Bhutan

Growth slipped for a second year running as construction at hydropower projects slowed and low water temporarily undermined electric power generation. Inflation trended downward with declines in import prices, and the current account deficit narrowed on stronger exports. The outlook is for growth to strengthen moderately. With the country’s expected graduation from least-developed status, the government plans reform to strengthen domestic resources toward better funding development.

Economic performance

Provisional estimates indicate GDP growth in fiscal year 2018 (FY2018, ended 30 June 2018) slowed further from 6.3% in FY2017 to 5.5% on weaker performance in industry (Figure 3.16.1). Construction remained an important driver of growth despite decelerating by nearly half from 9.8% expansion in FY2017 to 5.0%, mainly because of slower construction on hydropower projects. Moreover, hydropower generation, the other large component of industry, declined by 2.9% because of weak water flows. Services grew at a rapid 8.0% on robust expansion in wholesale and retail trade, hotels and restaurants, and transportation and communications. Revenue from international tourism rose by 5.0%. Agriculture expanded by 4.5%, partly on greater access to credit under the priority sector lending policy adopted by the government in December 2017, which requires banks to increase the share of credit granted to qualifying loan proposals from cottage and small industries, including agriculture.

On the demand side, capital formation increased only marginally as construction slowed (Figure 3.16.2). Growth in consumption expenditure was a major contributor to sustaining growth as private consumption markedly revived and government current spending remained robust. The trade and current account balances, though still in deficit, improved markedly again in FY2018, keeping net exports an important contributor to growth.

Inflation moved lower throughout FY2018, the monthly average falling from 4.3% the previous year to 3.6%. Food inflation was elevated for much of the year as adverse weather hurt domestic supply and import restrictions limited imports from India, but food prices trended much lower starting in March 2018 (Figure 3.16.3). Nonfood inflation fell notably
from November 2017, reflecting the impact of India’s adoption of a goods and services tax (GST) from July that reimburses exporters for all indirect taxes on production, thus lowering prices for goods imported from India. Although gasoline and diesel were not included in the GST, India waived central government excise taxes on these products, which eased food and nonfood inflation alike. Improved access to housing loans caused home rents to decline. From the beginning of FY2019, inflation began to rise as the 1-year impact of the change to a GST faded, and it once again tended to track inflation in India and developments in domestic demand.

Monetary policy remains oriented to maintaining price stability and supporting employment growth by channeling credit to productive sectors of the economy. Broad money growth slowed to 10.4% in FY2018 with net foreign assets, a main driver, declining by 3.2% (Figure 3.16.4). Growth in domestic credit reflected mainly a 15.7% increase in credit to the private sector, marginally higher than a year earlier. The expansion in credit largely benefited transportation, services, and housing, while credit to manufacturing slowed. Credit to the government was slight as its budget deficit shrank to near balance.

Government expenditure increased in FY2018 by 17.3% to reach 34.0% of GDP, providing a lift to domestic demand (Figure 3.16.5). Current expenditure grew by 18.6%, mainly on account of a higher bill for salaries and allowances, increase in government staff, an electricity subsidy to low-income consumers, and provisions for national elections. Capital expenditure rose by 16.1% to complete projects under the Eleventh Five-Year Plan, 2013–2018. Government revenue increased by about 27.8% in FY2018, three times average growth over the previous 5 years, driven by a 23.6% rise in tax revenue on buoyant domestic demand while nontax and other revenue was up by 39.2%. Grants also expanded markedly by 34.2%. On balance, the budget deficit declined from 3.4% of GDP in FY2017 to only 0.7%.

The current account deficit, though still high, continued to narrow in FY2018, falling by 5.0 percentage points to equal 18.2% of GDP (Figure 3.16.6). Most of the improvement came in the trade account, with the bulk of that coming from a 7.6% increase in exports as larger mineral exports overwhelmed the fall in electricity exports. Imports again declined, by 1.2% in FY2018 as construction slowed, but remained equal to nearly 40% of GDP, reflecting the country’s small manufacturing base.

External debt rose from $2.5 billion in FY2017 to $2.6 billion as debt unconnected to hydropower rose with the drawing down of about $100 million from a swap line with the Reserve Bank of India to build up Indian rupee reserves (Figure 3.16.7). Hydropower debt increased only marginally. The external debt position deteriorated slightly from the equivalent of 103.0% of GDP to 105.4%. The risk of debt distress is assessed
to be moderate because hydropower debt is associated with long-term export sales arrangements. Debt servicing was less than a quarter of export earnings.

Gross international reserves increased slightly by 0.6% to $1.1 billion in FY2018, providing cover for 13 months of merchandise imports (Figure 3.16.8). Indian rupee reserves, which are the working balances for settling about 85% of import transactions, declined slightly from cover for 4.4 months of imports to 3.3.

**Economic prospects**

Growth will likely accelerate slightly to 5.7% in FY2019 with electricity generation normalized in the rainy winter season and production higher at existing plants. Barring further delays to the commissioning of the Mangdechhu Hydropower Plant, a full year of operation in FY2020 will help lift growth to 6.0% in that year. Private spending is anticipated to strengthen following parliamentary elections and the formation of a new government in November 2018. Government spending is expected to see a major increase only in FY2020, however, after the new government begins implementing programs and projects under the Twelfth Five-Year Plan, 2018–2023. Services, particularly wholesale and retail business and tourism, will continue to underpin the economy. After resolving export clearance issues that prevented sales of certain crops to India for several months, agriculture is expected to grow moderately with continued improvement in access to credit.

Inflation is forecast to increase to 3.8% in FY2019 and edge up further to 4.0% in FY2020 as the initial benefits from India’s GST change taper and Indian inflation trends higher. Prices for export crops, particularly cardamom, will normalize following the resolution of the export clearance issue. Lower international oil prices forecast for 2019 and 2020 will help keep inflation at bay. Planned revisions to civil servant salaries and the minimum day wage will, once implemented, generate some inflationary pressure.

Following established practice in an election year, the outgoing government had Parliament pass an interim budget for FY2019 that covered current expenditure for the year and capital appropriations for ongoing projects but did not fund any new projects. As a result, capital expenditure in FY2019 is estimated to be about half that of FY2018. Government revenue is projected to drop by a third from a year earlier with the discontinuation of excise tax refunds from India under the GST, loss of revenue from a delay in commissioning of the Mangdechhu plant, and grants expected to be only a third of those a year earlier, mainly to support uncompleted projects. With India’s GST affecting the competitiveness of Bhutan exports, India has committed to a Nu4 billion grant over 5 years.
toward Bhutan making its products more trade competitive. On balance, the budget deficit is expected to increase to 2.8% of GDP and be financed by external and domestic borrowing.

The fiscal policy framework projects a sharp increase in budget revenue in FY2020 on Bhutan introducing its own GST to replace most indirect taxes, revenue transfers from full operation of the Mangdechhu Hydropower Plant, and a near tripling of grants from the previous fiscal year as the implementation of the Twelfth Five-Year Plan picks up. Expenditure is similarly projected to surge on large capital spending to implement new projects under the plan and on a pickup in current expenditure buoyed in part by expected recommendations of the Fourth Pay Commission to increase salaries for civil servants and contractors. On balance, the budget deficit is projected to increase to 3.6% of GDP.

The current account deficit is expected to shrink further in the forecast period. The deficit is forecast at 16.9% of GDP in FY2019, narrowing mainly on declining imports with further slowing of hydropower construction and a 6-month hiatus in new government capital expenditure in the transition to a new administration. The FY2020 current account deficit is estimated to fall to 13.4% of GDP even as the lower import trend reverses as government investment starts to pick up. This is because export revenue from full-year operation of Mangdechhu is forecast to be much larger.

A downside risk to growth forecasts would be any further delay in commissioning the Mangdechhu Hydropower Plant toward the end of FY2019.

Policy challenge—responding to fiscal pressures

Bhutan has made significant progress in improving its economy and reducing poverty over the past 3 decades, primarily driven by the public sector. Expenditure outlays, including current and capital expenditures in the Twelfth Five-Year Plan, have increased substantively from the previous plan by 38%, while foreign grants and domestic resource mobilization have not kept pace. As Bhutan prepares for graduation from United Nations least-developed-country status in 2023, the country will have limited access to concessional overseas development assistance. In addition, India will stop remitting an excise duty refund to Bhutan as part of the change to a GST regime from FY2019. Facing the fiscal pressures, over the next 5 years Bhutan aims to strengthen its tax system to mobilize larger domestic revenues to fund development expenditure.

The existing tax regime features low rates, a narrow base, and numerous incentives. Tax revenue, amounting to of 15.6% of GDP in FY2018, depends mainly on hydropower sales, which provide...
the bulk of corporate taxes (Figure 3.16.9). The ratio of tax to GDP is expected to decline for several years, however, owing to major delays in commissioning two large hydropower projects.

Hydropower development entails large fiscal swings, from very heavy expenses during construction to robust revenue flows upon commissioning. To accommodate such swings, a stabilization fund was established in November 2017 for setting aside at least 5% of hydropower revenue annually to be used during subsequent periods to smooth budgetary volatility and ensure more even distribution of expenditure. The completion of two large hydropower projects after FY2020 promises to sharply boost export revenue and contributions to the fund.

Toward comprehensive reform of the tax system, a GST regime is being planned for adoption in 2020. It will replace all indirect taxes with a tax rate that is uniformly applied to goods and services, allowing only a limited list of exemptions and items bearing higher tax rates. A standard value-added tax system is being considered, with tax crediting for inputs and mandatory business registration based on turnover. Such reform would be a major step forward for Bhutan, as it is one of only six economies in Asia and the Pacific that has not yet adopted a value-added tax.

Although fiscal incentives may encourage investors and stimulate private sector growth, they have been costly for the government. In 2017, foregone revenue amounted to about 17% of tax collected, mainly from indirect taxes, in particular on sales and from customs duty (Figure 3.16.10). The Fiscal Incentives Act, 2017 removed from the Ministry of Finance the authority to grant exemptions and tax holidays, making them subject instead to parliamentary debate and approval. Parliament would benefit from the establishment of a technical group to make assessments of requests to evaluate their net benefit to the country according to prescribed criteria. Counsel from the group would inform parliamentary debate and decisions on requests for tax incentives.

The large number of existing exemptions should be reduced to enable more revenue to be raised. Steering clear of tax holidays would likely be beneficial because, despite their ease of implementation, they lack transparency and invite tax avoidance. Removing tax holidays would not deter investors who see solid business opportunities but would discourage the entry of footloose opportunists ready to exit the market when the holiday ends. Further, the provision and administration of incentives should be simplified without compromising investment.

As a complement to revenue reform, public financial management needs further strengthening to ensure the proper collection and administration of revenue. A fully electronic system for government payments is currently being rolled out. However, room exists to improve the quality of reporting by making it more frequent and informative.