Bhutan Policy Notes

Investment Climate Reforms

Key issues and challenges

Bhutan’s investment climate is primarily constrained by imperfections in factor markets, limited access to product markets, and state dominance. Driven by the capital-intensive hydropower sector, the country achieved impressive growth rates, but created few jobs. The public sector stepped in, but has the capacity to absorb only about 1,000 graduates per year. The 2017 Investment Climate Assessment (ICA) survey revealed that employment remains concentrated in agriculture and the public sector, and that many firms are struggling to grow due to obstacles that hinder investment, productivity, and international trade.1 While some improvements in the investment climate have been made, many challenges persist.

Limited access to finance — caused by both supply- and demand-side factors — constrains the growth of firms, especially small firms. In 2015, the World Bank’s Enterprise Survey (WBES) conducted detailed interviews with managers of 367 nonagricultural firms in Bhutan. Managers — particularly of micro- and small enterprises — most frequently cited access to finance as the constraint that most inhibited firm growth. Lenders, on the one hand, are discouraged by a lack of credit information and by a complex, unpredictable, and ineffective restructuring and insolvency regime. Borrowers, on the other hand, are discouraged by high prices, poor quality, and limited availability of financial services. Collateral requirements hinder firm expansion, while the lack of a clear insolvency framework remains a barrier.

A limited supply of skilled labor impedes the development of high value-added products. Labor was the second most frequently cited constraint in the 2015 WBES, a complaint likely triggered by the limited access of firms to skilled labor. Due to Bhutan’s historically low levels of education, the domestic supply of skills — such as auditing, accounting, and information technology — is limited. Moreover, generous public-sector compensation packages discourage recent graduates from seeking private-sector jobs. Also, current caps on foreign workers and the inconsistent application of labor regulations causes skilled migrants to be crowded-out.

Access of firms to international markets is costly and impaired by deficiencies in transport and logistics. While relatively few firms rank access to external markets as a primary obstacle, data from Doing Business and the Logistics Performance Index suggest that exports are constrained by the high costs of accessing external markets. While Bhutan’s road network and custom procedures have recently improved, transportation costs are exacerbated by insufficient capacity at Phuentsholing port, poor domestic connectivity, cumbersome logistics and a landlocked geography. Also, internet connectivity remains low.

FDI inflows are suppressed by regulatory barriers, skill shortages, and insufficient investment promotion, which in turn restricts the access of domestic firms to foreign markets and technologies. Despite gradual liberalization since 2010, entry barriers remain high for foreign investors. Inflows remain small and the lowest in South Asia, averaging less than $20 million a year. The new 2010 FDI policy (amended in 2012) is a well-articulated and ambitious policy based on national development objectives of green economy, culturally sensitive industries, services investments and brand Bhutan, and knowledge economies. It was further liberalization in 2015 in relation to pharmaceuticals and land leasing. The policy governs general conditions, guarantees, operating environment, and the FDI approval process. However, some key aspects of the existing legal framework may not be conducive to attract, retain, expand and link FDI with the local economy (such as discretion on screening and approval cancellations, equity restrictions in priority sectors; minimum investment levels; limits on visas of skilled workers). The government is in the process of reviewing the FDI policy, in close collaboration with the World Bank.

The state’s dominant role in the economy has narrowed the space for the private sector to mature. The large size of some state-owned enterprises (SOE’s) and the extent to which affiliates of such enterprises

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1 The survey included 130 firms.
enjoy access to policy makers, potentially discourages private investments. DHI, the largest and only government-owned holding company in Bhutan, has shares in 19 different companies operating in the manufacturing, energy, natural resources, financial, communication, aviation, trading and real estate sectors, and all SOEs have been corporatized since 2000. While there is a heterogeneity of state enterprises with varying degrees of performance and commercial viability, more than one-fourth are loss-making. As a result, the space for the private sector is precluded by a lack of competition and high barriers to entry.

In the recent past, the country has undertaken some reforms to improve its investment climate but more needs to be done. The government has taken measures to increase access to finance by establishing a credit information bureau, three new commercial banks, and a minimum reference rate for lending. The country has also improved corporate governance and administrative efficiency by (a) enacting legislation that requires companies to nominate independent board members and set up an audit committee; (b) introducing dedicated benches for commercial cases; and (c) simplifying business registration. However, challenges remain in the provision of finance, the ease of hiring labor, and access to markets.

Policy Recommendations

To address these issues, in the short term, the government needs to:
- Adopt policies to expand the scope of collateralizable assets and deepen and broaden credit information.
- Implement the new insolvency bill that provides clear rules and regulations on bankruptcy.
- Deepen skills development by introducing a dedicated channel for skilled migration and providing vocational training to the adult labor force, especially on ICT and other key services.
- Promote broader use of e-commerce platforms by the private sector and customers.
- Create a formal public-private platform to ensure greater consultation on policies and reforms.
- Harmonize the tourism policy for regional and international tourism, including introducing fees for regional arrivals.
- Develop a set of regulations, clear oversight roles, and a communication strategy for Brand Bhutan, while simultaneously increasing awareness on and the use of quality standards and certifications by domestic producers.
- Increase access to finance by developing a credit scoring system for enterprises and providing proper valuations of property that can be used as collateral.
- Harmonize public sector compensation packages with the private sector.
- Improve market access by introducing risk-based border inspections and simplifying border processes.
- Amend FDI policy to streamline the approval process, lower equity restrictions, and reduce minimum capital investment amounts in order to accelerate FDI inflows.

In the medium to long term, the government needs to:
- Strengthen competition law and policy and monitor anticompetitive practices of state-owned enterprises.
- Liberalize, incrementally, the minimum daily package policy for tourists to ensure a market-based structure.
- Upgrade internet infrastructure through investments, especially in cable and fiber optics.
- Develop the agribusiness sector through the promotion of storage and logistics infrastructure to facilitate exports of high-value products.