RHETORIC AND REALITY: AN ASSESSMENT OF THE IMPACT OF WTO ON BHUTAN*

TASHI WANGYEL**

Bhutan is currently witnessing unprecedented political and economic reforms. On the political front, there is a transition from a monarchy to a democratic system based on a written constitution. On the economic front, Bhutan has applied for membership in the World Trade Organization (WTO), indicating a desire and willingness to undertake broader economic reforms. Both these reforms will bring about dramatic transformation in the social, economic and political spheres. The government has also come to recognize that globalisation is inevitable and irreversible, and the benefits of economic integration will eventually outweigh the costs. Global economic integration is increasingly viewed as an economic and a political necessity rather than a matter of choice. This is evident in the growing membership of the WTO with 145 members and 30 countries in the process of accession.

Although the WTO is a trade related body with economic roots, its membership has wide ranging social and cultural ramifications for the member countries. Membership in the WTO will oblige Bhutan to liberalize its economy; pursue domestic economic reforms; frame and enact new legislations; establish institutions; and harmonize national laws, regulations and procedures to conform to the WTO agreements. Fulfillment of these requirements has proven to be prohibitively expensive for many developing countries and concomitant harmonization of domestic policies with the WTO agreements have also prompted mass protests and labour unrest in many countries.

On the other hand, the benefits of WTO membership arising from market access, dispute settlement mechanisms etc., are long term and diffused. Thus, there is a deep dichotomy between the theory and reality

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** Tashi Wangyal is an economist/planning officer at the Ministry of Finance. The views presented are the authors and do not reflect those of the Royal Government or the Ministry of Finance

of the benefits of WTO membership, in particular for small developing countries like Bhutan.

The orthodox proposition that free trade promotes economic growth and enhances welfare is also being questioned as the experience of many developing countries shows otherwise. Empirical evidence shows that the positive impact of WTO membership is contingent on the level of preparedness of the acceding country to compete and benefit from enhanced market access. Hence the impact of WTO membership on Bhutan- beneficial or adverse – will depend on its ability to reconcile the incongruity between the perceived benefits of free trade and its limited ability as a small developing country to reap the benefits.

While it is impossible to fully comprehend the impact of WTO membership on Bhutan, one can assess the likely impacts by delineating the benefits and obligations of WTO membership based on experiences of other countries. As the tangible impacts, beneficial or adverse, depends on Bhutan's level of preparedness for economic integration, some assessment can be made by understanding the strengths and weaknesses of the Bhutanese economy.

This paper will attempt to provide a broad theoretical assessment of the impact of WTO on Bhutan. The fist chapter will discuss broad theoretical benefits of WTO membership with regard to small countries. The second chapter will assess Bhutan's economy and economic policies pertaining to trade. The third chapter will discuss the impact of WTO membership on the industrial, agricultural and the service sectors and Intellectual Property Rights. It will also discuss the social and cultural impact of WTO membership on Bhutanese society.

The World Trade Organization

On the premise that free trade fosters economic growth, generates employment, enhances consumer choices, enables efficient allocation of resources and helps to maintain international peace the WTO aims to promote multilateral trade in goods and services. The main agreements include: the General Agreement on Trade and Tariffs (GATT); the General Agreement on Trade in Services (GATS) and the Trade Related Aspects of Intellectual Property Rights (TRIPS) and a host of associate and plurilateral agreements. The main functions of the WTO are: administering WTO agreements, providing a forum for trade negotiations, providing a mechanism for dispute settlement and reviewing periodic national trade policies.

The WTO agreements aim to create a "level playing field" in international trade by progressively reducing tariff levels and removing barriers to trade arising from national laws, regulations and administrative procedures. The GATT focuses on progressively liberalizing trade in goods. The GATS aims to promote trade in services by ensuring that national laws and regulations do not impose barriers to the flow of services among member countries. The TRIPS agreement sets the minimum standards to protect intellectual property rights. Under the WTO, multilateral trade is based on the principles of non-discrimination and reciprocity as enshrined in the clauses pertaining to Most Favored Nation (MFN) and National Treatment.

While a rule based multilateral trade agreement provides numerous benefits in terms of providing a stable and predictable trading environment, reducing transaction cost and enhancing market access, the developing countries contend that the WTO is biased in favor of the developed countries. Many developing countries are not able to benefit from the WTO, as the playing field is not level to begin with. Unlike developed countries that framed the WTO rules, the developing countries lack strong institutions, established procedures and economic resources to adequately participate in the WTO.

WTO membership is commercially meaningful only if Bhutan can reap the benefits of market access by gaining market entry. Successful economic integration is a factor of export competitiveness; an area where developing countries are significantly disadvantaged due to poor resource endowments, technological backwardness and unfavorable terms of trade etc. Small developing countries like Bhutan face even greater challenges in economic integration into the global markets due to constraints arising from its size, structural and locational disadvantages.

Small States and the WTO

Smallness in national unit-size carries both advantages and disadvantages: advantages in terms of social cohesion and mutual understanding, and hence in flexibility of response to external shocks, disadvantages in lack of diversification and in terms of the unit cost of infrastructure and some public goods (including human capital). Again, disadvantages in international bargaining power are apparent from smallness, whether in bilateral or multilateral negotiations, or vis-à-vis multinational corporations (MNCs); but again there are also advantages, in that concessions may be more readily secured simply because they are less costly to the counter party.

Current development theories contend that infrastructure and integration into the world economy are essential for economic development. Small countries like Bhutan face considerable challenges, as the cost of infrastructure provision is very high, and successful integration is constrained by several structural and locational problems associated with smallness and remoteness. The high costs of infrastructure provision makes small countries heavily dependent on external assistance for capital investments.

There is a paradoxical relationship between small states and international trade. On one hand, international trade makes it possible for a small country to exist and even thrive, as trade enables a country to be politically independent while depending on external trade for its economic needs. On the other hand, small developing countries as "price takers" in the global market often face adverse terms of trade and are highly vulnerable to exogenous shocks. Under modern economic conditions, some very small states are among the most prosperous national units; for example, Iceland, Singapore and Luxembourg share this advantage. Others appear barely viable; for example, Djibouti or Guinea-Bissau is in this position, and there are a large number of countries in between, which could grasp or let slip opportunities.[1]

Though cautious and gradual, Bhutan's social and economic modernization process has transformed Bhutanese society in many ways. Successful economic development polices, rising education levels, foreign trade, travel and the mass media have changed the people's perception from being very Bhutan-centric to having a more global outlook. National development priorities have also shifted from the creation of basic infrastructure to addressing relatively more complex economic issues such as economic diversification and employment generation.

In view of these dynamic changes, the state is compelled to look beyond national and regional boundaries to address the emerging economic needs in order to become a vibrant actor in the international arena. The government is convinced that globalisation is inevitable and irreversible, and that the benefits of economic liberalization will outweigh the costs in the long run. WTO membership is, therefore, viewed as an important means to attract foreign investment, boost the private sector, generate employment, enhance competitiveness of Bhutanese goods and services and diversify Bhutan's export markets.

Accession to the WTO: Benefits and Challenges

The WTO publications contend that membership confers numerous benefits to small developing countries by promoting a rule based trading system in order to create a "level playing field" for all members. The following is a summary of the main benefits of WTO membership:

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[1] Among small developing states, which have prospered in recent decades without specific advantages such as oil or other mineral wealth, are Fiji, Mauritius, Seychelles, and The Gambia.

Market access: WTO membership will confer Bhutan a stable and predictable access to the markets of other member countries based on the principles of reciprocity and non-discrimination. In accordance with the Most Favored Nation clause and the principle of "single undertaking," Bhutan can enjoy the benefits of multilateral trade without having to negotiate individual trade agreements with each and every member country. The National Treatment clause will ensure that Bhutanese goods are not discriminated against using tariff and non-tariff barriers. The MFN and national treatment clause are particularly of interest to small countries as they grant protection from unilateral pressures arising from larger countries.

Enabling Economic Reforms: Bhutan will have to make binding commitments and pursue economic reforms to ensure that its laws regulations and policies are non discriminatory, transparent and WTO consistent. For example, in many developing countries there are vested interest groups who have monopoly access to natural resources such as minerals, forest products and tourist resources. Such groups collect monopoly rents from privileged access and impose severe costs on the national economy.[2] External commitments often help governments to overcome such domestic anti-reform coalitions as other WTO member countries can contest such policies that are discriminatory and inconsistent with the WTO obligations.

Bridging the Credibility Gap: As a member of the WTO, Bhutan will have to pursue economic reforms and establish appropriate institutions to meet WTO obligations. This helps to overcome the credibility gap in attracting foreign investment as WTO membership provides a powerful guarantee of the governments policy direction.

Dispute Settlement Mechanism: The access to a rule based dispute settlement mechanism is recognized as one of the greatest benefits to small countries, as they can challenge even larger trading partners if the latter adopts measures that are non-consistent with the provisions of the WTO.

Shaping the future of Trade: Membership in the WTO will allow Bhutan a voice to help shape the future direction of international trade. This is particularly touted in the WTO as each country has one vote, symbolizing an egalitarian approach to decision making, unlike the World Bank and the International Monetary Fund where the votes are

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[2] Langhammer, R.J. & Lucke M., *WTO Negotiations and Accession Issues for Vulnerable Economies*, Discussion Paper 2001/36 United Nations University and World Institute for Development Economics Research. July 2001 page 3

weighted according to contributions, thus giving richer countries more power.

Freedom of Access: Though never an adequate substitute to good neighborly relations, Article V of the GATT provides freedom of access. This is of particular importance to landlocked countries such as Bhutan, Nepal, Laos and Cambodia.

Special and Differential Treatment for Developing Countries: WTO confers special and differential treatment (S&D) for developing and least developed countries (LDC). There are over 150 provisions covering a wide range of developing country concerns like greater market access in agriculture and manufacturing, flexibility in meeting WTO commitments including more time to meet WTO commitments, greater opportunities for safeguard measures to protect their economies and access to technical assistance. As Bhutan is still an LDC, early accession will enable Bhutan to benefit from the provisions of S&D treatment.

Technical Assistance: The WTO is a complex legal agreement, which requires skills in trade diplomacy as well the capacity to undertake complex negotiations. Small countries like Bhutan lack trained personnel who can adequately understand the legal, political and economic aspects of WTO membership and its obligations and rights.[3] An acceding country is often burdened with the need to coordinate legislations, trade policies, WTO related documentation; and work with government agencies, which can overwhelm existing staff. Considerable resources are also needed to prepare for accession negotiations. To tackle these issue, Bhutan can benefit from technical assistance offered by the WTO, UNESCAP, UNDP, UNCTAD, the Bretton Woods institutions and other bilateral donors.

While these benefits are compelling, the experience of many developing countries shows that there is a deep dichotomy between the theoretical benefits of WTO membership and the practical challenges of meeting WTO obligations. This is especially pertinent for small developing countries, which have limited financial and human resources.

Though important, market access is meaningless if countries cannot gain commercially by benefiting from market entry, which is in turn dependent on product competitiveness. Small economies like Bhutan cannot fully benefit from market access due to supply side constraints, diseconomies of scale, high transportation costs[4], and lack of export

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[3] ibid., p.9

[4] Estimates show that a median landlocked country pays 50% more in transportation costs than the median coastal country. Hausman, Ricardo, "Prisoners of Geography" *Foreign Policy,* January 2001.

diversification. (This issue will be dealt in detail in Chapter 2). On the other hand, the reciprocal nature of the WTO agreement implies that Bhutan must provide market access to other countries through progressive tariff reduction. This will lead to increase in imports, and enhance short-term current account deficits heightening external vulnerability if exports cannot be enhanced proportionately.

One of the primary obligations of WTO membership for Bhutan will be the harmonization of Bhutan's national laws, regulations and administrative procedures with the WTO agreements. Under the GATT, Bhutan must make tariff-binding commitments, and also progressively liberalize the services sector as per the GATS commitment. In accordance with the TRIPS, Bhutan must ensure that domestic laws provide at least a minimum protection for intellectual property rights. The existing laws pertaining to intellectual property rights are basic and there is a need to enact additional legislations to meet WTO requirements. Bhutan will also be required to establish appropriate institutions to meet WTO requirements for Sanitary and Phyto Sanitary measures as well as Technical Standards and Customs procedures. Estimates show that the total cost of compliance is about US$130 million for developing countries.[5]

Membership in the WTO, it is claimed, will enhance Bhutan's credibility and attract foreign investors to Bhutan. While such credibility is necessary, it is not a sufficient condition to attract investment as investors look for high returns to capital, access to cheap factors of production, flexible labor markets and access to large markets. Foreign investors will be mainly attracted to power intensive industries and tourism sectors, as Bhutan offers comparative advantages in these areas.

The dispute settlement mechanism appears to be one of the biggest benefits for small developing countries that lack bargaining power in international organizations. In practice, this mechanism has limited use for small countries because the ultimate tool of enforcement of rights and obligations is trade retaliation. The costs of retaliation are proportionately higher for the small economies as they could lose a large export market compared to the larger economies whose exports to the small economies are nominal.[6] Furthermore, it is expensive for developing countries to pursue dispute settlement, as they have to hire trade lawyers from private firms. The minimum cost for hiring the services of trade lawyers

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[5] Finger, J.M. & Schuller P. (1998) *Implementation of Uruguay Round Commitments: The Development Challenges*. World Bank Research Department, Washington DC.

[6] Although Ecuador won the Banana dispute with the European Union, the former did not impose the authorized sanctions of more than US$ 200 million as it would have been a "pinprick" for European exporters, while substantially raising the cost of essential imports from the EU.

is estimated at US$ 300,000.[7] This is prohibitively expensive for a small country like Bhutan.

The notion that each member has one vote and that even small members have an equal voice in shaping the course of future trade can appeal to small developing countries with limited bargaining power. However, evidence shows that the views and interests of the "quad" comprising of the US, Canada, EU and Japan dominate the decisions. Most recently UNDP in its *Human Development Report 2002,* criticized the WTO for its undemocratic decision making process, where major decisions are taken by a few powerful countries in the "green room".[8] Furthermore, most small, developing countries lack financial and human resources and have limited opportunities to participate in the numerous WTO meetings. In an institution where all concessions are obtained through negotiations, limited resources constrain the ability of small developing countries to benefit from the WTO.

Many countries have also realized that the special and differential (S&D) treatment accorded to the developing countries and the LDCs are inadequate to compensate for the structural and economic disadvantages faced by developing countries in international trade. The S&D concessions lack any substantive assistance to compensate for the disadvantages faced by developing countries and merely provide an extension of time for implementing WTO obligations.

The WTO does not have a standard procedure for accession. Article XII of the WTO only provides a broad outline for the rules of accession. Thus the specific terms of accession are negotiated between the applicant and the incumbent member countries. Although this provides a degree of flexibility, the lack of a clear accession procedure has proven problematic for many countries. For example, some acceding developing countries have been asked to bind all tariffs, while the incumbents have relatively high shares of their non-agriculture tariff lines unbound.[9] The stalled accession of Vanuatu due to a stalemate in the negotiations with the United States on issues related to tariff binding and opening of the telecom sector, is an example of the vulnerabilities of acceding countries to the pressures of incumbent members.[10] Thus, the terms of accession

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[7] Williams Frances, "WTO minnows cry foul on Mediation" *Financial Times*, October 24, 2002.

[8] *Human Development Report 2002*, United Nations Development Program, New York

[9] Bachaetta, M., & Drabek, Z. *Effects of WTO Accession on Policy Making in Sovereign States: Preliminary lessons from the recent experience of transition countries*. Staff Working Paper DERD 2002-2003 WTO.

[10] Grynberg, R.& Mickey Joy, R. "The Accession of Vanuatu to the WTP: Lessons for the Multilateral Trading System" in *WTO Accession and Development Policies*, UNCTAD, Geneva 2001.

for Bhutan will depend on the list of demands placed on Bhutan and the ability to negotiate effectively with incumbent members.

The above examples show that there is deep incongruity between the theoretical benefits and the realities of small countries in the WTO system. The obligations of membership are mandatory and impose heavy financial and social costs. Likewise, the rights and benefits from WTO membership are diffused, long term and often biased against the interest of small developing countries. Practical benefits such as market access are contingent on efficiency and cost competitiveness, of which developing countries and LDCs by definition are lacking. Furthermore, the ability to exercise the rights conferred by WTO membership is dependent on the availability of financial and human resources and the economic clout of a country.

Most developing countries cannot fully utilize the opportunities offered by trade liberalization due to economic backwardness and lack of economic diversification, weak institutions and lack of trained personnel to deal with complex multilateral trade issues. Moreover, developed countries are better positioned to take full advantage of concessions and market access given by the WTO as they have framed the rules of the WTO and also dominate future plans of action.

Hence the benefits of WTO membership and trade liberalization are dependent on the level of economic preparedness of a country.[11] For example, trade liberalization in the 1980s benefited the East Asian Tiger Economies, but many other developing countries were adversely affected. The UNCTAD Trade and Development Report 1999, found that for developing countries (except for China,) the average trade deficit in the 1990s was 3 percentage points of GDP higher than the 1970s while the average growth rate was lower by 2 percentage points. The faster increase in the trade deficit is attributed to a combination of declining terms of trade, slow growth, in industrial countries, and "big bang" liberalization of trade and capital accounts in developing countries. This reinforces the point that WTO membership and trade liberalization is not a panacea for a country's economic problems. It is more likely to magnify any existing structural weaknesses if countries do not take measures to strengthen their domestic economies, in particular their private sectors.

Impact of WTO Accession

Trade liberalization has a profound impact on the allocation of economic resources as well as distribution of income. On the import side,

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[11] Khor M. *Globalisation and the South: Some Critical Issues* UNCTAD Discussion Paper 147, Geneva, April 2001.

trade liberalization increases competition for domestic firms. On the export side, removal of export taxes and other incentives can create new market opportunities. Trade is beneficial for sectors that are efficient, competitive and able to adjust to new market competition, while it could adversely affects the weak sectors of the economy that lack the capacity to adjust to the new competitive circumstances. WTO membership and economic liberalization often lead to mass protests in countries like China and India, which have large public sector enterprises, protected markets and strong labour unions.

Accession to the WTO signifies Bhutan's willingness to conform its domestic laws, regulations and administrative procedures, particularly those pertaining to trade, to WTO agreements. Hence, WTO membership will have wide ranging implications for Bhutan as the economy is liberalized to foreign competition and domestic laws and regulations are subject to external scrutiny. The major WTO obligations include: tariff binding; elimination of non-tariff barriers, removal of subsidies, harmonization of laws and regulations and harmonization of sanitary and phytosanitary standards.

The impact of WTO membership on Bhutan will depend on Bhutan's ability to reap the opportunities offered by trade liberalization and manage the changes induced by WTO membership. Hence, it is important to understand Bhutan's economic realities including the resource endowments, the characteristics of the external sector and the economic policy environment to assess the impact of WTO on Bhutan.

Bhutan's Economic Realities

While Bhutan has achieved significant socio-economic progress in the last few decades, the progress in the real economic sector has not been as impressive. Apart from donor funded infrastructure works and establishment of a handful of government initiated power intensive industries, there has been minimal growth in the manufacturing sector. Rapid social development and population growth coupled with weak growth in the private sector has led to the emergence of new concerns like unemployment and the need for economic diversification.

The GDP growth, estimated at about 6-7% per annum, is largely driven by the hydropower sector and the transport and construction sectors related to construction of large hydropower projects and donor funded infrastructure projects.

2.a.1 The Economic Structure

With a population of about 0.7 million people, land area of 47000 sq Kms, and an estimated GDP of about Nu. 25 billion (US$ 518 million, 2001) Bhutan is a small economy by all measures.[12]

Table 12. Sectoral Share in the GDP in 1980 prices

Sectors	1980	1990	2001	GDP Growth 2001
Agriculture	55.7	44.1	32.9	3.2
Mining and Quarrying	0.6	0.9	1.3	19.4
Manufacturing	3.2	7.0	7.1	7.3
Electricity	0.2	9.1	10.2	12.3
Construction	7.9	6.1	12.1	17.5
Wholesale and Retail trade, hotels and restaurants	10.9	6.0	5.8	7.2
Transport and Communications	4.3	7.6	9.6	4.0
Finance, insurance and real estate	6.3	9.4	10.5	8.8
Community and social services (govt)	10.8	9.9	10.5	6.4
Total	100	100	100	6.6

Source: Central Statistical Organization, National Accounts Statistics Report 2002, Thimphu

Like many small countries, Bhutan's public sector is dominant due to late modernization, a weak private sector, costly infrastructure and the need to provide numerous public services that are indivisible. Government expenditure accounts for almost half the GDP and donor financed capital investments represent almost half the government expenditure. The civil service is a major source of formal sector employment and the construction sector is dependent on contracts related to government or donor-funded activities.

While structural changes have occurred in the last two decades, the modern economic sector has neither diversified nor experienced significant growth as seen in the table above. An assessment of the factors

[12] Population and land area reflect size of economic endowments, GDP reflects market size and is an indicator for domestic demand.

of production is also revealing as Bhutan faces a labour shortage which makes labour expensive[13], land scarcity and a lack of adequate capital. The high cost of non-tradables like land and infrastructure in Bhutan is a barrier to competitiveness. While construction materials such as sand, stones and wood are abundant in nature, lack of transparent licensing system, bureaucratic rent seeking behavior, and stringent environmental requirements have led to exorbitant price increases resulting in rising costs for infrastructure development.

The rudimentary domestic transport infrastructure and Bhutan's landlocked geography impose high transportation costs, posing a significant barrier to competitiveness for Bhutanese goods. Kolkota, India, the nearest seaport, is about 700 miles from Bhutan. As most exports comprise of low value added bulky commodities like mineral products or perishable agriculture produce, cheap and efficient transport is essential. Air transport is also limited due to a small fleet of two aircrafts and the operational and geographic limitations of the only airport at Paro.

A strong and vibrant financial sector is a prerequisite for private sector development. However, the financial sector in Bhutan is small, comprising of two commercial banks, and two non-bank financial institutions (this includes an insurance company and a development bank). Financial intermediation in these institutions is limited to simple lending and deposit operations. In the recent past, the financial sector has been experiencing excess liquidity due to lack of investment opportunities in Bhutan. This is attributed, in part, to high interest rates, high collateral requirements, and conservative lending practices with limited products on offer from the banks.[14]

The narrow domestic resource endowments and lack of economies of scale have severely limited the industrialization process. The government aims to attract foreign direct investment (FDI) to establish export-oriented industries such as light electronics. However, the high import contents of such assembly line products require skilled labour and reliable transport networks as for "just in time" production systems both areas where Bhutan lacks competitiveness.

Hydroelectricity is the main economic resource of Bhutan, with a potential to generate 30,000 mw of electricity. Currently Bhutan has an installed capacity to generate 420 mw of electricity. This sector comprises

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[13] Although there is no minimum wage rate, the administered wage rates of employees in the national work force (engaged in publicly funded infrastructure projects) has become the de-facto-minimum wage for the private sector also. Thus wages are not closely related to productivity.

[14] World Bank, *BHUTAN Private Sector Survey, 2002*

11 % of GDP and accounts for 45% of the total domestic revenue the single largest source of domestic revenue, amounting to Nu.1,818.5 million (US$ 39.2 million) in 2001. The dominance of this sector will increase with the commissioning of the 1020 mw Tala Project in 2005. Almost 90% of the electricity currently generated is exported to India and the exports tariffs are bilaterally negotiated at a political level. Payments are received in Indian Rupees.

Table 13. Comparative Electricity Prices in South Asia for Industrial Usage

Country/city	Price per kw hour
BHUTAN	1.7
INDIA	
Delhi	7.7
West Bengal	7.2
Assam	7.6
Bihar	5.6
PAKISTAN	6.2
BANGLADESH	6.1
NEPAL	8.2
SRI LANKA	6.1

(Prices in US Cents per kw hour)

Source: World Bank, BHUTAN Private Sector Survey 2002

The excessive economic dependence on the hydropower sector and market concentration in a single market expose Bhutan to external economic shocks arising from political or geo-structural sources. Further, the hydropower sector itself can neither generate employment nor have backward linkage effects in the economy. The availability of cheap electricity has, however, led to development of certain power intensive industries in the towns bordering India.

The advantages for the private sector include: free access to the large Indian market, access to cheap labor from India, stable labor relations and labor market flexibility, low electricity prices, and good governance in the country. As Bhutan is in the early process of modernization and marketisation, most of the laws required in a modern market economy are still being framed. Therefore, unlike the transition economies. Bhutan does not have to undergo the cumbersome process of reforming existing laws and procedures from a different system to be WTO consistent.

2.a.2 The External Sector

Like many small economies, Bhutan has a highly open and trade dependent economy with trade comprising 65% of GDP. The bilateral trade with India dominates Bhutan's external trade signifying limited diversification of export markets. This creates a mismatch between the import and exports from third countries, as 20% of imports are denominated in convertible currency, while less than 5% of exports earn convertible currency. Thus, the direction of trade has several policy implications for foreign exchange and foreign direct investment policies.

Table 14. Direction of Trade

Nu in millions				**US $ in millions**	**As percent**
	1998	1999	2000	2000	2000
Exports					
India	4,175.64	4,711.22	4,376.95	97.40	94.83
Bangladesh	194.68	209.45	164.77	3.67	3.57
Others	85.30	67.29	74.10	1.65	1.61
Total	4,455.62	4,987.96	4,615.82	102.71	100.00
Imports					
India	3,620.00	5,845.28	7,462.60	166.06	81.95
Japan	410.23	260.36	305.21	6.79	3.35
Germany	72.02	0.00	28.29	0.63	0.31
United States	42.72	22.44	34.33	0.76	0.38
United Kingdom	33.17	31.28	205.41	4.57	2.26
Singapore	398.34	997.88	251.36	5.59	2.76
Thailand*			105.84	2.36	1.16
China*			71.78	1.60	0.79
Bangladesh*			49.26	1.10	0.54
Nepal*			24.66	0.55	0.27
Others	939.90	677.64	567.55	12.63	6.23
Total	**5,516.37**	**7,834.88**	**9,106.29**	**202.63**	**100.00**

* Till 2000 the data for these countries have been included in others.

Source: Department of Revenue and Customs, Bhutan Trade Statistics 2000, Thimphu, 2002

The Bilateral Free Trade Agreement governs trade in goods between India and Bhutan and all transactions are conducted in Indian Rupees and the Ngultrum. The Ngultrum is pegged to the Indian Rupee at parity and the Indian Rupee circulates freely in Bhutan. While such an arrangement restricts independent monetary policy, creates trade diversion and has disadvantages of being pegged to a non reserve currency, the advantages, including the provision for a platform for stable trade with India, currently outweigh the costs.

Sale of electricity comprises almost 50% of the exports to India. Because of increased electricity tariffs and higher volume of electricity sales, Bhutan has experienced a positive balance of trade with India since 1996. There was a sharp reversal in the trend in 1999 with increased imports of machinery for large power projects at Tala and Kurichu. Other major exports include mineral and chemical products, wood and wood products, fresh fruits and vegetables. Imports from India include chemicals, minerals and products, and heavy machinery that are used in the industries and construction of hydropower plants. Bhutan also imports most of its consumer goods from India.

Although the discriminatory nature of such a free trade agreement contradicts the MFN principle, GATT Article XXIV allows such arrangements if it facilitates trade, while minimizing the adverse impact on their trade with other WTO members. The WTO members can examine such trade agreements periodically to ensure transparency and consistency with WTO rules.

Bhutan also has a Preferential Trade Agreement 1980, with Bangladesh, the second largest export market for Bhutan accounting for 4% of exports and less than 1% of its imports. Trade with Bangladesh is denominated in US dollars. In 2001-02, imports from Bangladesh amounted to US$1.7 million, while exports to Bangladesh was US$ 4.5 million resulting a trade surplus. The major exports included fresh fruits, vegetables and minerals and imports included garments and other consumables. Apart from tourism, the earnings from exports to Bangladesh comprise a major source of hard currency.

In the recent past, some contentious issues have arisen between Bhutan and Bangladesh trade. In the early years, the two countries waived off full duty on imports from each other. However, in 1992 Bangladesh applied 50% of leviable duty on products from Bhutan in addition to supplementary duty and added income tax, raising the effective duty rates on products of interest to Bhutan such as apples and oranges to 52.9%. Bangladesh contends that as a member of WTO they cannot grant full preferential access to Bhutan, once Bhutan becomes a WTO member; as it would violate the MFN principle unless such concessions are granted to all other members of the WTO. In order to overcome this issue, a free trade agreement is to be negotiated with Bangladesh.

While Bhutan is a signatory to the South Asian Preferential Trade Agreement (SAPTA) there has been minimal progress on this front. This is apparent in the fact that intra SAARC trade accounts for less than 5% of the regions share in world trade.[15] This is attributed to the lack of trade complementarities, the economic dominance of India, poor infrastructure and Indo-Pakistan tensions, among other factors.

The volume of imports from third countries (such as Japan, Singapore, US and Thailand) has increased in the recent years. Imports from Thailand have almost tripled from Nu.105 million in 2000 to almost Nu. 290 million in 2001, and this trend is expected to continue. The major import items from third countries include motor vehicles, computers, and other manufactured and consumer goods as shown in appendix 2. For a small economy, even the purchase of a single item can have a visible impact on the trade statistics. Imports from countries like Germany are directly related to development aid as seen in the table above. Similarly, there was a one time marked increase in imports from UK in 2000. This is mainly on account of the purchase of aircraft spare parts for the national airlines from British Aerospace.

One of the major consequences of WTO membership will be Bhutan's obligation to trade with China on an MFN basis. Currently, there are no direct trade relations with China, as most merchandise trade is carried through the sea route via Hong Kong and Kolkota. The establishment of trade relations with the giant northern neighbor will have tremendous economic and social impact if direct trade routes are opened through the Himalayan passes. Assuming a stable trade and transit route on land via Nepal and India, imports from China will provide direct competition to Indian merchandise. However, the advantages of cheaper imports could be significantly reduced for Bhutan if the payments for imports from China have to be made in convertible currency.

Although there are several structural limitations and external sector vulnerabilities, the government has followed prudent policies to ensure a sound macroeconomic environment. Bhutan pursues a conservative fiscal policy. Domestic revenues have to meet recurrent expenditure and

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[15] Kanes, "Future of SAPTA" *The Island/ Upali*, 14/4/02 , www.origin.island.lk

capital expenditure is largely determined by the availability of external assistance. The external debt is mainly comprised of government borrowings from the Government of India for the power projects and from the multilateral financial institutions for investment in priority infrastructure works such as roads, schools, education and infrastructure. The total outstanding debt is US $ 331.7 million, of which 55 % is comprised of Indian Rupee loans. The remaining US$ 147.9 m is in convertible currency. The debt service ratio is at 3.5%.[16]

The balance of payments is an important indicator of a country's economic performance and is particularly relevant for small countries like Bhutan with high exposure to the international economy through openness to trade.

[16] Royal Monetary Authority, *Selected Economic Indicators 2002*, Thimphu

Table 15: Balance of Payments

	Millions of Nu		
Item	1999	22000	2001
A. CURRENT ACCOUNT	1130.0	44.1	-406.5
Goods	-3087.3	-490.4	-4371.7
Exports	4987.9	4615.8	4708.6
Imports	-8075.2	-106.3	-9080.3
Services (Financial, travel, govt service, transport, communication, posts, insurance)	-465.8	-55.2	-17.6
Credit	828	1570.3	1530.3
Debit	-1293.9	-625.5	-1547.9
Income (deposits,)	451.9	622.8	372.2
Credit deposits	550.4	718.5	436.3
Debit (debt servicing)	-98.5	-95.7	-109.1
Current Transfers	4231.5	3966.9	3655.7
Credit (grant aid, trust funds)	7547.9	7018.2	6956.9
Debit (worker remittance, aid related remittance)	-3316.6	-051.3	-3301.2
B. CAPITAL ACCOUNT	811.4	2308.6	2849.5
Foreign Direct Investment	0.0	0.0	86.8
Net Official Flows (concessional loans)	811.4	2308.6	2762.7
Other Loans	0.0	0.0	0.0
C.Net Errors and Omissions	-352.3	-228.7	-777.1
D. OVERALL BALANCE	1589.1	1124.1	1665.9

Source: Royal Monetary Authority, Selected Economic Indicators 2001

Although Bhutan has experienced persistent deficits on the merchandise and services account, the capital account has been in surplus due to the inflow of external aid and on account of concessional loans. Though the balance of payments is positive, such a position is not sustainable if economic productivity and export competitiveness are not enhanced in the real sector. Currently the imports are funded mainly through aid and loans.

The gross international reserves stand at US$322.7 million, of which 253 million is denominated in US dollars and the rest in Indian Rupees.[17] The total reserves are estimated to support 20 months of imports, which by international norm is more than adequate. However, these reserves have been built over time with savings from foreign aid and loans since convertible currency export earnings are only a quarter of the outflows for imports. The foreign currency reserves form an important insurance for a small country like Bhutan, which faces external sector vulnerability.

2.a.3 Economic Policy Environment

Benefits of WTO membership will only accrue if Bhutan's exports are competitive in the world market. Therefore, a vibrant private sector is a pre-requisite for successful economic integration. As constraints like smallness and location cannot be changed, enabling a policy environment for the private sector is of utmost importance. Since the 1980s the government has pursued several privatization, divestment and demonopolisation policies. Several tax incentives have also been introduced to encourage investment in manufacturing and services sectors.

Various efforts are underway to increase exports that earn convertible currency, given the limited diversification of trade. For example, the government has waived off Corporate and Business Income Tax for the income earned in convertible currency, for manufacturing units and information technology industries or services and agriculture produce.[18]

The private sector on the other hand contends that the existing regulations and policies are restrictive.[19] The main concerns relate to the restrictive labour policy and the bureaucratic burden. Due to the shortage of skilled domestic labour, over 50,000 Indians are employed in Bhutan in the construction sector. The government, on the other hand, has adopted strict limits on the number of imported laborers allowed due to political compulsions. However, such labour restrictions adversely affect competitiveness of Bhutanese products as Bhutan lacks other sources of comparative advantage. The lack of consistency in government policies

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[17] Royal Monetary Authority, *Monthly Statistical Bulletin*, Thimphu, January 2003 p. 5

[18] ibid

[19] Detailed discussion is presented in World Bank, *Bhutan Private Sector Survey 2002*.

relating to labour, taxation and licensing is also perceived as a constraint by the private sector.

On the other hand, due to economic weaknesses and vulnerabilities on the external front, the government has been compelled to adopt cautious and conservative policies pertaining to foreign exchange, foreign direct investment and taxes. While these policies reflect the economic realities of Bhutan, WTO membership will impact on the provisions that are not consistent with the WTO agreement.

2.a.4 The Foreign Exchange Regime

While there is full convertibility between the Ngultrum and Rupee on the current account, restrictions apply on capital account transactions. However, there are restrictions on both the current and capital account convertibility with regard to other currencies. Foreign exchange controls on current account apply to traders and holiday travelers, although this is to be revised to eventually abandon the control. The four categories of current account controls include: ceilings on amount of foreign exchange that commercial banks can hold; limits on foreign exchange requirements for importers; limits on foreign exchange earnings exporters can retain in foreign currency; and limits on foreign currency that business people or private travelers can take out of the country.

Capital account controls relate to investment and borrowings abroad and include controls on foreign direct investment; offshore investment and borrowings. The offshore investors have to obtain permission from the Royal Monetary Authority to invest or borrow from abroad.

2.a.5 The Foreign Direct Investment Policy

In December 2002, the government approved the Foreign Direct Investment (FDI) Policy with a view to foster private sector development, generate employment, enable transfer of capital, technology and skills and enhance convertible currency earnings. In the case of Bhutan, FDI is understood as investments made in convertible currency only. Prior to the policy, limited foreign investment was allowed into the banking, tourism and industrial sector on a "case by case basis." The table below shows existing foreign investment in Bhutan.

Table 16: Summary of Foreign Investment in Bhutan[20]

Sector	Local Partner (LP)	Foreign Partner (FP)	Year	Ownership distribution		
				FP	LP	Public
Finance	BoB	State Bank of India	1971	20	80	0
Manufacturing	BFAL	Marubeni Corp (Japan)	1990	20	40.12	39.88
Finance	BNB	Asian Dev Bank	1996	20.1	27.2	52.77
Tourism	BTCL	Aman Resorts (Singapore)	2001	60	30	10
Tourism	BIC	M?s HPL (Singapore)	2001	60	30	10

Source: Monthly Statistical Bulletin, Royal Monetary Authority, Thimphu, Bhutan, January 2003

The FDI Policy sets the broad parameters for foreign investors by delineating areas and size of investments, skills transfer requirements, and the need to comply with the Foreign Exchange Regulations. Section 7 (a) relating to Foreign Exchange Regulations stipulates the following: foreign currency requirements for import of capital goods be met out of foreign equity, repatriation of profits and dividends must be balanced by net foreign exchange earnings, and repayment for foreign currency loans shall be permitted subject to prior approval of the loan by the government.[21] (A full list of the sectors open for foreign investment is attached in Annexure 1).

While the adoption of an FDI policy is significant, it is still deemed conservative. This reflects the cautious approach of the government to ensure that local entrepreneurs are not unduly disadvantaged. Considering the small Bhutanese market and few comparative advantages that Bhutan offers, it is unlikely that foreign investors will rush into Bhutan apart from limited sectors such as tourism and power intensive industries.

Although FDI will be important to promote export-oriented industries, the structural and locational constraints place severe limitations on its success. While access to the vast Indian market, via

[20] BoB: Bank of Bhutan; BFAL: Bhutan Ferro Alloys Limited; BNB: Bhutan National Bank; BTCL Bhutan Tourism Corporation Limited; BIC : Bhutan International Company.

[21] Royal Government of Bhutan, *Foreign Direct Investment Policy*, December 2002 p. 5

Bhutan, would have been an attraction even a few years ago, the economic liberalization process in India makes such a move unnecessary today. Given the geographic realities, India will remain the most important market for Bhutanese products. The non-convertibility of the Indian Rupee on the capital account will constrain potential foreign investors from investing in Bhutan.

2.a.6 The Tariff Regime

As Bhutan is an import dependent economy, there has been minimal compulsion to protect the domestic economy with import tariffs or quantitative restrictions. The tariff regime comprises of the Bhutan Sales Tax (BST) and the Customs Duty. The BST is imposed on all imports and on the sales of hotels, restaurants and cement. The BST rate ranges from 0-15 % with higher rates of 50 % applied on alcoholic and tobacco products. In accordance with the Free Trade Agreement with India, the Indian exporters can claim the BST as a rebate against the Indian Sales Tax, hence nullifying the impact of BST on Indian imports.

The customs duty has five non zero rates, namely: 10, 20, 30 and 50% for non-alcoholic beverages and beer and 100 % for tobacco and alcoholic beverages. The customs duties for most goods fall in the 10-30 % range. Import of raw materials is exempt from the BST. Customs duty is exempt on imports of industrial plant, machineries, their spare parts and raw materials if the final product has at least 40% value addition and/or the convertible currency earned by the company during the year covers at least the cost of the raw materials. Bhutan's tariff rate on import of industrial products is well within the 20-40 % range as applied to such products in most developing countries.[22]

Unlike many countries, which depend on import duty for a substantial portion of national revenue, the proceeds from import duties are nominal at less than 2% of the total revenue. Customs duty is used to discourage import of products like alcohol and tobacco and to conserve convertible currency reserves by controlling the import of luxury goods from third countries whose payments require hard currency.

However certain GATT consistent quantitative restrictions, as allowed under Article XX, are imposed in Bhutan for import of the following products: arms and ammunitions; explosives; endangered animal and plant species; banned chemicals; hazardous scraps; secondhand vehicles; gold and silver; plastic carry bags; and drugs and pharmaceutical products. Similarly there are export restrictions on

[22] GATT Secretariat, "The Results of the Uruguay Round of Multilateral Trade Negotiations, market access for goods and services: overview of the results", November 1994

endangered plants and animal species; antiques; narcotics and psychotropic substances and raw timber. Quota restrictions apply on import of LPG gas and Kerosene although this will be discontinued in the near future.

Gatt and the Impact on Trade in Goods

The impacts of multilateral trade on Bhutan's economy will be transmitted via the following avenues:

Impact of foreign competition on domestic firms;

Impact on export performance arising from greater market access opportunities;

Impact on Domestic Laws and Regulations due to WTO Obligations

To realize the gains from market access, Bhutanese products will have to become cost competitive and penetrate new markets. Competitiveness is dependent on specialization and technology, both of which are lacking in Bhutan. Although Bhutan, as a LDC, already has the opportunity to export at zero tariffs to many countries, it has not been able to diversify its markets due to structural and supply side constraints. Therefore, it is unlikely that WTO membership will help Bhutan if adequate steps are not taken to pursue domestic economic reforms and strengthen the private sector.

At this point in time it is not possible to assess the impact of WTO on Bhutan's agriculture, industries and services sectors as the depth of liberalization is dependent on bilateral negotiations conducted between Bhutan and the incumbent WTO members. Therefore this study will provide a broad theoretical assessment of the impacts of WTO accession on the various sectors and the economy.

3.a Impact on the Industrial Sector

Under the GATT, members have to make substantive obligations including removal of non-tariff barriers, elimination of trade distorting measures such as subsides, and adoption of progressive tariff bindings in trade in goods. Bhutan has a small industrial sector (including manufacturing and mining) dependent on processing agriculture, mineral and wood based industries as shown in Table 17 below. This sector employs about 12,500 people, which is about 5% of the labour force.[23]

Table 17: Licenses in Manufacturing Sector

[23] Central Statistical Organisation, *Labour Force Survey*, Thimphu 1999

Sub-sector/Type	Total Licenses	Employment %
Agro-based	116	20
Forest (Wood)-based	317	18
Mineral-based	46	47
Others	90	18
Total	569	100

Source: Ministry of Trade and Industries 2002.

There are a few large-scale energy intensive industries that process cement, calcium carbide and Ferro silicon. As electricity comprises almost 60% of the cost of production in the case of ferro silicon, cement and calcium carbide, these industries derive comparative advantage from the availability of cheap and reliable hydroelectric power. Most of these products are exported to India as shown in Annexure II. The recently established Coca-Cola bottling unit also exports 90% of its products to the Indian market.[24]

Trade liberalization through the WTO seeks to reduce tariffs, remove quantitative restrictions and thereby exposes domestic industries to foreign competition. In the case of Bhutan almost all consumer goods and manufactured products are imported with India as the dominant source for these imports. Given the high import dependence, and lack of a viable domestic manufacturing sector, there has been minimal compulsion to protect the manufacturing sector. This is evident in the fact that customs levies accounts for less than 2% of the total domestic revenue.

Table 18 below is indicative of the duty and tax imposed on goods similar to those that are manufactured in Bhutan.

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[24]SourcetheFinancialExpress:
http://www.financialexpress.com/fe_full_story.php?content_id=27571

Table 18. Comparison of tariff levels on products of interest to Bhutan

	BHUTAN			INDIA
Products	**Sales Tax**	**Customs Duty**	**Total Tariff**	**Total Tariff ***
Cement	5	20	25	30
Calcium Carbide	5	10	15	30
Ferro Silicon	-	5	5	30
Particle Board	10	20	30	30
Wooden Furniture	10	30	40	30
Distillery products	50	100	150	182
Polythene Pipes	10	0	10	30
Plaster of Paris	10	30	40	25
Plywood	20	5	25	30
Polymer products	0	10	10	30

*This does not include the various state taxes and supplementary charges. In the case of Calcium Carbide and Ferro Silicon the applicable antidumping duties that are not included.

Sources: Department of Revenue and Customs, Bhutan Trade Classification Customs Tariff and Sales Tax Schedule January 2002 and Centax Publications Customs Tariff of India 2002-2003, 35th Edition, New Delhi

As shown in the above table, tariffs are applicable on imports that compete with the domestic industries. The Indian imports can, however, claim a rebate on the BST based on the Free Trade Agreement with India. Thus Bhutanese firms are effectively in competition with Indian firms as most of the above listed manufactured goods are destined for export to the Indian market (see Appendix 2). The Bhutanese firms enjoy comparative advantage arising from cheap hydropower and ready availability of minerals and forest products.

Given the high level of integration with the Indian market, the pace of liberalization in India will have a greater impact on the performance of these industries compared to the impact of Bhutan's accession to the WTO. For example, there were concerns that calcium carbide exports from China were driving down the price in India, thereby posing a threat to Bhutan's calcium carbide exports. In 2000, India imposed antidumping duty on calcium carbide originating from China and Romania at a rate of US$ 13.88 and US$ 24.29 per metric tonne respectively.[25] Similarly ferro

[25] Notification 77/2000- CUS; date 26-5-2000, *Customs Tariff of India 2002-2003*, Centax Publications, 35th Edition, New Delhi

silicon originating from China and Russia is subject to an antidumping duty of US$ 764 per metric tonne.[26] This has shielded the prospects of two major industries, which continue to enjoy access to a protected market in India.

WTO member countries could in future contest that industries in Bhutan receive electricity subsidy.[27] Similarly, tax exemptions granted for industries that earn convertible currency can also be contested as an export subsidy. However, as a LDC, Bhutan would be exempt from the rule prohibiting subsidies till it reaches export competitiveness.[28]

In most cases, trade liberalization helps to lower the cost of imported inputs thereby increasing the competitiveness of exports. However in Bhutan most inputs, including plant and machinery are exempt from sales tax and customs duty. Raw materials imported from India are already exempt from the BST and raw materials imported from third countries are exempt from customs duty if the firm earns convertible currency.[29]

As the existing manufactured or semi-manufactured products are bulky and have low value added component, any competitiveness -in third country markets- due to comparative advantage of cheap energy will be offset by the high transportation costs. Therefore, it is likely that India will remain a major trade partner for Bhutan. However, it is imperative to adopt export-oriented policies to capture the benefits of market access and diversification.

Unlike the above large scale industries dependent on the Indian markets, there are numerous small and medium scale enterprises (SMEs) that mainly serve the domestic market. An example is the small and medium scale wood based industries comprising of 56 sawmills and 65 furniture workshops. Other SMEs include handicrafts, handmade paper and incense manufacturing.

In the case of wood based industries, Bhutan enjoys a comparative advantage in the availability of cheap timber at prices ranging from US$ 65-102/m^3 compared to international prices of US$ 126-238/m^3. The labour costs are also competitive at US$ 89 per month compared to $136

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[26] Notification no. 672001 cus dated 25-6-2001

[27] As per the WTO definition a subsidy is granted when a government confers a benefit by providing goods or service for less than the prevailing market price.

[28] A country is said to have reached export competitiveness in a product if it has attained a share in the world market of 3.25% for two consecutive years. *Business Guide to the World Trading System,* International Trade Center, Geneva 1999, p. 130

[29] Ministry of Finance, *National Budget Report, 2002-2003*, Bhutan June 2002

in Bangladesh and US$ 156 in the Philippines.[30] However, the lack of technology, lack of economies of scale and low productivity levels means Bhutan cannot compete effectively with imported furniture from Thailand, despite high tariffs of 40% tariff levels. Any further reduction in tariff will increase competition for the Bhutanese industries.

There can be some respite considering the fact that so far the SMEs have managed to survive despite competition from India. Most of the SMEs are involved in niche products such as furniture, handmade paper, handicrafts and incense manufacturing, which have a ready market in Bhutan. As niche products, incense and handmade paper have also gained small markets in Europe, East Asia and North America. However, these have negligible export contribution given the low value added component and small quantity.

Impact on the Agriculture Sector

Agriculture comprises about 33% of the GDP and is a source of livelihood for almost four fifths of the population. Prospects for agriculture productivity growth are limited due to the rough terrain, poor soil quality and the limited availability of arable land, which is approximately 7%. Although Bhutan is a nation of farmers with 80 % of the population living in the rural areas, there has been no pressure to protect the farming sector due to the lack of commercial orientation in this sector or an effective farm lobby. In Bhutan, small families run farms, with an average size of 3.4 acres, is only able to provide subsistence to a household at the most. The farmers produce rice, wheat, maize, potatoes, barley, and buckwheat, depending on the altitude of the farms. With a growing population, the grain deficit has also increased, as reflected in the increasing import of food. In 1998, 34813 metric tones of rice, 6369 metric tones of wheat, 3449 metric tones of wheat flour and 1960 metric tones of maize were imported.

The liberalization of the agriculture sector is one of the most emotive and sensitive political issues in both the developed and the developing world. Strong farm lobbies in the developed world, often under the guise of food security and national/cultural reasons, champion for huge farm subsidies that lead to commercial agriculture practices and over production. The sway of this lobby is evident in the fact liberalization of the agriculture sector has been slower than most other areas.

WTO membership will theoretically confer greater market access to Bhutanese agriculture products. However, increased market access is

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[30] A detailed discussion on this issue can be found in World Bank: *Bhutan Private Sector Survey 2000*

unlikely to benefit Bhutan as competitiveness in the agriculture sector, as in other sectors will be determined by scale, technology and transport costs all areas where Bhutan suffers significant disadvantages. Even if productivity can be enhanced through technological application, the agriculture sector will have to meet numerous packaging and health safety requirements related to sanitary and phyto-sanitary standards and technical standards. Given the limited export volume, these products will also face difficulties entering the global commodity supply chain.

The agriculture sector is conventionally protected by restricting imports through high tariffs and quantitative restrictions and providing subsidies to producers and subsidizing exports. Bhutan does not impose tariff on imports of essential agriculture commodities from India, the main source of a bulk of agriculture imports. The Government neither provides price support nor imposes quantitative restrictions in the agriculture sector. Government intervention in the farming sector has been limited to provision of hybrid seeds and subsidized farm machinery, construction of irrigation channels and extension services.

Customs duty levied on imports from third countries have the main objective to conserve the convertible currency reserves rather than to protect the agriculture sector. If Bhutan has to gradually reduce the customs duty on third country imports, it is likely that food imports from third countries will rise and that the Bhutanese consumers will have access to a wide variety of food commodity as evident in the availability of Thai rice and Australian apples in the market. Any surge in imports without commensurate rise in exports will place pressure on the convertible currency reserves. The volume of imports from the third countries will be determined by the ability of Bhutanese agriculture produce to compete with Indian produce after considering the high transportation costs from the nearest seaport in Kolkota, India.

Table 19. Comparison of Tariff rates on products of interest to Bhutan

		BHUTAN		INDIA
Products	**BST**	**Customs Duty.**	**Total Tariffs**	**Tariff**
Cereals	0	20	20	60-100
Processed Foods	15	30	45	30
Apples	0	20	20	50
Oranges	0	20	20	40
Cardamom	5	20	25	70

Sources: Department of Revenue and Customs, Bhutan Trade Classification Customs Tariff and Sales Tax Schedule, January 2002 and Centax Publications, Customs Tariff of India 2002-2003, 35th Edition, New Delhi

On the export side, WTO obliges members to remove export subsidies. In Bhutan income from the exports of those agriculture products that earn convertible currency are exempt from income tax. While this could be construed as a subsidy, Bhutan will be allowed to retain this subsidy as a LDC country. As a LDC, Bhutan can also make higher tariff binding commitments in the agriculture sector.

As the scope for large-scale farming is limited, Bhutan has to explore special niche markets for its agriculture produce. For example an entrepreneur has started exporting local "red rice" to health food stores in the United States, while others export fresh mushrooms to Japan and Singapore. However, the Bhutanese farmers are not able to fully benefit from such niche markets due to supply side constraints associated with lack of marketing skills, technology and high transportation costs. The ability to benefit from market access as a result of WTO membership will be contingent on overcoming these bottlenecks and also fulfilling the stringent criteria that WTO members impose through the sanitary and phytosanitary regulations

With the unstoppable trend of rural to urban migration, increased access to education, and cheap food imports, it is likely that the farming population will shrink in the next two decades. The higher profit margins in cash crop production will encourage people to move away from the traditional sector to the production of fruits and vegetables. This trend will have a direct impact on the Land Act of Bhutan, which states that paddy land cannot be converted to other use. As most paddy land is on flat areas of the valley, also the most suited places for construction of high density residential buildings, the higher returns on real estate in the urban areas will also place pressure on the government to reconsider the provisions of the Land Act. Such pressure in conjunction with party politics in the future will inevitably compel the government to either relent to the pressure or provide some subsidy to keep the farmlands.

In the future, Bhutan's membership in the WTO could provide greater impetus for employment opportunities in the modern sector, drawing people away from the farms. Once the market economy expands and economic and social transactions are monetised in the rural areas, then modern sector employment that provides monetary remuneration will become more attractive than subsistence farming. This could change the economic and social landscape of Bhutan.

The major cash crops of Bhutan are apples, oranges and cardamom, mainly cultivated in the western and southern parts of Bhutan. These cash crops also have vibrant export markets in Bangladesh and India. In 2000, the export earnings from the three crops totaled about Nu. 260 million and exports of fresh vegetable accounted for Nu. 134 million. As the exports to Bangladesh are denominated in US dollars, this sector is one of the only sources of hard currency earnings in addition to tourism.

Given the relatively higher returns from the cash crop exports, the Bhutanese have made sizable investments, including growing application of scientific methods. Almost 90% of apple production is in the Thimphu and Paro valleys and the dominant orange producers are in southern Bhutan.[31] Businessmen, local landlords, and the civil servants who have better access to information and technology own most of the orchards. Such benefits will extend to rural farmers once road access is improved to the far corners of the country. The government provides support in marketing these produce in the regional markets. In November 2002, Sri Lanka agreed to provide duty free access to apple exports from Bhutan under the auspices of the SAPTA agreement.

A reliable transport network in the country is crucial for these perishable products where the quality, which is mainly a factor of the freshness of product, fetches the premium price in the export market. As India and Bangladesh are the major markets, the infrastructure and political situation in the bordering areas and the liberalization of the agriculture sector will have a direct bearing on the export of agriculture products.

Trade Related Investment Measures

In accordance with the GATT requirements, Bhutan will have to phase out any Trade Related Investment Measures (TRIMS) that are not consistent with GATT Article III and XI, namely national treatment and general elimination of quantitative restrictions. The prohibited TRIMS include: local content requirements, foreign exchange balancing requirements, trade balancing requirements and domestic sales requirement. For example, the foreign exchange balancing requirement stipulated in Bhutan's FDI policy, though important to conserve hard currency, is TRIMS inconsistent. Bhutan will have to notify the WTO on the use of prohibited TRIMS and adopt its progressive removal.

GATS and the Impact on the Service Sector

The GATS is a framework agreement to liberalize trade in services. The term "service" covers any service in any service sector including the production, distribution, marketing, sales and delivery. The GATS agreement and rules cover all commonly traded services, including 12

[31] Ministry of Agriculture, *Renewable Natural Resource Statistics 2000*, p. 38

sectors[32] and 155 sub sectors and the four modes of delivery: cross border supply such as international telephone calls and consultant reports; consumption abroad such as tourism and higher education; commercial presence though establishment of subsidiaries or branches and presence of natural persons such as fashion models, lawyers and architects. The GATS Agreement 1.3 (b) states that only government services that are "supplied neither on a commercial basis nor in competition with one or more service suppliers" may be excluded from GATS coverage.

WTO members must ensure that national laws, rules, regulations, policies, procedures and administrative actions do not inadvertently or indirectly affect the supply of services. Members must extend MFN treatment, ensure transparency of regulations and adhere to mutual recognition of qualifications and rules governing monopoly. Each country is also required to establish a national enquiry point to respond to queries and concerns pertaining to the service sector.

Unlike GATT, market access and national treatment obligations do not apply across the board. A country can identify which sector to open and what restrictions they wish to maintain in relation to these sectors in their schedule of commitments. However, this must be pointed out in the initial negotiations. Accordingly, a country is required to provide national treatment to an external service supplier only if it has made a specific commitment to provide foreigners access to its services market. For example, in limiting market access a country must specify the limit on the number of service providers, total value of transactions, total quantity of output, foreign shareholdings and legal requirements of joint ventures, as well as limit the number of persons employed in a sector by a particular employer.

The GATS, however, has a built in obligation to expand and deepen the coverage of services through negotiations and increase country specific commitments. These commitments are bound like bound tariffs and can only be reversed after negotiations with affected parties. It is a one-way road to greater commercialization of services with a standstill commitment, which stipulates that a member cannot reverse liberalization of services without compensation to the affected members. The compensation is granted by opening other service sectors of equivalent value. Exceptions can, however, be made if the country faces a balance of payments problem and invokes the safeguard mechanism.

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[32] The GATS includes the following twelve service sectors: business, communications, construction, distribution, education, health, environment, financial, tourism and travel, recreational and cultural services, transport and any other sector not included elsewhere. These are again divided into hundred and fifty-five sub-sectors.

The GATS has raised alarm among many interest groups and developing counties who contend that GATS is driven by corporate interest and is "privatization of services by stealth." The areas of concern include possible deregulation and privatization of service such as education, health, water, and energy services, which are traditionally the domain of governments. There is ambiguity on this issue as evident in the contradicting statements of the US Trade Representative who stated that services such as health care, education, water, energy would be included in the GATS purview, while the United Kingdom Department of Trade and Industry stated that such services would be exempt from GATS.[33]

Bhutan's main service sectors comprise of construction, transport, telecommunication, tourism, hotels, and retail trade. The high growth rates in the transport and construction sector are related to the construction of large hydropower plants in the country. Publicly funded infrastructure works including the construction and repair of roads and housing complexes dominate the construction sector. Although passenger transport services were demonopolised, there has been limited competition among the transport operators due to low passenger volumes. To ensure reasonable fares, the government regulates the fares. Passenger transport vehicles are exempt from both BST and the Customs duty[34] and also receive interest subsidy for purchase of new passenger vehicles.

As Bhutan's service sector is small and nascent, it is unlikely that there will be any tangible benefits for Bhutan from GATS. The primary benefits from service sector liberalization will accrue to developed countries, which have a strong service sector. Tourism is perhaps the only service sector which may be of interest to foreign firms in the near future. The entry of foreign suppliers could have a positive catalytic impact on the private sector in Bhutan. For example, foreign banks will be able to provide the Bhutanese entrepreneurs with better services and more sophisticated financial products. However, it is unlikely that foreign suppliers will rush to Bhutan's small service market, given the limited market for services and the high cost of delivery of services in Bhutan.

GATS obligations will have wide-ranging impact on the laws, rules and regulations governing the service sector and foreign investment in the sector. Bhutan will be obliged to amend various policies and regulations governing the service sector. Currently many of the

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[33] White Marceline, GATS and Women, *Foreign Policy in Focus*, Volume 6, Number 2, January 2001

[34] Ministry of Finance, *National Budget Report 2001-2002*, Thimphu, June 2001, p.17

provisions under Bhutan's Foreign Direct Investment Policy and the Foreign Exchange Policy conflict with the GATS. In particular, they pertain to limits on foreign equity participation, restrictions on transfers of convertible currency and employment of foreign workers. Article XI of the GATS does not permit restrictions on international transfers and payments for current and capital transactions unless permitted by the WTO to safeguard the balance of payments.

Countries like Bhutan face a dilemma in such cases. On one hand Foreign Direct Investment will provide immense benefits in technology and capital transfer helping to build domestic supply capacity and overcome the current constraints. On the other hand, a liberal FDI policy could expose Bhutan's fragile economy to balance of payments problems due to excessive outflows of convertible currency resulting from profit and dividend repatriation, uncontrolled imports etc. Therefore, it will be prudent to follow a conservative FDI policy till such a time that the Indian rupee, the main source of import earnings, is convertible.

The tangible impact of foreign competition to Bhutan's service sector will depend largely on the schedule of commitments that Bhutan offers in the accession negotiations. Bhutan may have to open at the least three service sectors to foreign competition. It is safe to assume that the sectors Bhutan opens will include some of the following eight service sectors open to foreign investments: tourism, including hotels, transport services, roads and bridges, education, business infrastructure, information technology, financial services and housing as stated in the Foreign Direct Investment Policy.

3.c.i Impact on the Tourism Sector

The impact of GATS on the tourism, an important service sector for deserves mention in some detail. Bhutan enjoys a unique comparative advantage in the sector due to its unique culture and pristine natural environment. The tourism sector is the single largest source of convertible currency earnings with significant backward linkages in the economy and potential for employment generation. This sector was liberalized in 1999, and currently there are about 100 tour operators. However, it is unbalanced with more than 50 % of the market share dominated by the top 6 travel agencies. Currently this sector provides direct employment for 500 regular employees and over 2000 temporary workers. The tourist numbers vary between 6,000 to 7,000 visitors annually, earning close to US$ 10 million.

Following a "high value low volume" tourism policy[35] the government administers the tariffs in the tourism sector ranging from US$ 165 in the low season to US$ 200 in the high season per person per day.[36] The tour companies must pay 35% of the daily tariff to the government as royalty fees. The convertibility currency receipts of the tour operators are channeled through the RMA, which retains the convertible currency and pays Ngultrum equivalent to the tour operators.

Currently foreign investments in the tourism sector are limited to the hotel or resort construction sector, as tour operation licenses are restricted to Bhutanese nationals only. Foreign investment in this sector will help to improve the quality of services in the hospitality industry as well as allow investments in hotels of higher standards. Partnerships with foreign companies will also boost the marketing efforts of the local companies in the foreign countries.

However, under the GATS, the tourism sector liberalization also includes opening of distribution marketing and sales of tourism related services. With liberalization, Bhutan's large tour companies could effectively monopolize the industry through partnerships with major international companies that control tourism related sectors, including hotels, airline reservation and information systems, thereby reducing market share of the small tour companies.

Other countries could challenge the administered tariff system as being a non-tariff barrier. The onus will be on the Royal Government to prove that such a tariff is a necessary safeguard measure consistent with the WTO. Furthermore, as foreign companies will want to repatriate profits earned in convertible currency, Bhutan cannot restrict the profit repatriation in convertible currency. The cultural and environmental policies of Bhutan could also be undermined if the large foreign companies and their influential local counterparts, if any, place pressure to open more areas for mass tourism.

3.c.ii Impact on the Hydropower Sector

Hydroelectricity is the main economic resource of Bhutan with a potential to generate 30,000 mw of electricity. Currently Bhutan has an installed capacity to generate 420 mw of which Chhukha Hydro Power Corporation has the largest with a capacity of 336 Mw. Akin to the oil rich states of the Persian Gulf, the hydropower sector is an important national resource.

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[35] This has recently been changed to "high value low impact" policy.

[36] This tariff is inclusive of food, lodge, and transport and guide services.

This sector comprises 11% of GDP and accounts for 45% of the total domestic revenue, the single largest source of domestic revenue amounting to Nu.1, 818.5 million (US$ 39.2 million) in 2001. The dominance of this sector will increase with the commissioning of the 1020 Mw Tala Project in 2005. Almost 90% of the electricity currently generated is exported to India. The exports tariffs currently at Nu. 1.50 per unit is bilaterally negotiated at a political level.

Though an important source of revenue, the hydropower sector is neither able to generate productive employment nor helpful in diversifying the export market apart from supporting a few power intensive industries. The scope for competition among the generating units is limited due to the administration of preferential export tariffs and the single market in India. The wide difference in the sizes of the companies (Tala 1020 mw; Chhukha 336 mw; Kurichhu 60 mw and Basochhu 22 mw also affect the competitiveness of the smaller power companies.

The power generation units are government owned companies. The Bhutan Power Corporation, formed in 2002, is responsible for the utility functions including transmission and distribution services. Foreign companies are unlikely to invest in the transmission and distribution services in the country due to the high costs in Bhutan considering the terrain, scattered settlements and low population density.

If this sector is open to foreigners, it is possible that foreign energy companies will be interested in generating hydroelectricity for sale in the neighboring countries, which suffer from energy deficits. Given the proximity, India is a captive market. However, the opportunities for private firms to benefit from power exports will depend largely on the pace of electricity sector reforms in India, particularly the State Electricity Boards.[37]

The Impact of Trips

The Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS) is one of the three main pillars of WTO, along with the GATT and GATS. Based on the principle of "single undertaking," countries automatically become a signatory to this agreement upon WTO membership. The rationale behind the TRIPS is based on the perceived need to protect intellectual property rights as ideas and knowledge form

[37] The existing electricity export arrangements with India are based on bilaterally administered tariff rates. The generating unit sells power to the Power and Grid Corporation of India Ltd (PGCIL) a public company, which in turn sells to the State Electricity Boards. The payment is also made by PGCIL to the generating company in Bhutan.

an important part of trade, and the lack of such an agreement poses a barrier to trade.

The TRIPS has aroused controversy and elicited emotional responses from developing countries and non government organizations, who argue that such an agreement is biased against the interest of the developing countries as it inhibits knowledge diffusion in developing countries, that are technology followers. The developing countries contend that TRIPS is essentially "technological protectionism" aimed at international division of labor, where the developed countries generate innovations and developing countries serve as markets for resulting services and products.[38] Further, laws on intellectual property rights are viewed as unbalanced as they enforce "patent ownership", while disregarding unauthorized commercial exploitation of traditional knowledge and biological resources.

The TRIPS is a framework of obligations to set minimum standards in protection of intellectual property rights (IPR), and an agreed mechanism for rule based dispute settlement in issues related to IPR. This agreement covers the following seven areas: copyrights and related rights; trademarks, including service marks; geographical indications; industrial designs; patents; layout designs of integrated circuits; and undisclosed information including trade secrets.

Intellectual property protection is a new area in Bhutan, and the fundamental laws including the Copy Right Act and the Industrial Property Act (including designs, patents and trademarks) have only been enacted in 2001. Bhutan is already a signatory to the following international agreements related to IPP:

Convention on establishing the WIPO (1994)

Paris Convention on Protection of Industrial Property (2000)

Madrid Agreement Concerning International Registration of Marks (2000)

Protocol relating to Madrid Agreement Concerning International Registration of Marks (2000)

Bhutan must ensure that its domestic laws pertaining to protection of IPR conform to the minimum standards set by TRIPS. Bhutan is also obliged to sign the Berne Convention for Protection of Literary and Artistic Works (copyright), and ensure that adequate domestic laws are enacted to cover: protection of geographical indication, layout designs of integrated circuits and undisclosed information including trade secrets.

[38] Hong E. "Globalization and the Impact on Health: A Third World View" *Peoples Health Assembly*, December 2000, Savar Bangladesh p. 37.

The penalties for infringement of IPR must also be spelt out and be adequate to deter violation of the obligations.

In addition to the legal obligations, Bhutan must establish appropriate institutions to ensure transparency and facilitate registration of intellectual property. The current institutions must be significantly strengthened to meet the legal, administrative, procedural and reporting requirements of the WTO. For example, it is obligatory for members to make certain notifications to the TRIPS council to allow members to review each other's legislations and ensure transparency of member's policies on IPR. Bhutan lacks legal expertise to frame laws pertaining to IPP and ensure compliance to WTO agreements. The costs of establishing institutions and computerized database for registering trademarks, and patents are prohibitive for many developing countries. Bhutan will also be obliged to prohibit the production or import of counterfeit and pirated goods. This will require training and creation of awareness among the Bhutanese people as well as extra vigilance of the customs personnel at the port of entry and exit. These obligations pose significant financial costs for small developing countries.

While obligations are mandatory and expensive, the tangible benefits of TRIPS will accrue to Bhutan only if there is a vibrant domestic source of innovations, inventions and creations that require international IPR protection. The benefits of TRIPS are marginal for small developing countries like Bhutan as the research and development capacity is non-existent and the artistic industries presently have a limited domestic market.[39] The contention that IPR is "technological protectionism" is convincing, as the advanced industrialized countries are a source of most of the innovations. Estimates show that the OECD countries led by the US, Japan and Germany account for more than 80% of the R&D expenditure; about 90% of the patents taken and over 90% of the technology fees received in the last three decades.[40]

The establishment of transparent laws and binding regulations will set the basis for protection of Bhutanese entrepreneurs and artists from IPR infringement in Bhutan as well as abroad. For example, the Copyright Act 2001 protects the IPR of the local artist in Bhutan from duplication and sale of his/her works without consent, but this does not accord the artists any protection abroad. Once Bhutan becomes a signatory to the Berne Convention then the IPR of the Bhutanese artist

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[39] Countries like India with a large non-resident population abroad have great interest to gain copyright protection for their audio-visual industries.

[40] Kumar, N. "Intellectual Property Rights, Technology and Economic Development: Experiences of Asian Countries." *Economic and Political Weekly*, Vol 38, No.3, January 18-24 2003. p. 210

will be recognized in all signatory countries. In the last two years, there have been two reported cases of domestic copyright infringement pertaining to the local audiovisual industry.[41] However, these cases have not been pursued due to the lack of awareness of IPR in the country and the reluctance to pursue litigation in a small society.

One of the main areas of interest for Bhutan is the protection of Bhutan's traditional knowledge from commercial exploitation by foreign companies without acknowledgement and compensation. Though important for many financially poor but knowledge rich developing countries, the TRIPS do not have any provisions to protect traditional knowledge. Similarly, there have been numerous cases of "biopiracy" by companies based in developed countries to patent the use of biological resources from developing countries.[42] In order to prevent theft of traditional knowledge, it will be important for Bhutan to study and document existing patterns of traditional knowledge including textile designs, indigenous medicine, etc.

Since Bhutan depends on India for most technology related products such a pharmaceuticals, fertilizers, machinery etc., the imposition of TRIPS obligations on India will invariably affect Bhutan. For example, in the case of pharmaceutical products, Bhutan currently enjoys access to cheap medicines from India as the patent laws in India recognize process patents and not product patents. As India is obliged to follow both product and process patents under the TRIPS agreement, the prices of medicines are projected to increase by 182-225% at the end of the transition period in 2004.[43] This will have significant impact on the cost of delivery of health services in Bhutan, particularly as health services are entirely provided free of cost by the government. There is some respite since a vast majority of drugs are out of patent protection. However, this excludes medicines for emerging diseases such as AIDS, cancer, renal problems and cardiac failures. The ability of developing countries to develop such drugs under a lax process patent will be constrained by the TRIPS agreement.

The costs of implementing TRIPS obligations far outweigh its benefits for a country like Bhutan. Bhutan cannot benefit from the

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[41] Gyeltshen, T. "Music video brings copyright issue into focus" 5/8/02 and "Song theft may be the first copyright case" 1/2/02 *Kuensel*, Thimphu

[42] For example, in 1995 there was an attempt to patent the use of turmeric for healing wounds in the United States. However, this was challenged successfully by India, as the use of turmeric is a case of traditional knowledge that is not novel.

[43] Kumar, N. "Intellectual Property Rights, Technology and Economic Development: Experiences of Asian Countries."*Economic and Political Weekly,* Vol 38, No.3, January 18-24 2003. p. 220

transition period accorded to LDCs as such concessions are availed only to those countries that were WTO members on 1st January 1995.

6. Macro Economic Impacts

6.a Balance of Payments

Theoretically, economic liberalization and a possible decline in foreign aid receipts will lead to a worsening of the current account balance and the balance of payments if it is not offset by private capital inflows and export sector growth. While the current account balance with India is likely to be favorable with increased electricity exports from Tala Hydropower Project and the projected increase in the electricity tariff, trade deficit with third countries will increase due to enhanced propensity to import as a result of lower tariffs. This trend will place significant pressure on the hard currency reserves.

Article XVIII of the WTO provides Balance of Payments safeguard measures for developing countries when it deems a threat of decline of its monetary reserves or is of a view that the monetary reserves, are not adequate to cover its foreign exchange payments. This however, is a temporary measure and is not granted automatically. The country seeking such a safeguard has to fulfill several administrative procedures stipulated by the WTO placing great financial and administrative burden on small LDCs.

6.b Impact on National Revenue

There is widespread perception that globalization impinges on the traditional spheres of government activity such as taxation, public spending, income redistribution and macroeconomic policy. This is pronounced in the case of WTO membership, as governments have to ensure conformity of national laws and rules to the various WTO agreements. Trade liberalization leads to the decline of domestic revenues, particularly for countries that depend heavily on import tariffs. This impact is greater, if the decline in import revenue is not offset by accompanying increase in taxes from others sources resulting from enhanced exports or other economic activities.

Bhutan's membership in the WTO will undoubtedly have an impact on the national revenue. Bhutan's national revenue can be segregated into tax and non-tax revenue as seen below.

Table 20. Summary of National Revenue

	1998-99	**1999-2000**	**2000-01**	**As % 2000-01 Revenue**
TAX REVENUE	1,459.57	2,198.86	2,200.63	47.11

	1998-99	1999-2000	2000-01	As % 2000-01 Revenue
Direct Tax	913.92	1,273.19	1,525.68	32.66
Corporate Income Tax	594.342	833.249	919.539	19.68
Business Income Tax	71.924	134.764	231.954	4.97
Salary Tax	30.805	56.55	65.845	1.41
Health Contribution	16.292	19.783	22.215	0.48
Royalty	193.743	221.788	275.867	5.91
Rural Tax	6.814	7.051	10.255	0.22
Indirect Tax	545.646	925.679	674.953	14.45
Bhutan Sales Tax	224.492	299.878	351.401	7.52
Export Tax	19.799	9.371	13.554	0.29
Excise Duty	184.647	470.325	130.273	2.79
Tax on Motor vehicle	45.155	58.949	60.219	1.29
Import Duty	44.171	57.946	76.623	1.64
Business professional licenses	11.697	12.429	18.53	0.40
Other Tax Revenue	15.685	16.781	24.353	0.52
NON-TAX REVENUE	2,087.93	2,182.27	2,470.89	52.89
Admin. Fees & Charges	56.821	71.557	80.932	1.73
Capital Revenue	86.298	71.36	76.055	1.63
Rev from Govt. Dept	445.547	564.413	310.52	6.65
Dividend	970.612	1,222.49	1,296.09	27.74
Transfer of Profit	526.358	248.193	705.608	15.10
Other Non Tax Rev	2.291	4.259	1.684	0.04
Total	**3,547.49**	**4,381.14**	**4,671.52**	**100.00**

Source: Ministry of Finance, National Budget Reports

Unlike many developing countries, import taxes contribute a miniscule 2% of the total revenue. This reflects the dominance of Indian imports (which are tax and duty free), the generally low level of import tariffs as well as the exemptions granted for government/donor-funded projects, the exemptions in import of plant and machinery. Though not established thoroughly the under valuation of goods by importers also contributes to leakages. Therefore, tariff reduction will have minimal impact on the national revenue. Apart from the hard currency concern, further import tariff reductions may help to overcome the trade deflection that favors Indian goods though most third country products are often cheaper and better in quality.[44]

The single largest source of national revenue is from transfer of dividends from government shares in the industrial, financial and power sector amounting to 27% of total revenue.[45] The proceeds from Chhukha Hydropower Corporation contribute more than 90 % of the total dividend earnings (2001). The Corporate Income Tax (CIT), is the second largest source of revenue with 19% contribution to total revenue. The proceeds from Chhukha Hydropower Corporation form almost 70% of the total CIT. The other sources of CIT include major industries, financial institutions, tourism sector, and the construction sector.

The third largest source is from the transfer of profits from Bhutan Lotteries and the return on overseas investments of the Royal Monetary Authority (RMA), comprising 15.5 of total revenue. The RMA contributes to about 80 % of the total transfer of profits.

The Bhutan Sales Tax, with a total contribution of 7% of the total revenue, is the fourth largest source of national revenue. This comprises of tax on goods imported from third countries as well as sale of cement and revenues from hotels and restaurants. The provisions of the BST may have to be reviewed, as the current practice – of exempting most domestic products from BST- will not be consistent with the principle of national treatment applicable under WTO.

By assessing the four largest sources of domestic revenue, almost three quarter of the revenues are dependent on the profits of the hydropower sector and the RMA operations. Though an indication of poor economic diversification, there is some solace as WTO membership is unlikely to affect these two sources of domestic revenue.

Economic liberalization in India could affect the national revenue indirectly if export performance of Bhutan's industries (BFAL, BCCL, PCAL) are affected due to competitive pressure in the Indian markets, leading to declining CIT and dividends from these companies.

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[44] This is true in the case of many electronic and technology related goods.

[45] The data for this section has been obtained from, *National Revenue Report*, Ministry of Finance, 2000-2001.

The other subtle effects of liberalization include erosion of the government's power to collect taxes due to a long list of "fiscal termites gnawing at the foundation of tax regimes."[46] This list includes cross border shopping, increased mobility of skilled labor, growth of e-commerce, expansion of tax havens amd intermediate trade within multinational companies. With such enhanced mobility of tax sources, the less mobile factors like unskilled workers and the rural sector are likely to be affected adversely.

6.c Institutional Impacts

As the WTO is a complex legal agreement, Bhutan will require both legal and economic expertise to handle WTO affairs professionally. This is pertinent, as most of the concessions a country seeks will depend on the ability to negotiate such concessions. The establishment of WTO cells in the Government and posting of staff in Geneva will cost the exchequer. To meet transparency requirements of the GATS, specific offices will also have to be established as point of enquiry.

In order to ensure minimal trade distortion, WTO countries are obliged to establish institutions to ensure compliance to the Agreements on Technical Barriers to Trade (TBT), sanitary and phytosanitary Standards (SPS) and enquiry points for GATS. Although these agreements may not be immediately necessary for a small developing country like Bhutan, considerable expenses will be incurred in training of competent technical persons, as well as procurement of equipments and laboratories.

4. Socio Cultural Impact of WTO

Currently, there is an intense global debate on the impact of globalization on the nation state as globalization impinges on the areas considered traditional domains of governments. The WTO, as one of the most powerful agents of globalization, will constrain the policy options of governments as the national laws, policies and administrative procedures have to conform to the WTO agreements. Countries must abide by the market principles and any attempt to diverge is illegal and subject to challenge by other members. Thus the latitude of governments to pursue certain social goals, through subsidies, quotas, for example is limited as it may prove to be a barrier to trade.

Although orthodox theories claim that trade liberalization enhances welfare, experience in other countries shows that, without appropriate

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[46] Tanzi, V. "Globalisation and the Work of Fiscal Termites" *IMF Working Paper 00/181*, Washington 2000

policies, the vulnerable sections of society are marginalized further. Though a simplistic analogy, just as trade benefits the strong sectors of an economy, WTO membership will benefit the Bhutanese elite and skilled workers. For example, market access in agricultural products will benefit cash crop exporters more than subsistent farmers. In fact, it may marginalize the latter if government interventions favor export sectors and fail to protect subsistent farmers from cheap imports. Similarly, economic liberalization and foreign investment will enhance employment and income opportunities for well-educated and skilled workers far more than poorly educated unskilled people.

If the government gradually phases out the free health services, the impact of TRIPS on the pharmaceutical sector in India, will directly affect the poor people in Bhutan, as the poor may not be able to afford expensive medicines. Global economic integration allows mobile factors of production like skilled workers to transfer their income sources from taxation. This will place an extra burden on the unskilled workers and rural economies as their sources of income are less mobile. Furthermore, reduction in social sector expenditure, for economic reasons will also adversely affect the poor.

Economic liberalization marginalizes the vulnerable sections of society, especially the poor and women, if adequate social safety nets are not in place. Fortunately, in Bhutan there are no societal and legal discrimination based on gender. In fact, employment opportunities for women may increase in the future with the expansion of the service sector and potential investments in assembly line jobs.

There is also ample literature on the impact of globalization on local traditions and culture. Such impacts are magnified in the case of traditional societies like Bhutan, that have not had colonial ties and are rapidly modernizing. Bhutanese have been exposed to the outside world through travel abroad, literature, visits of foreign tourists and more recently through television and Internet. As medium of mass communication, the introduction of television in 1999 has had a profound impact on Bhutanese society and culture.

WTO, as an agent of globalization, will accelerate the pace of change, as it will open the economy to external ideas, goods and services. Market values like consumerism and individualism and accompanying economic modernization will challenge traditional Bhutanese values like the joint family system, tradition of gift giving, and support extended to poorer relatives through education of their children, care of elderly and other informal social safety nets.[47] These networks and norms, also referred to as social capital, serve as potent mechanisms for social safety net, cohesion, harmony and collective action. As market values displace these traditional values, the state has to ensure that adequate institutions and policies are in place to insure the poor who will be marginalized as an unintended consequence of economic liberalization.

Economic liberalization will also lead to the emergence of the new rich, a class of entrepreneurs whose positive energies could lead to productive investments and employment generation. On the other hand, historical evidence shows that the emergence of new riches invariably involves emergence of corruption.[48] Thus it is important to ensure good governance with proper institutions and procedures so that public sector employees are not susceptible to such malpractices. Although corruption in Bhutan is not a rampant phenomenon as yet, Bhutan is vulnerable with the politicization of public offices, emergence of new power centers, emergence of new wealth and general disillusionment of the people with the declining quality in the delivery of public services.

Bhutan has a distinct advantage as a late developer, since it can learn from the experience of others and adopt international best practices. Its modern public institutions are still in the formative stage as evident in the written constitution that is being drafted. Thus Bhutan has the ability to chart a future course of change that is realistic and beneficial to all Bhutanese people without having to resort to political bargaining or violent means to bring about change.

The WTO requirement for transparency and strong legal, institutional and procedural mechanisms will be beneficial as it will undo the current practice of deciding on many issues on a "case by case basis." Such practices inevitably lead to sub-optimal economic outcome due to extensive rent seeking behavior and its bias in favor of the social economic and political elite. The establishment of fair and transparent ground rules and accountability to an intergovernmental organisation, such as the WTO, will not only break the implicit monopoly culture but also enable all budding entrepreneurs to participate in the economy based on competition, transparency and efficiency.

Conclusion

WTO membership will have wide ranging social, cultural and economic impact on Bhutan. Application for WTO accession symbolizes

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[47] Wangyal, T. "Ensuring Social Sustainability: Can Bhutan's Education System Ensure Intergenerational Transmission of Values" *Journal of Bhutan Studies*, Vol. 3, No. 1, 2001

[48] Huntington, S.P., *Political Order in Changing Societies*, Yale University Press, New Haven, 1968

the policy decision to open the economy to external competition and reap the benefits of a multilateral trading system. The tangible benefits arising from market access will materialize only if Bhutanese firms can compete in the international markets. While benefits are diffused and long term, Bhutan has to bear immediate costs of accession including policy adjustments, establishment of institutions and the risks of exposure to the international economy

The competitiveness of Bhutanese firms abroad will depend on foreign direct investment and the transfer of technology and skills in high value added sectors. However, the FDI is currently constrained by a conservative foreign exchange policy, necessary for a country with limited capacity to earn convertible currency. On the other hand, most of the exports, including electricity, are destined for markets in India where the earning is in a non-reserve currency. The most tangible benefits of WTO accession for Bhutan is contingent on the pace and depth of liberalization in India and the capital account convertibility of the Indian rupee.

Given the limited tangible benefit and the inherent costs and risks of economic liberalization, it is imperative to clearly understand the impact of WTO on Bhutan in view of the existing supply side constraints and the external factors that will determine Bhutan's successful integration. Hence, the impact, beneficial or adverse, will depend on the success of the private sector, and the ability of Bhutan to negotiate accession on terms that are most relevant to Bhutan's realities rather than on theoretical benefits conferred by the WTO.

Economic liberalization also has far reaching social and cultural impact, particularly for traditional societies. It will be vital for the state to properly manage such transitions with appropriate institutions and policies as it could lead to marginalization of vulnerable sections of society as well as emergence of corruption and nepotism. Bhutan is at a crucial stage in its path of development in view of the rapid political and economic reforms currently taking place. It can ride on the high wave and become a success story, or let slip the opportunity and join the ranks of failed states, thus jeopardizing its security and sovereignty.

Appendix

Appendix 1: List of Sectors Open to FDI

The FDI Policy states that the following manufacturing areas are open to FDI with a minimum investment of US$ 1 million where the foreign investor can hold upto 70% equity:

Mineral processing
Forestry and wood based industries
Agriculture and Agro processing
Livestock based industries
Light Industries including electronic industries
Engineering and power intensive industries

The open sectors stated above, with the exception of the last two, all fall in the areas of processing primary products in which Bhutan has a comparative advantage as a result of natural endowment. Power intensive industries are also feasible as Bhutan has abundant and reliable hydropower resources.

With a minimum investment required of US$ 500,000 service sectors open for FDI include:
Tourism including Hotels
Transport services
Roads and Bridges
Education
Business infrastructure
Information Technology
Financial Services
Housing

Source: Royal Government of Bhutan, Foreign Direct Investment Policy, Thimphu, December 2002

Appendix 2. Top ten Industries and direction of sales 2001

Industry	Sales in million Nu	As % of total sales of the top ten
Penden Cement Authority Ltd	763.9	25.3
Exports to India	316	
Exports to other countries	0	
Sales within Bhutan	447.4	
Bhutan Calcium Carbide Ltd	675.9	22.4
Exports to India	509.4	
Exports to other countries	0	
Sales within Bhutan	166.4	
Bhutan Ferro Alloys Ltd	579	19.2
Exports to India	579	
Exports to other countries	0	
Sales within Bhutan	0	
Bhutan Board Products Ltd	294.1	9.7
Exports to India	255.8	
Exports to other countries	0	
Sales within Bhutan	38.3	
AWP Distillery	283.8	9.4
Exports to India	74	
Exports to other countries	0	
Sales within Bhutan	209.8	
Eastern Bhutan Coal Co	141	4.7
Exports to India	8.3	
Exports to other countries	50.5	
Sales within Bhutan	82.2	
Bhutan Fruit Products Ltd	111.6	3.7
Exports to India	87	

Industry	**Sales in million Nu**	**As % of total sales of the top ten**
Exports to other countries	6.9	
Sales within Bhutan	17.7	
Druk Satair Corp Ltd	98.3	3.3
Exports to India	74.6	
Exports to other countries	8.9	
Sales within Bhutan	14.9	
Bhutan Polythene Company	46.9	1.6
Exports to India	11.5	
Exports to other countries	0	
Sales within Bhutan	35.3	
Bhutan Agro Industries Ltd	27.9	0.9
Exports to India	13.3	
Exports to other countries	1.8	
Sales within Bhutan	12.7	
TOTAL	3022.4	100
Exports to India	1929.4	64%
Exports to other countries	68.1	2%
Sales within Bhutan	1024.9	34%

Source: Royal Monetary Authority, Selected Economic Indicators 2002. Thimphu.

Appendix 3: Composition of Trade with India in 2000

A: Top ten Imports

Items Imported	Nu in millions	%
Products of Chemical Industries	1659.34	22.24
Mineral Products	1227.84	16.45
Machinery and Mechanical Appliances	966.94	12.96
Base Metals and Base Metal Products	791.69	10.61
Transport Equipment	503.85	6.75
Cereals, Vegetables, Fruits, Nuts, Coffee, Tea &Spices	502.37	6.73
Prepared foodstuffs	422.22	5.66
Wood and Wood Products	238.77	3.20
Animal Products	209.89	2.81
Vegetables Fats and Oil	168.61	2.66
Others	939.7	12.72
Total	7462.61	100.00

B. Top ten Exports

Items Exported	Nu in millions	%
Electricity*	2189.6	50.03
Mineral Products	527.4	12.05
Products of Chemical Industries	485.5	11.09
Base Metals and Base Metal Products	449.95	10.28
Wood and Wood Products	250.64	5.73
Cereals, Vegetables, Fruits, Nuts, Coffee, Tea &Spices	197.73	4.52
Prepared Foodstuffs	194.37	4.44
Miscellaneous Manufactured Articles	45.56	1.04
Stone, Plaster, Cement and Asbestos Products	12.54	0.29
Plastic and Rubber Products	10.77	0.25
Others	12.91	0.29
TOTAL	4376.97	100.00

Source: Department of Revenue and Customs, Bhutan Trade Statistics 2000, Thimphu, 2002

Appendix 4. Composition of Trade with other countries 2000
Top ten Imports

Item	Nu in millions	%
Machinery, Mechanical Appliances, Base Metals	1268.05	77.15
Plastic and Rubber Products	84.601	5.15
Mineral Oil and Fuel	66.93	4.07
Whiskies and Processed Food	46.075	2.80
Textiles	43.863	2.67
Wood pulp Products	38.055	2.32
Miscellaneous Manufactured Articles	28.087	1.71
Medicines and Pharmaceuticals	20.572	1.25
Wood Products	12.548	0.76
Products of Chemical Industries	9.111	0.55
Others products	39.904	2.12
TOTAL	1643.685	100.00

Top Ten Exports

Items	Amount	In %
Vegetables & Fruits	117.884	49.35
Mineral Products	74.7	31.27
Processed Food	14.254	5.97
Textiles	13.952	5.84
Household items & Personal effects	9.844	4.12
Machinery	4.188	1.75
Wood pulp Products	3.211	1.34
Handicrafts Products	0.515	0.22
Philatelic Products	0.25	0.10
Wood Products	0.084	0.04
Others	0.03	0.00
Total	238.885	100.00

Source: Department of Revenue and Customs, Bhutan Trade Statistics 2000, *Thimphu, 2002*

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