26.5	26.5	26.4
Total Loans in % of GDP	101.6	121.8	111.3	113.5	114.2					
Nominal GDP(Calendar Year)	116388.6	128534.6	145072.9	159571.7	167326.8					
Exchange Rate Ngultrum/USD exchange rate	63.8	67.6	64.5	68.6	68.9					

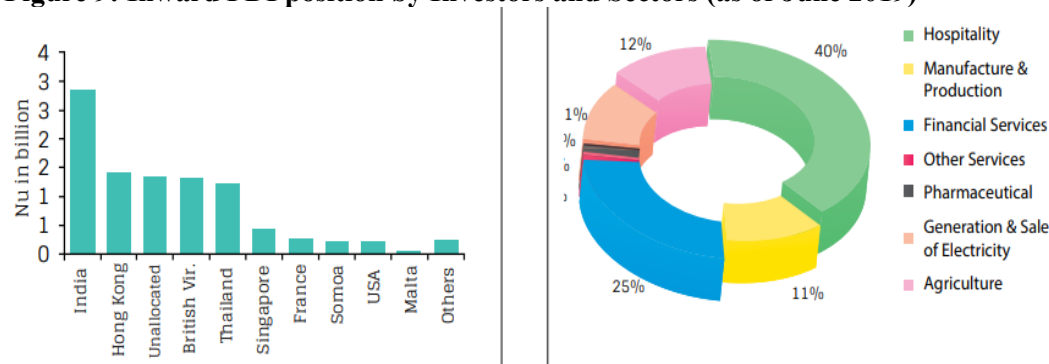
Note: Debt data published by the RMA include the total external debt of the country (public + private) and are therefore not comparable to data published by the Ministry of Finance which covers only public debt. Furthermore, the RMA uses calendar year GDP figures for all ratios to the GDP. Hydropower debt excludes accrued interest.

Source: Department of Public Accounts, Royal Monetary Authority of Bhutan & private sector enterprises.

Source: Annual report of Royal Monetary Authority of Bhutan, 2019.

II.2.11 Foreign Direct Investment (FDI):

Besides external borrowing, inward FDIs are also increasingly becoming an important financing source to fill up fiscal gap and bridge saving-investment gap in the Bhutan's economy. For FDIs to flow in, foreign exchange rate risk is considered as one of the critical factors in their investment decision. However, there are conflicting studies with regard to the direction of relationship between FDI and exchange rate. In the case of Bhutan, the relationship follows mainly from exchange rate to FDI as it is more likely to attract foreign investors to invest when Ngultrum depreciates relative to their currency. Foreign equity inflow as of June 2019 stood at Nu 9,968 million, an increase of about 8 % from December 2018. India continues to be the single largest investor, constituting around 29 % of the equity inflows, followed by Hong Kong. Apart from India, remaining investors are affected by exchange rate fluctuations. Most importantly, the hospitality sector, being the largest sector attracting third country investors, is the most vulnerable sector as far as exchange rate fluctuation is concerned.

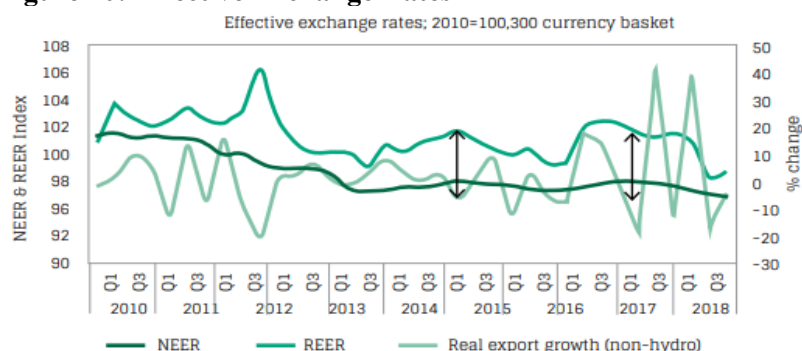
Figure 9: Inward FDI position by Investors and Sectors (as of June 2019)

Source: National Statistical Bureau of Bhutan

II.2.12 Nominal and Real Exchange rates:

The *Nominal Effective Exchange Rate* (NEER) and the *Real Effective Exchange Rate* (REER) are considered as key indicators to measure a country's international competitiveness. The NEER is the weighted average of bilateral nominal exchange rates of the home currency in terms of foreign currencies, weighted according to its trade share with each country. An increase in NEER indicates an appreciation of the local currency against the weighted basket of currencies of its trading partners. On the other hand, REER is the weighted average of NEER adjusted by the ratio of domestic price to foreign prices. It captures inflation differentials between Bhutan and its major trading partners and reflects the degree of external competitiveness of Bhutanese products. Ceteris Paribus, an increase in REER means that domestic goods are becoming more expensive relative to its trading partners implying loss in trade competitiveness.

Figure 10: Effective Exchange Rates



Source: Annual Report of Royal Monetary Authority of Bhutan, 2019.

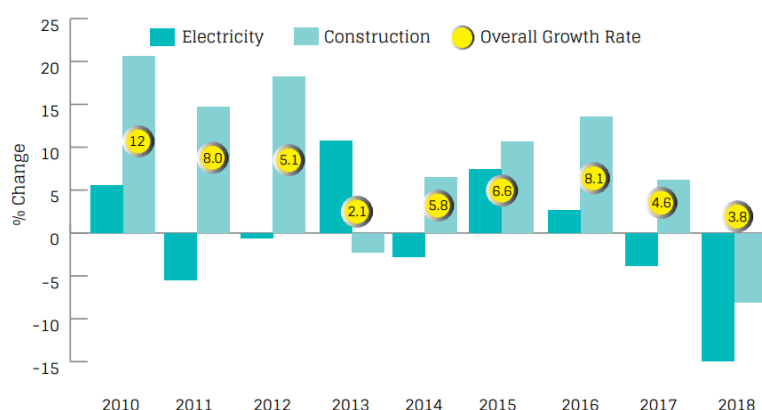
Quarterly movement of NEER and REER for Bhutan since 2010 is presented in above. While both NEER and REER have steadily depreciated over the years, the REER has been more volatile on account of changes in relative prices. The REER has depreciated by 1.9% (year-on-year) in the first quarter of 2019, more than NEER which depreciated by 0.71% and remained constant in the following quarter. As illustrated in the chart, opposite movement of REER against real export growth shows that export picked up with decrease in REER. Given India's dominant share of trade (above 80%), fluctuation in NEER and REER is heavily influenced by exchange rate movement of INR and price changes in India.

II.1.2 Domestic Environment:

i. Real Sector

Successive decline in hydro-electricity production and public investment slowed growth to 3% in 2018 from 4.7% in 2017. Growth has dipped to its lowest level since 2014. Due to lower hydrological flows in 2018, the Gross Value Added (GVA) of the electricity sector dropped by 14.9% from 2017. Given that existing hydropower plants are run-of river, the drop in hydrological flows adversely affect generation. During the period, the combined effect of Chhukha and Tala power plants constituted about 85% of the decline in generation. At the same time, construction activities decreased by 8% due to slash in government capital budget allocation in the interim budget of FY 2018/19, falling by more than two thirds, followed by slowing hydropower construction activities. These are the main contributing factors for slippage in growth trajectory by almost 2% points in 2018.

Figure 11: GDP Growth Trend

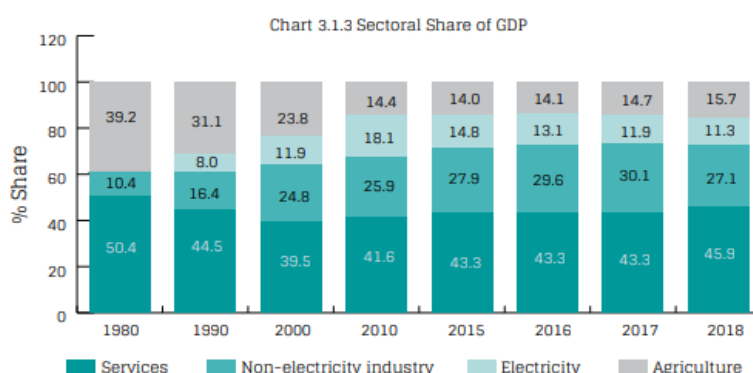


Source: Annual Report of Royal Monetary Authority of Bhutan, 2019.

Driven by growth in tourism and increased domestic credit financing, trade and restaurant (10.2%), transport and communication (10.9%), and financial activities (11.7%) consequently expanded in 2018. There has been a simultaneous expansion in mining and quarrying, induced by growth in housing construction activities, especially residential construction activities in urban areas. The growth in agriculture sector rebounded through targeted policy interventions undertaken in the recent years, contributing an average growth of 4.4 % compared to 2.9% in 2017. On the other hand, the manufacturing sector growth slowed down significantly to 3.7% compared to 6.5% in 2017, largely because of lower domestic demand and weakening external demand for domestic products. This was in particular predisposed to high concentration of exports in few selected manufacturing goods, which are dependent on selected markets.

In terms of broad sectoral development, service sector (tertiary) continues to dominate the GDP. In nominal terms, the service sector constituted about 45.9 %, followed by industry sector (non-electricity industry sector and electricity) with 38.4 % and remaining by the agriculture sector at 15.7 %. The fall in industry sector is attributed to low level of electricity production, uncompetitive manufacturing sector and lack of new construction of hydropower projects. As a result, the dominance of service sector has been consistently increasing since 2014 without a significant change in the structure of the economy in the recent years.

Figure 12: Sectoral Share of GDP



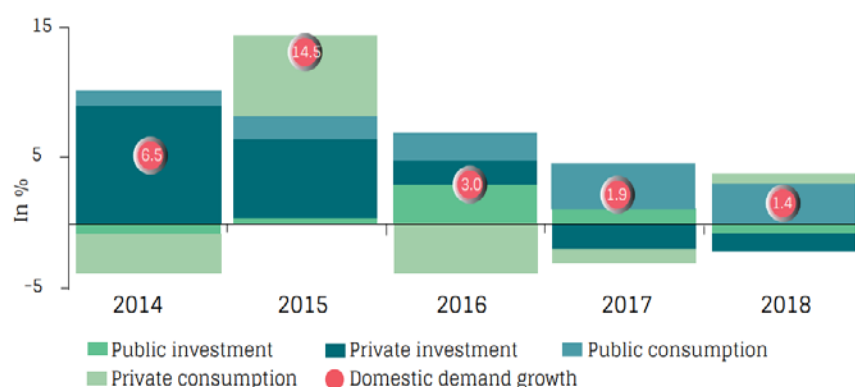
Source: Annual Report of Royal Monetary Authority of Bhutan, 2019.

On the expenditure front, expenditure on goods and services was dominated by consumption demand with increased government consumption growth by 8.1% and a rebound in private consumption at 3.2%, from a negative 4.5% in 2017, domestic expenditure growth sustained at 3% in 2018. On the other hand, investment level fell consecutively with an average of 2.1% and 5.6% in 2017 and 2018 respectively. A slash in government capital expenditure and slowdown in hydropower investment resulted in a 5.6% drop in overall investment expenditure in 2018. During the interim period, between the transition from the 11th FYP to the 12th FYP, capital budget was limited to spillover projects. As such, government

investment decreased by 9.7% in real terms. At the same time, the near completion of ongoing hydropower projects and slower kick start of pipeline projects resulted in a 4.3% drop in private investment. Despite uptick in non-hydro goods (Ferro silicon) exports and simultaneous drop in hydro-related imports, the trade deficit slightly improved.

Receding investment and saving rate have weakened domestic demand and income growth. Domestic demand is largely supported by consumption growth through increasing government operation expenditures. During the period, fall in both hydropower investment and government capital expenditure had a double effect on output growth. The deterioration in domestic savings and slowing investment rate in the recent past have also contributed in weakening economic growth. Due to subsequent fall in investment rate in 2018 to 46.5% (54.2% in 2016) and domestic saving rate to 26.7% (30.9% in 2016) the growth trajectory has fallen to 3% (8.1% in 2016). Against this backdrop, slowing economic growth affected income prospects. Income level, as measured by the per capita gross domestic income (GDI), increased to Nu 207,334 in 2018 from Nu 198,099 in 2017, equivalent to a 4.6% growth in nominal terms and only 2.7% increase in real value. However, in terms of US dollar, with depreciation of domestic currency, the per capita GDP fell to USD 3,031 in 2018 from USD 3,043 in 2017. As a result, weak income growth was not able to boost real domestic demand in the economy.

Figure 13: Domestic Demand Growth and Contribution



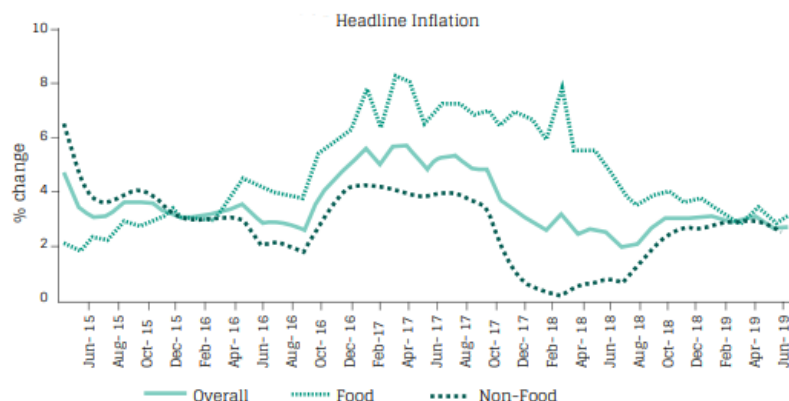
Source: Annual Report of Royal Monetary Authority of Bhutan, 2019.

ii. Inflation:

With slowing food price pressure, headline inflation remained at a lower level of 2.7 % in June 2019. The annual headline inflation rose moderately to 2.7 % in June 2019 from 2.6 % in June 2018 due to favourable supply, especially in the agriculture sector, and moderate increase in consumer demand. The enhancement in agriculture production on the supply front and moderate consumption growth resulted in lower inflation of food prices, from 5.1 % in June 2018 to 3.1 % in June 2019. However, non-food inflation, which comprises about 60 % of the total consumer basket, elevated to 2.6 % in June 2019 (0.9 % in June 2018).

With slowing inflationary pressure in the region, particularly in India, the imported inflation comprising about 52 % of total consumer basket, experienced lower inflationary pressure compared to domestic inflation. Therefore, the relative contribution of imported inflation to headline inflation slowed down to 40 % in June 2019 compared to 72 % of the previous review period.

Figure 14: Inflation



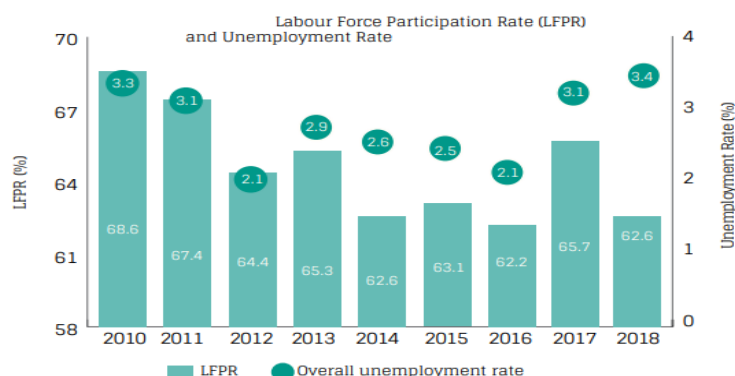
Source: National Statistical Bureau of Bhutan

iii. Employment and Labor Market:

Based on Population and Housing Census of Bhutan 2017, the estimated population for 2018 is 734,374, about 1% growth from 2017. The male population constitutes about 52.2%, equivalent to sex ratio of 110. The working-age population, 15 years and above, is 496,550, which constitutes about 68% of total population. On an average, for every ten persons, there are seven potential workers, reflecting higher level of economic support ratio. In 2018, a total of 185,694 potential workers remained out of the labour force, largely students (43%), attending family duties (28%) and old age (15%). In terms of age, youth population in the age group 15-24 years comprises 48% of total inactive population followed by old age population above 65 years (18%).

During the period, labor force participation rate (LFPR)- labor force to working-age population decreased to 62.6 % compared to 65.7 % in 2017, with increase in number of potential workers attending family duties³. Compared to female LFPR (55.5%), male LFPR is higher at 70.1 % whereby 18 % of potential female workers are engaged in household works compared to 2 % of male. Although LFPR in urban areas is higher than rural areas, there is higher gender disparity; only 45.1 % of potential female workers are in labor force compared to 60.1 % in rural areas. Unlike in urban areas, rural female labor force is easily absorbed in the agriculture sector.

Figure 15: Labor Force Participation Rate (LFPR) and Unemployment Rate



Source: Ministry of Labor and Human Resource of Bhutan

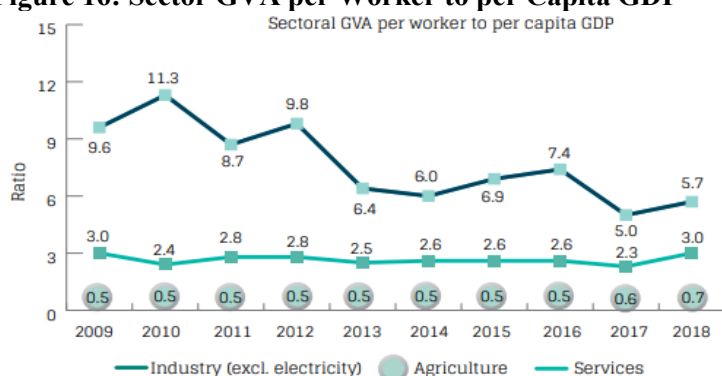
Agriculture is still a principal economic activity in rural areas generating more than half the total workforce. However, with gradual economic transformation from agriculture to industry to service sector, employment in agriculture has been steadily declining from 59.6% in 2010 to 54% in 2018. About 75% of rural employment is in the agriculture sector, largely composed of female workers. More than 80% of female employment in rural areas are in the agriculture sector compared to 6.6% in urban areas. The labor productivity in agriculture sector is also comparatively lower than industry and service sectors. Driven by the electricity sector, which is capital intensive in nature, labor productivity in the industry sector is higher than the agriculture sector. Overall, employees work 53 hours per week at

national level whereas workers in agriculture, industry and services sector work 54 hours, 51 hours and 53 hours respectively.

This, in general is higher than the international standard of maximum of 40 hours per week. As measured by the sectoral output to hours worked, labor productivity in industry and service sectors are 17 and 9 times higher than the agriculture sector. Average income earned by a worker in agriculture sector amounts to Nu 63 per hour compared to Nu 1,060 per hour in industry sector and Nu 560 per hour in service sector. This shows high income disparity amongst the workers across sectors. In fact, majority of poverty-stricken population are also found in the rural areas who are largely dependent on the agriculture sector. The agriculture productivity gap indicates misallocation of labour in the economy. The gap in the agricultural sector has been an improving trend with the gradual economic transformation from agriculture to industry and service sectors. However, it is still high at 6.3 in 2018, indicating high degree of labor misallocation in the market. In such a situation, reallocating labor from the agriculture sector to more productive sectors will enhance economic output without requiring additional production inputs.

In addition, the relative income of employees by sector (measured in terms of sectoral GVA per employee vis-à-vis per capita GDP) shows GVA per capita in agriculture sector is less than per capita GDP. On the other hand, GVA per capita for industry and service sectors are much higher than per capita GDP. Although, the ratio of agriculture GVA per worker to per capita GDP has been narrowing, it is still half of the per capita GDP while GVA (Gross Value Added) per worker in service sector is about 3 times higher than the per capita GDP and 8 times higher for industry sector workers (excluding electricity). Further, estimated underemployment rate has increased from 2.8 % in 2010 to 6.1 % in 2018. It is highly prevalent in rural sector, comprising 87.8 % of total underemployment in 2018 (18,200). The main reason for increase in underemployment over the years is financial needs, as earning from the given employment is inadequate to meet economic needs. During the period, GVA per capita of agriculture worker increased by 230 % (Nu 4,400 per month in 2010 to Nu 13,450 per month in 2018) whereas general price level increased by 237 %. Therefore, enhancing productivity in the agriculture sector is of paramount importance to improve income levels in rural areas for poverty reduction and narrowing income inequality.

Figure 16: Sector GVA per Worker to per Capita GDP



Source: Annual Bulletin of Ministry of economic affairs of Bhutan.

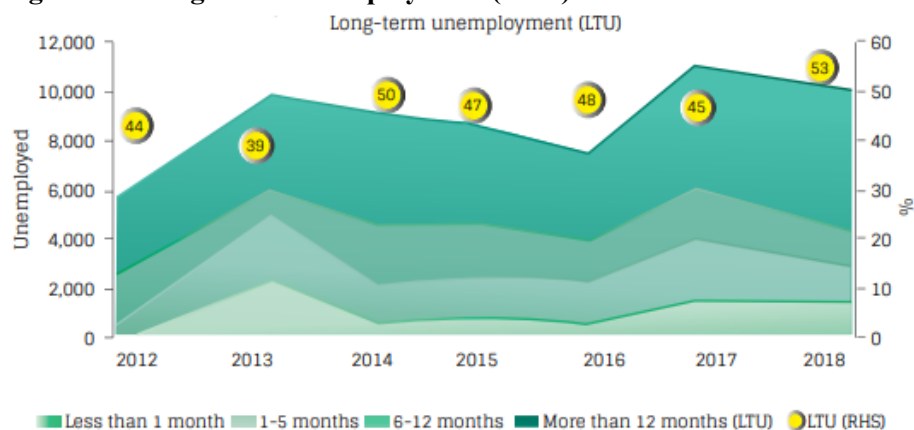
The employment in service sector is recorded at 32.9%, largely driven by employment opportunities in public administration (10%). The concentration of services employment is comparatively higher at 72.9% in urban areas and 16.9% in the rural areas. Likewise, employment in the industry sector is also higher in urban areas. The employment scenario is still dominant in the informal sector. Of the total employment, 73.6% are working in the informal sector and only 26.4% are in the formal sector. The informal sector employment is largely distributed in the rural areas in agriculture. For instance, in 2018, of 162,239 employees in the agriculture sector, almost all were in the informal category with 54% in family workers and 45% in own account workers. Formal sector employment is largely concentrated in the public administration and manufacturing sectors. Employability in formal sector increases with education level and about two thirds of informal employment are those with either no formal education or with minimal education level. This clearly reflects how disparity in education affect the quality of employment in the labor market.

Economic deceleration adversely affected employment prospects: Youth unemployment rate touched historic high at 15.7% in 2018. The persistent slowdown in economic growth for the past two years has limited job creation, resulting in overall unemployment rate of 3.4% (or 10,414 persons), highest since 2010. The key factor for growing unemployment in the market is mainly due to demand side constraints and skill mismatches as indicated by sharp decline in output and explained by fall in investment and employment level. One third of the unemployed population in the labor market feel there is limited job offers despite growing labor supply. At the same time, there is a supply side constraint with more than half of the unemployed labor force either lacking appropriate experience or required qualification and skills for available jobs. Therefore, the combined effect of labor market mismatches and lackluster economic growth caused higher unemployment level in 2018.

Private sector employment remains less attractive for job seekers. In 2018, more than a third of the unemployed labor force (or 7,253 persons) preferred jobs either in civil service (55%) or public corporations (15%) compared to total labor demand of 2,166 (civil service: 1,444 and corporations: 722). Despite constant efforts made for private sector development, labor market in the private sector still, remain less attractive due to job security and non-competitive employment benefits compared to the civil and corporate job market. The labor demand in the private sector was 2,452 (52%), therefore, enhancing employability in the private sector is a key determinant for minimizing unemployment rate.

Unemployment level is chronic in nature Due to slower and lack of broad-based economic growth and skill mismatch in the labour market, more than half of the unemployed remained without job for more than 12 months - long-term unemployment. In the recent past, long-term unemployment rate has been rising from 1.4 % in 2017 to 1.8 % in 2018. During the last five years, of every 10 unemployed persons, 5 persons were in search of work for more than 12 months. Youth are more exposed to long-term unemployment with high mismatch of skills and lack of experiences despite meeting required level of qualification. In 2018, 47 % of youth were in chronic unemployment group, which further contributed to structural unemployment as they are more likely to remain out of work even at adult working age cohort. In such cases, potential workers may get discouraged and become economically inactive, leading to fall in overall labour productivity. Therefore, appropriate policy interventions are necessary both at macro level to boost labour demand and at micro level to supply skilled labour to reap the potential demographic dividend.

Figure 17: Long-Term Unemployment (LTU)



Source: Ministry of Labor and Human Resource of Bhutan

iv. Money and Credit

The monetary and liquidity conditions during FY 2018/19 slowed down in tandem with lower economic growth and policy initiatives introduced to ease volatility of liquidity in the market. In absence of effective monetary policy operations, the persistent build-up of liquidity in the banking system often causes high volatility in the level and path of reserve money and money supply (M2).

Despite slowdown in economic growth, domestic credit improved in FY 2018/19 on account of continued higher demand for construction and services sector and mobilization of deposits. Other combined macroeconomic factors such as moderate level of inflation, softening of interest rate and depreciation of exchange rate also affected the demand for credit. Similarly, total deposits grew

moderately in FY 2018/19 with increase in usage of digital payment and policy initiatives to promote saving habits.

Monetary base (M0) comprises the central bank liabilities that directly influence expansion and contraction of money supply in the economy. Currently, Cash Reserve Requirement (CRR) is the only monetary instrument used by the RMA to manage liquidity in the banking system. The growth in monetary base was largely influenced by currency in circulation, Cash Reserve Requirement at the Central bank and excess reserves.

During FY 2018/19, monetary base continued to record negative growth of 4.5 %, due to sharp decline in excess reserves maintained with the RMA. The significant decline was mainly due to RMA's effort to sterilize bank's excess reserves through sweeping of the current accounts that are mostly volatile inflow of foreign currencies, particularly hydropower proceeds and official grants. The Currency in Circulation (CiC), which accounted for 39.2% of total monetary reserve, grew by 2.3% as of June 2019, compared to 6.4% during the previous period.

Similarly, the currency to GDP ratio also decreased to 6.7% from 7.1% in FY 2017/18, reflecting decline in cash transactions in the economy. The increase in digital payments and higher opportunity costs of holding cash might also have attributed to low currency demand. Banks' deposit (CRR and excess reserves) with the RMA continued to experience negative growth (10.7%) during FY 2018/19. The moderate deposit growth in commercial banks and active sterilization of excess liquidity through sweeping measures by the RMA have resulted in decline in banks' reserves.

Net Foreign Assets (NFA), which is a key source of reserve money, also recorded a negative growth of 3.8% as of June 2019. The decline in NFA was attributed to uncertain flows of hydropower receipts, official grants and scheduled re-payment of short-term borrowings. The growth in money supply is influenced by the magnitude of money multiplier. During FY 2018/19, the money multiplier stood at 3.8 higher.

The money supply, measured by the broad money (M2), grew by 5.6% as compared to 10.4% in the FY 2017/18. The total deposits, which forms 92% of component of money supply, grew by 5.6 % in FY 2018/19 as compared to 10.9% in the previous year. The demand deposits grew at 4.2% in FY 2018/19 lower than 9.9% in FY 2017/18. The both savings (16.9%) and current deposits (-11.5%) growth fell in FY 2018/19, contributing to the slowdown of aggregate deposits. Similarly, the time deposits, which constitutes 47% of aggregate deposits, remained stable at an average growth of 13.7% in FY 2018/19, although there has been up-ward revision in interest rate.

Table 5: Monetary Aggregate

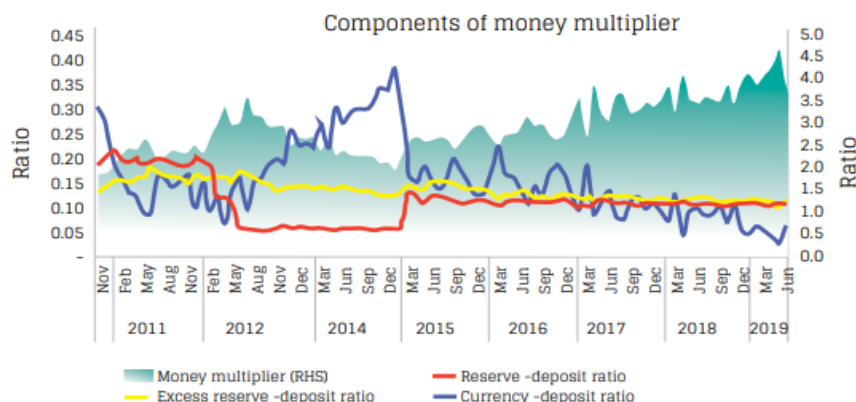
Item	Nu. Million			Growth In Percent		
	2016/17	2017/18	2018/19	2016/17	2017/18	2018/19
I) Reserve Money	34,327.90	33,469.80	31,973.90	23.50	(2.50)	(4.50)
II) Broad Money (M2)	104,113.60	114,973.70	121,416.70	31.50	10.40	5.60
III) Narrow Money (M1)	60,723.30	66,295.10	69,203.40	35.10	9.20	4.40
IV) Components of M2						
1 Currency Outside Banks	8,787.70	9,234.00	9,744.10	44.00	5.10	5.50
2 Transferable Deposits	51,935.60	57,061.00	59,459.30	33.70	9.90	4.20
3 Time Deposits	41,285.50	46,163.90	51,011.30	26.50	11.80	10.50
4 Foreign Currency Deposits	2,104.90	2,514.80	1,202.00	32.50	19.50	(52.20)
V) Sources of M2						
1 Foreign Assets (Net)	68,186.70	66,006.30	63,920.60	0.60	(3.20)	(3.20)
2 Claims on Government	2,852.90	5,029.40	2,406.90	151.20	(15.60)	(52.10)
3 Claims on Other Public Sector	7,046.80	8,306.00	6,230.80	15.40	17.90	(25.00)
4 Claims on Private Sector	75,185.10	86,985.10	104,850.50	15.40	15.70	20.50
VI) Money Multiplier	3.00	3.40	3.90			

Source: Annual Report of Royal Monetary Authority of Bhutan, 2019.

Note: The monetary aggregate includes data from RMA and Commercial Banks, which is comparable between June end.

In terms of sources of money supply, NFA continued to show declining trend over the period. The flow of Indian Rupees (INR), particularly hydropower receipts and foreign grants, which are volatile in nature, contributed to the decline. The credit to private sectors, which constitutes around 86% of total domestic credit, expanded by 20.5% in June 2019 from 15.7% in the previous year. The higher growth was due to increase in demand for construction and housing sector and higher mobilization of deposits.

Figure 18: Components of Multiplier



Source: Annual Report of Royal Monetary Authority of Bhutan, 2019.

The money multiplier, as a key monetary parameter, increased slightly to 3.8 in FY 2018/19 from 3.4 in FY 2017/18. The decrease in excess reserve-deposit ratio, which is inversely related to money multiplier, contributed to higher money multiplier. Similarly, the currency-deposit ratio, which captures the public's preference for cash and deposit habits, decreased marginally. The velocity of money continued to remain at 1.5, reflecting stability in the financial system.

II.1.3 Fiscal position

The fiscal policy of the Government is to maintain fiscal balance at sustainable levels through effective resource mobilization and prudent expenditure management. The financing needs of the Government is met through debt financing only after fully exhausting the possibilities of obtaining the required financing in the form of grants. In order to achieve these policy objectives, the recurrent expenditures are met from the domestic resources while the capital expenditure is met from revenue surplus and grants, and any deficits are financed through borrowings from concessional windows and domestic market.

Considering the impact of COVID-19 pandemic on the economy, FY 2020-21 budget will pursue to achieve following fiscal targets:

1. Minimum GDP growth of 2%
2. Containing fiscal deficit within 5% of GDP
3. Tax to GDP ratio at least 10%
4. Recurrent expenditure to be covered by internal resources and
5. Non-hydro debt below 35%

In order to achieve the above-mentioned targets for FY 2020-21, the Government will pursue the following fiscal policy interventions.

II.1.3.i Economic Contingency Plan (ECP) and Reprioritization of 12FYP Activities:

The Government has already initiated the implementation of ECP in the areas of Tourism, Agriculture, Build Bhutan Project and improvement of Farm Roads over and above the regular budget. In addition, 12FYP has been re-prioritized for acceleration and front-loading starting FY 2020-21. Particular emphasis will be placed on revitalizing the rural economy, creating employment opportunities amongst others.

II.1.3.ii Strengthen Resource Mobilization:

In order to overcome the present economic disruptions and with a view to stabilize the economy and stimulate growth, the Government will continue to mobilize additional resources such as grants, concessional borrowings and other financing windows, including bilateral sources. In addition, the Government will also continue to pursue mobilization of resources in kind. On the domestic front, the Government will rigorously monitor the economic situation and accordingly initiate interventions.

Considering the tax exemptions passed by the last session of the parliament and the fiscal measures implemented by the government in FY 2019-20, domestic resources for FY 2020-21 is estimated to fall by 14 %. As such effective resource mobilization and enhancing tax administration and compliance will be of utmost importance.

II.1.3.iii Rationalizing Expenditure:

Under the circumstances, where domestic revenue is estimated to decrease, the Government will rationalize current expenditure by spending in areas where it is necessary and minimize wasteful expenditure. In order to deepen fiscal decentralization and provide flexibility in the budget execution, the budget for Dzongkhags and Thromdes will be provided as annual grants from the FY 2020-21, similar to the Gewogs. In addition, current grants will be introduced to all the central agencies. These reforms are expected to promote ownership in the optimal utilization of the allocated budget for priority activities by the budgetary bodies.

II.1.3.iv Fiscal Balance:

The fiscal target for the 12FYP is to maintain an average fiscal deficit within 3 % of GDP. However, the fiscal deficits are adjusted to support the growth target. For FY 2020-21, due to the impact of COVID-19 pandemic there is need for new spending by implementing Economy Contingency Plan (ECP) and allocating higher level of capital outlay to offset the GDP loss. As such, against the target to contain fiscal deficit within 5 % of GDP, the estimated fiscal deficit is 7.36 % of GDP. This is on account of capital budget provisioning of up to 31 % of the plan outlay to facilitate front-loading and acceleration of 12FYP activities. The fiscal target is expected to be achieved with concerted effort to mobilize additional resources and by exercising prudent expenditure management.

II.1.3.v Managing Debt:

With limited domestic resources and committed grants not sufficient to finance the entire capital budget, concessional external borrowings and internal borrowings will be resorted. As such, it will be important to ensure that all additional borrowings will be for investment, in keeping with the Public Debt Policy.

II.1.4 Fiscal Frameworks

The fiscal framework provides fiscal outcomes for the last two fiscal years, estimates for the current year and projections for the two outer fiscal years. Under the current situation of COVID-19 pandemic, the fiscal deficit is estimated at 7.36% of GDP for FY 2020-21. However, in the medium term, it is projected to improve to 4.38% in FY 2021-22 and 0.24% in FY 2022-23. With the initiative to front load grants in FY 2020-21, the resources for the two outer years are projected to decline unless additional resources are mobilized. On the revenue front, assuming that the economy normalizes, domestic revenue is estimated to grow by 10% in FY 2021-22 and 14% in FY 2022-23. The capital expenditure is projected to decline as a share of total outlay to 20% and 9% in the last two fiscal year of the plan. This is based on the assumption that capital outlay for the last year and the current year are fully utilized. However, current expenditure is expected to increase marginally depending on the situation of the economy and revenue performance. With the decrease in the capital expenditure, external borrowing and domestic borrowing to finance budget deficit will also gradually fall.

Table 6: Medium Term Fiscal Framework.

Particulars	2018/19 Actual	2019/20 Revised	2020/21 Estimates	2021/22 Projection	2022/23
Total Resources	42,033.30	52,726.62	53,822.07	49,547.26	47,997.96
Domestic Revenue	34,707.67	38,495.85	33,189.39	36,617.91	41,582.39
Other Receipts (Net)	(3,190.86)	507.80	489.83	292.58	250.78
Grants	10,221.41	13,722.97	20,142.85	12,636.77	6,164.79
Total Expenditure	44,776.73	64,615.47	69,151.12	59,629.66	48,633.72
Current Expenditure	27,768.66	35,819.35	32,900.00	35,449.56	38,846.54
Capital Expenditure	16,285.47	28,796.12	36,251.12	24,180.09	9,787.18
Advance/ Suspense (Net)	722.59				
Overall Balance	(2,743.43)	(11,888.85)	(15,329.05)	(10,082.40)	(635.76)
Financing	2,743.43	11,888.85	15,329.05	10,082.40	635.76
Net Lending	1,319.16	559.58	1,316.67	3,736.38	3,819.48
Net External Borrowings	1,101.10	4,720.34	422.15	(4,253.77)	(4,749.17)
Net Internal Borrowings	323.17	6,608.93	13,590.23	10,599.79	1,565.45
GDP	176,404.30	192,353.09	208,199.70	229,952.91	259,638.09
Fiscal Balance as % of GDP	-1.56%	-6.18%	-7.36%	-4.38%	-0.24%

Source: National Budget Report, FY 2020-2021, Ministry of Finance, Bhutan

Note: All figures in Nu (millions)

III. Tax structure

III.1 History and Background

Before 1960's, Taxes were collected in kind and in form of Labor contribution. This decade old tradition of paying Taxes in kind and services gradually phased out with monetization of Bhutanese economy, which began sometimes in 1958 or later. It also coincides with modernization period under the then the reign of 3rd King (The late His majesty Jigme Dorji Wangchuk: 1929-1972) who was known as modern father of Bhutan.

The first Major tax reforms was recorded in the year 1989 with the objective to take stock of various tax measures. Under these reforms, the government of that time took an initiative to develop coherent and rational tax system, to establish a system of tax in fair, equity and efficient that minimizes the need for frequent change and to fully document the system in a way that promotes taxpayer awareness. The main feature of the reform were as follows:

- BIT on net profit replaced 2% turnover tax
- Export income exempted
- Plant machinery exempted from sales tax and import duty
- other nuisance taxes were abolished

Second reform took place in the year 1992 and this time, the purpose of such tax reform was to rationalize tax structure, expand the tax base and to simplify administrative procedures for compliance and transparency purpose. Until such time Bhutan has no formal Income tax Act or rules and the existing tax were collected based on tax policy documents which contained a simple instructions and collection procedures.

It was in the year after 2000 that Bhutan has its first Act and rules in place for Direct taxes and Indirect taxes. This marks an important milestone in the history of Department of Revenue and Customs (DRC) which is currently the Department responsible for collection of all kinds of Taxes. The department is one of the Department under Ministry of Finance and is entrusted with overall administration of tax revenue matters. This department was formally established in the year 1971.

III.2 Present Structure

The Department of Revenue and Customs is apex department responsible for collection, monitoring and enforcement of tax laws in the country and mostly known as DRC in short. It envisions contributing to nation building through developing effective revenue system by ensuring that the Tax and Customs administration has the capacity to collect taxes efficiently and effectively at minimum cost. It upholds to be impartial and consistent in enforcing regulations, and to provide a convenient and honest service to the taxpayers.

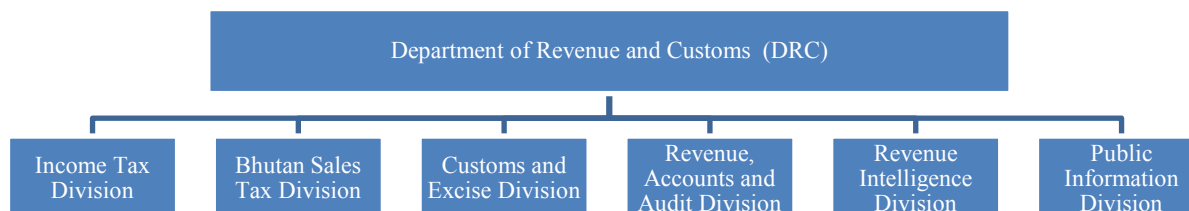
Department of Revenue and Customs (DRC) is headed by Director General and has six separate divisions at Head Quarter (HQ) level and eight regional offices currently. The six divisions are responsible for administration of each type of taxes, which we will discuss in the section that follows. The division at HQ level are as shown in below:

1. Income Tax Division
2. Sales Tax Division
3. Customs and Excise Division
4. Revenue, Accounts and Audit Division
5. Revenue Intelligence Division
6. Public Information Division

At regional office set-up level, the six divisions at HQ level is represented by separate sections except for Public information division and Revenue Intelligence Division. The regional level office has Income

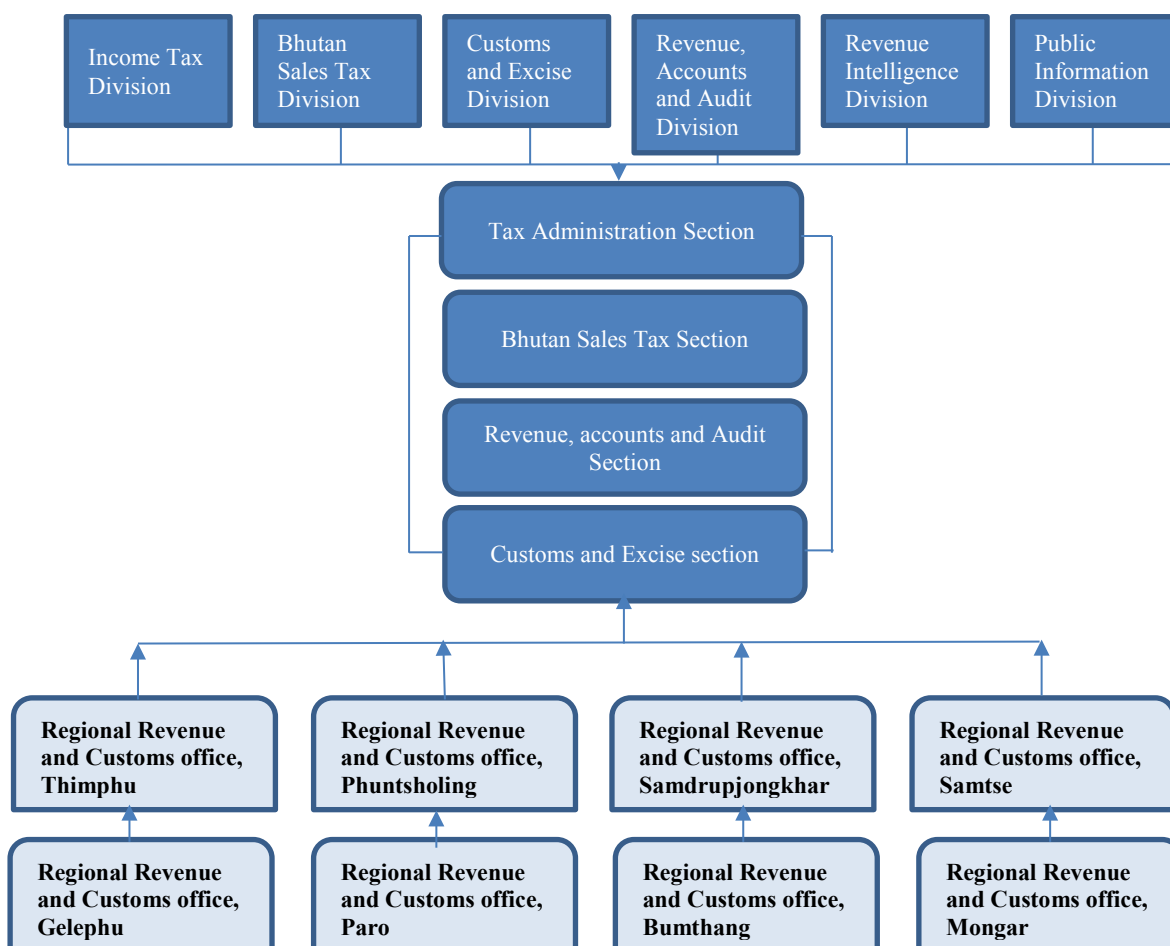
Tax Section, Customs and Excise Section, Bhutan Sales Tax section and Revenue, Accounts and Audit Section. All these sections are supervised under the leadership of Regional commissioners. The complete organogram/set of office administration at HQ level and at Regional Level is as shown in the below diagram.

Figure 19: Office Administration at HQ Level



Source: Department of Revenue and Customs, Ministry of Finance of Bhutan.

Figure 20: Office Administration at Regional Level



Source: Department of Revenue and Customs, Ministry of Finance of Bhutan.

III.3 Functions of Divisions

III.3.1 Income Tax Divisions:

This division is mainly responsible for administration of Direct Taxes. The type of Direct taxes are summed up within three types of taxes namely, Personal Income Tax (PIT), Business Income Taxes (BIT) and Corporate Income Tax (CIT). Their broad functions are as shown in below:

- Implement and monitor the Income Tax Act of the Kingdom of Bhutan, 2001 and the Rules.

- Review and advise the Ministry of Finance on all revenue related matters, tax policy and planning.
- Revision of legislation, etc. from time to time.

III.3.2 Bhutan Sales tax Division:

This division is mainly responsible administration of sales tax at the point of sales of goods and within the country. The tax at the point of entry of goods are although administered by this division but Customs Administration makes the actual collection of taxes for goods entering Bhutan as a part of Trade facilitation. Their broad function includes:

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

However this Division will soon be replaced by Goods and Service Tax division from July, 2021 onwards. The Goods and Service Tax (GST) Act and Rules will supersede the existing Bhutan Sales Tax Act 2000. GST is known to broaden the tax base and improve tax revenue collection due to its broad nature of levy on consumption irrespective of downfall in the economy.

III.3.3 Customs and Excise Division:

Customs and Excise Division is responsible for administration of customs and excise law in the country. Apart from collection of customs duties and sales tax on the import of goods, they also play a major role in facilitating the Trade and economic activities and also invigilate on illicit goods and service movements across the border. Their broad functions are as listed below:

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

III.3.4 Revenue, Accounts and Audit division:

This division is responsible for administration of tax revenues that are not under the purview of other Division. Their broad function includes following:

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

III.3.5 Revenue Intelligence Division:

The Revenue Intelligence shall use specialized, skills and techniques for obtaining, analyzing and sharing information about the tax and customs unlawful operations which may have an immediate or

potential influence on the decision-making in the revenue administration to prevent revenue leakages in the system. It shall aim to assist and guide the revenue administration in planning and execution of its legal authorities, especially in combating tax evasion, customs frauds and any other economic crimes. Revenue Intelligence shall strive to ensure detection of breach of tax and custom laws and prevent leakages of revenue bringing the offenders to the book proactively. Their broad function includes:

- identification of risks related to tax and customs frauds which have revenue implication;
- to be vigilant of any suspected individual/entity with sudden increase in wealth or unexplained windfalls and businesses that may be at high risk from illicit activities;
- perform preventive operations to deter against noncompliance tax and customs fraud;
- to carry out independent investigations in selected cases involving complexity and multiple jurisdictions;
- widening and broadening tax base through identification of non-filers and by providing information for proper selection of cases for scrutiny assessments;
- recommend control mechanism for ambiguity in the law and procedures to combat tax and customs frauds; and
- it will have no routine job of its own which mandates RID to collect a certain amount of revenue. It will act proactively on intuitions and intelligence to combat revenue frauds adopting means as appropriate and justified for ends it seeks to achieve.

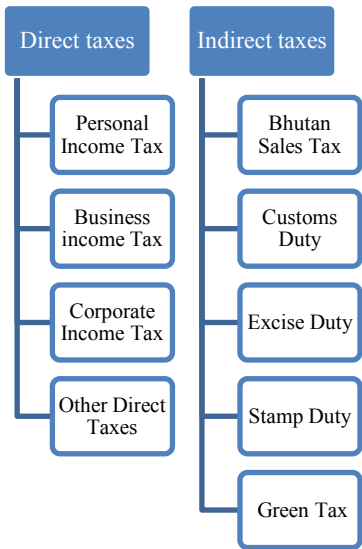
III.3.6 Public Information Service:

The PIS (Public Information Service) is responsible for dissemination of direct and indirect tax information, rules and regulation through smart service and media in collaboration with an IT unit of the Department. Currently, the toll free taxpayer call center service that started since 2018 is attached under its supervisory roles.

III.3.7 Tax Structure:

This section will follow the discussion on types of taxes DRC administers. In General, tax revenues comes from two major head of revenue that are divided, into Direct Taxes and Indirect Taxes. Direct taxes are taxes levied on income while indirect taxes are taxes on sales/import/purchase of goods and services and it is taxed on calendar year basis. The particulars of type of taxes can be understood from the following Diagram.

Figure 21: Types of Taxes



Source: Department of Revenue and Customs, Ministry of Finance of Bhutan

III.3.8 Direct taxes Structure

Direct taxes are taxes on income and Income Tax Act and Rules of Kingdom of Bhutan, 2001, governs collection of Direct taxes. Types of Taxes under collected under Direct taxes includes Personal Income Tax (PIT), Business Income Tax (BIT) and Corporate Income Tax (CIT).

Under *Personal Income Tax*, five major sources incomes are taxed and they are as follows:

- i. Income from Salary
- ii. Income from Real Property
- iii. Income from Dividend
- iv. Income from other sources
- v. Lottery taxes (applicable from 2020 onwards)

As per Income tax Act of Kingdom of Bhutan, 2001, it stipulates that all citizens and residents who has income from above five sources and whose net taxable income exceeds Nu.200,000 are to be taxed under Personal Income taxes. It is considered that PIT system follows a progressive taxation system. The table following shows the progressive rates at which incomes are taxed under PIT system in Bhutan.

Table 7: Tax Rates under Personal Income Taxes

Taxable Income	Tax Rate
Where the total net taxable income does not exceed Nu.300,000.00	Nil
Where the total net taxable income exceeds Nu.300,000.00 but does not exceed Nu.400,000.00	10 % of the amount by which the total net taxable income exceeds Nu. 300,000.00
Where the total net taxable income exceeds Nu.400,000.00 but does not exceed Nu.650,000.00	Nu.10,000.00 plus 15% of the amount by which the total net taxable income exceeds Nu.400,000.00
Where the total net taxable income exceeds Nu.650,000.00 but does not exceed Nu.1,000,000.00	Nu. 47,500.00 plus 20%of the amount by which the total net taxable income exceeds Nu.650,000.00
Where the total net taxable income exceeds Nu. 1,000,000.00 but does not exceed Nu.1,500,000.00	Nu. 117,500.00 plus 25% of the amount by which the total net taxable income exceeds Nu.1,000,000.00
Where the total net taxable income exceeds Nu.1,500,000.00	Nu. 242,499.00 plus 30% of the amount by which the total net taxable income exceeds Nu.1,500,000.00

Source: Income Tax Act of Kingdom of Bhutan, 2001, Ministry of Finance of Bhutan.

However, the lottery taxes under PIT system is taxed separately. A withholding tax rate of 20% shall be applicable for lottery winnings whose amounts exceeds Nu.5000 and the withheld amount is treated as final taxes.

Under *Business Income taxes*, income from unincorporated business are taxed and under *Corporate Income Tax*, income from incorporated business are taxed. Taxes under this category are taxed based on net profit of its business and the rates applicable are as shown in below table.

Table 8: Tax Rates for Corporate Income Tax and Business Income Tax

Types of taxes	Tax rates
Business Income Tax	30% of Assessed net Profit
Corporate Income Tax	
i. State Owned Corporations	30% of Assessed net Profit
ii. Corporations others than State owned	25% of Assessed net Profit

Source: Income Tax Act of Kingdom of Bhutan, 2001, Ministry of Finance of Bhutan.

With recent amendment to Income tax act of Kingdom of Bhutan, 2001, certain sections under corporate income tax system has been repealed with revision of Tax rates particularly for corporations other than state owned enterprise. The rates has been revised downward from 30% of its net profit to 25% of its net profit.

III.3.9 Withholding Taxes (Tax deducted as sources)

Withholding tax system serves as an important mechanism in the entire tax system. Withholding tax system allows withholding taxes from its sources at rates applicable in Tax laws. This system makes

government organizations, business houses and any tax entity to oblige to deduct taxes on behalf of Department of Revenue and Customs and deposit with it. Non-compliance to this obligation attracts penalties as per the tax laws. The following table provides rates of applicable Taxes (TDS) to be deducted on certain sources of income.

Table 9: Withholding Tax Rates on Applicable Sources of Income

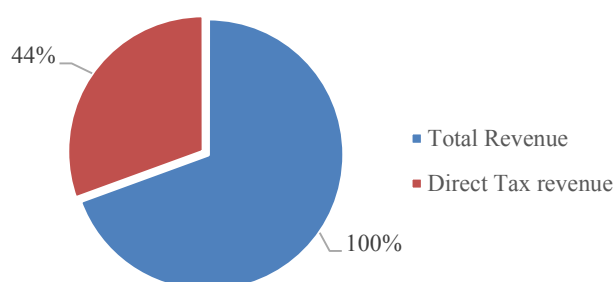
Sl. No.	Withholding Agencies	Source of Income	TDS Rates
1	Employer or authorized representative	Salary	As per Annexure III
2	Government, Semi-Govt., & Non Govt. Organizations (NGOs), Companies, Businesses and Persons/Individuals.	Rental	5%
3	Companies	Dividend	10%
4	Financial Institutions	Interest	5%
5	Tourism Council of Bhutan	Tour Income	2%
6	Contract Awarder or authorized representative	Contract Income	2% for Bhutanese firms and 3% for non Bhutanese firms
7	Government, Semi-Govt., & Non Govt. Organizations (NGOs), Companies, Businesses and Persons/Individuals.	Income from Other Sources	5%

Source: Income Tax Act of Kingdom of Bhutan, 2001, Ministry of Finance of Bhutan.

III.3.10 Direct Tax revenue Contribution:

The share of Direct Tax revenue to national exchequer for fiscal year 2018-2019 was almost Nu.12.5 billions out of Total Tax revenue of Nu.27.5 billions. This is almost 44% of Total Tax revenue.

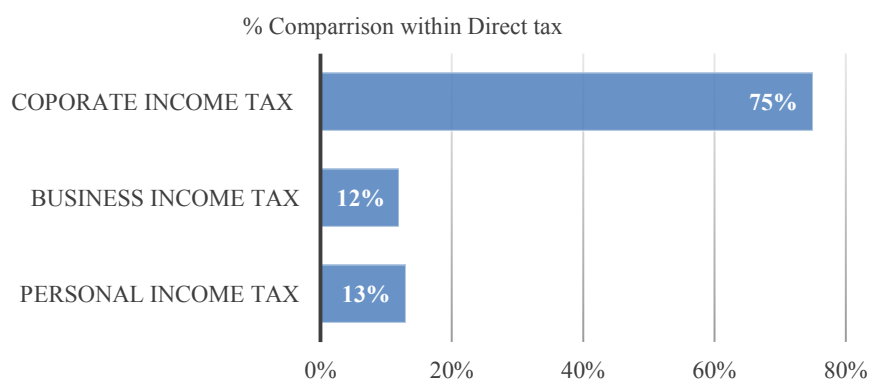
Figure 22: Direct Tax Revenue Contribution



Source: Performance Indicator Report, 2018. Department of Revenue and Customs of Bhutan.

The major contributor under Direct taxes comes from Corporate Income Tax followed by Personal Income Tax and Business Income tax.

Figure 23: Breakdown of Direct Taxes (%)



Source: Performance Indicator Report, 2018. Department of Revenue and Customs of Bhutan.

III.3.11 Indirect Taxes

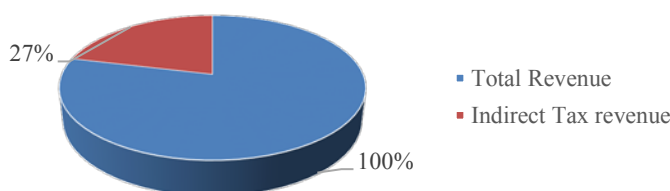
Indirect taxes includes, Bhutan sales Tax and Customs and Excise duties and both of this tax is administered by single Act and Rule (i.e Sales Tax, Customs and Excise Act of Kingdom of Bhutan,2000) currently. Although governed by single act, but at administrative level, separate divisions enforces this Indirect taxes as described earlier.

A major reforms has been made under the indirect tax system and this change will be effective from July,2021 onwards. Goods and Service Tax system will repeal the old and existing Bhutan Sales tax system. Separate Act and Rule has been enacted for the purpose of GST implementation, however, Customs and Excise duty will be enforced with its existing Act and Rule.

The share of Indirect taxes to total revenue accounts for almost 27% of total tax revenue during fiscal year 2018-2019. The total taxes collected as indirect tax amounts to Nu.7.3billions. The introduction of GST is expected to boost revenue performance in coming years with uncertainty looming around at least during the pandemic period.

Figure 24: Indirect Tax Revenue Contribution

Indirect Tax revenue contribution to Total tax revenue

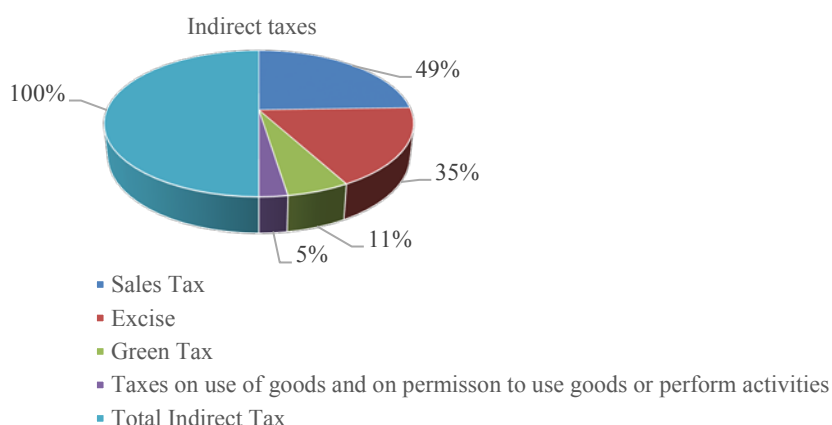


Source: National Revenue Report (Fiscal Year 2018-2019)

III.3.12 Percentage of Indirect taxes break-up

As discussed earlier, the indirect taxes consist of BST along with Customs and Excise duty. There are also other taxes under Indirect taxes, which are Green tax, Taxes on uses of goods and service and on permission to use goods or perform activities. The pie chart following this shows percentage contribution from each tax type under indirect tax system.

Figure 25: Indirect Taxes Break-up (%)



Source: National Revenue Report (Fiscal Year 2018-2019)

III.3.13 Tax to GDP Ratio

The following table gives you the summary of GDP growth rate and Government Revenue performances particularly the Tax revenue performances as a percentage of GDP over the four-year period. The Tax revenue to GDP ratio mostly remained static over the four year period with decline in

its ratio during the year 2019 though GDP increased by 6.4%. The Department observed a drop of Tax revenue performance from 16.24% in 2018 to 12.75% in the year 2019.

Table 10: Tax to GDP Ratio

Indicator	2016	2017	2018	2019
GDP and GNI (Nu in Millions)				
GDP	145,072.86	159,571.70	167,339.97	178,201.89
GNI	132,609.03	145,712.30	152,281.39	162,037.05
Government Revenue as a % of GDP				
Tax Revenue	14.96	16.99	16.24	12.75

Source: National Statistical Bureau of Bhutan.

It is still apparent that tax revenue performances are positively related with budget appropriation of Government. The government spending plays a crucial role in improving the tax revenue. This is because, the government is still the biggest major consumer in the economy. Increase share of budget for capital works as well as re-current works is a major source of income for most of the stakeholders in the economy. The increase in tax revenue performances is expected with the increase in governments spending policy which has been the trend until 2020 unless if otherwise.

IV. Country Specific Fiscal Issues

To analyze this section, let us look at the summary on selective key indicators from Budget report 2020-2021.

IV.1 Fiscal Balances

Table 11: Fiscal Deficit as Percentage of GDP

Summarized Fiscal Framework				
Particulars	2019-2020 Revised	2020-2021 Budget	2021-2022 Projection	2022-2023
Total Resources	52,726.62	53,822.07	49,547.26	47,997.96
Total Expenditures	64,615.47	69,151.12	59,629.66	48,633.72
Fiscal Deficit	-11,888.85	-15,329.05	-10,082.40	-635.764
FD % of GDP	-6.18	-7.36	-4.38	-0.24

Source: National Budget Financial year 2019-2020

RESOURCES

- COVID-19 pandemic to impact domestic revenue by 14 %.
- Total resources estimated at Nu. 53,822.073 million.
- Domestic revenue estimated at Nu. 33,189.392 million.
- Grants estimated at Nu. 20,142.848 million, expected to cover 56 % of capital expenditure.
- To ensure that the revenue targets are met, the MHP shall be maintained under profit transfer modality during the FY.

EXPENDITURE

- Total expenditure estimated at Nu. 69,151.122 million, 7 % increase from the previous year.
- Capital expenditure Nu. 36,251.122 million and current expenditure Nu. 32,900 million.
- Deepen fiscal decentralization with the upscaling of Annual Grants to Dzongkhags and Thromdes besides Gewogs.
- Introduction of Current Grant system of current budget allocation to the central agencies.
- Flagship Programs (Health, Education, Water, CSI Development, Digital Drukyl, National Organic, Tourism, Waste and Stray Dog Management) amounting to Nu.5,148.212 million.
- Implement Economic Contingency Plan which includes improvement of about 1,447 km of Farm Roads with existing road connectivity

IV.2 Financing and Debt situation

Table 12: Internal & External Debt as a Percentage of GDP

Financing and Debt Situation (in Million Nu.)				
Particulars	2019/20 Budget	2020/21 Revised	2021/22 Projection	2022/23
Financing	11,888.85	15,329.05	10,082.40	635.764
Net Lending	-559.58	-1,316.67	-3,736.38	-3,819.48
Net External Borrowing	4,721.14	420.03	-4,253.77	-4,749.17
Net Internal Borrowing	6,608.13	13,592.35	10,599.79	1,565.45
% of GDP				
Total Public Debt	111.2	103.9	97.9	102.6
Total External Debt	111	103.7	95.3	99.6

Source: National Budget, Financial year 2019-2020, Ministry of Finance.

Bhutan fiscal issues can be understood well from analysis of fiscal balance and from studying the financing and debt pattern. The government aims to reduce fiscal balances or at least to maintain fiscal balances at manageable level by prioritizing the developmental activities and plans. Bhutan fiscal policy is largely centered upon the noble idea of achieving Gross National Happiness through meeting recurrent

expenditure from internal revenue in full and at least provide 20% of leverage from internal revenue for Capital expenditure purpose. Over the years, the fiscal balances has been increasing because of the fact that expenditure grew more than increase in revenue. However, it is projected to decline over the period of 2021-2022 to 2022-2023 to at least 0.24%.

In summary:

DEBT SITUATION AND OUTLOOK

- Fiscal Deficit amounts to Nu. 15,329.049 million, 7.36 % of GDP.
- External borrowing of Nu. 4,032.120 million and Domestic borrowing of Nu. 13,604.622 million.
- Debt servicing for the FY to be Nu. 5,652.056 million, of which interest payment is Nu.2,027.697 million.
- Public Debt stock as on 31st March 2020 stood at Nu. 192,962.920 million of which nonhydro debt stock is estimated to be Nu. 47,842.346 million.

Covid-19 impact on fiscal matters:

Under the pandemic scenario, the situation forecasted may turn out to be different due to the fact that, pandemic has slowed down many economic activities. This slowdown in economic activities may hinder the overall economic growth of the country. Bhutan witnessed increased expenditure due to escalation of cost of goods imported, shortage of labor for contributing to delay in completion of construction works, increased expenditure for medical equipment and facilities to battle pandemic, increase in direct transfer for people who have lost job and business because of pandemic. On the other hand, the revenue performances may not see an increase as overall economic activity has been impacted due to lockdowns of countries border for tourism, which is one of the major contributor in the economy. Tax revenue may also decline significantly leaving less revenue for public finance amidst increase in government expenditure.

One of the issues that persist in the fiscal sector is the high public debt. On average, the public debt as a %age of GDP hovers around 100% and above. The debt composition is dominated by external debt and is used mostly to finance the construction of Mega-hydro projects in Bhutan. The high debt profile is a major concern going by its statistical record but however, as most of the debts are incurred for projects that shall pay off its debt in future, the debts are known to be self-liquidating in nature. This ensures that the fiscal credibility and its policy are managed well within its paying capacity.

V. Conclusion: Where We Stand and Where We Go?

Bhutan to the outside world is generally known to be a one of the happiest country in the world but the country itself does not claim to be one of it. The reason why it has been known as a happiest country is because of the fact that the, Happiness concept popularly known as Gross National Happiness (GNH), which is a philosophical yardstick to measure development progress, originated from Bhutan and became so popular for the outside world thus calling Bhutan to be 'the land of happiness'.

GNH is an additional key indicator to measure the development aspect of country's growth in addition to GDP. This noble idea to measure happiness was a great gift and contribution from 4th monarch of Bhutan, His Majesty the King of Bhutan, Mr. Jigme Singye Wangchuk. The philosophy was first coined in the year 1972 when the king declared, "Gross National Happiness is more important than Gross Domestic Product." This statement takes a connotation that irrespective of the material development progress that Bhutan achieves, if people of Bhutan's happiness does not progress, then the real development has not taken place or the government has failed on achieving the real development progress. In short, it meant that, it is not the GDP that matters but it is GNH that matters in measuring the real progress of the development. Since then, all the policies and framework to pursue development path has been aligned or designed to include this aspect of happiness. Separate commission to champion on this philosophy was instituted and today it is called Gross National Happiness commission. This commission has the responsibility to champion on this philosophy in the area of policymaking and in advancement of the literature.

In general, the GNH has four major pillars and they are good governance, sustainable socio-economic development, cultural preservation, and environmental conservation. In addition, the GNH Index includes nine other domains, which are as follows.

- Psychological wellbeing
- Health
- Education
- Time use
- Cultural diversity and resilience
- Good governance
- Community vitality
- Ecological diversity and resilience
- Living standards

Despite having a well-developed philosophy, Bhutan still has its own challenges. Bhutanese economy is one of the smallest economy of world in Asian region. Being mountainous and landlocked country itself presents a difficult opportunity to accelerate on economic development due to high transportation cost and stringent environment policies and low score in ease of doing business coupled with structural issues like smallness in the size of market. Smallness in the size of market has also proven as a hindrance to foreign investors despite having cheap power resources. However, Bhutan has demonstrated a strong track record in sustaining economic growth and reducing poverty over the past two decades or so. Its progress in other socio-economic indicators as reflected in its success in achieving many of the 2000-15 Millennium Development Goal (MDG) targets is also worth noting. Bhutan successfully met the least development countries (LDCs) graduation criteria in two United Nations triennial reviews of 2015 and 2018. There it is set to graduate from the group of LDCs in 2023. This transition involves loss of certain trade preferences and other international support measures. However, the significance of these benefits are quite limited for Bhutan, and LDC graduation will not be a major cause for concern.

In order to achieve self-reliant goals, the country needs to adopt varied and vibrant economic policies to stimulate domestic economy, open more trade routes and diplomatic ties and capitalize on hydropower generation in the Asian region. Bhutan has the potential to tap renewable natural resources like water to capitalize on hydropower generation. The second best alternatives is to promote a sustainable tourism and stimulate private sectors.

For Bhutan, dealing with general development challenges should remain important policy priorities. It has embraced a proactive policy stance for graduation by combining its eighth five-year development plan, Sustainable Development Goals (SDGs) and Gross National Happiness (GNH) indicators. Bhutan has huge potential for developing supply-side capacities and generate employment opportunities through further development of such sectors as tourism, agribusiness, ICT and hydropower. Major impediments for exerting dynamism in these sectors include lack of investment, infrastructure deficit, and poor connectivity. Diversification of economic activities is a challenge for which one priority attention should be on developing the private sector.

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