

Export Diversification and Inclusive Growth in Land-Locked Countries in Asia:
Bhutan, Kazakhstan, Mongolia and Turkmenistan*

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Table of Contents

I. Introduction: the Paradox of Resource Wealth in the Central/South Asian Context	3
1. The Resource Curse	3
2. What can be done?	5
3. The Central/South Asian Context	7
References	10
II. Kazakhstan	12
1. Introduction	12
2. Oil and Macroeconomic Policy	14
3. Private Sector Development	15
4. Institutions and Governance	28
5. Diversification strategies	33
6. Conclusion	42
References	43
III. Turkmenistan	46
1. Introduction	46
2. Dominance of Natural Gas	47
3. Macroeconomic Management	50
4. Obstacles to Private Sector Development	53
5. Institutions and Governance	64
6. Diversification Strategies	68
7. Conclusion	76
References	76
IV. Mongolia	78
1. Introduction	78
2. Converting Mineral Wealth into Development	80
3. Macroeconomic Policy and Management of Mineral Wealth	81
4. Private Sector Development	85
5. Institutions and Governance	94
6. Diversification Strategies	99
7. Conclusion	106
References:	108
V. Bhutan	110
1. Introduction	110
2. Macroeconomic Management of Hydropower	111
3. Obstacles to private sector development	119
4. Institutions and Governance	131
5. Diversification Strategies	134
6. Conclusion	142
References:	143

I. Introduction: the Paradox of Resource Wealth in the Central/South Asian Context

This document examines prospects for economic diversification and inclusive growth in four Asian economies characterized by high levels of natural resource dependence and challenging geographical and historical contexts: Kazakhstan, Turkmenistan, Mongolia and Bhutan. Diversification away from natural resources is not easy to begin with. A history of political and economic isolation and/or strong state control of the economy add additional difficulties.

1. Natural Resources: Blessing or Curse?

One would expect natural resource abundance to be a great advantage in fostering prosperity in developing countries. In some cases, such as Botswana (Kojo 2015), revenues from natural resource exports have enabled rapid improvement in living standards. In practice, more often than not, natural resources have proven to be a “curse,” inhibiting rather than promoting economic development (Venables 2016, Collier 2007). The growth performance of natural-resource abundant countries has generally been lackluster, as Sachs and Warner (1995) were the first to point out. In the 2000s, the “Commodity Super-Cycle” of rising commodity prices driven by Chinese demand for raw materials, particularly energy, led to booming growth in many natural resource-importing countries (Gangelhoff 2015). Falling oil and other commodity prices since 2015, associated in part with a slowdown in China’s growth, has revealed the fragile foundation of this growth and the lack of structural transformation in many natural resource exporters, with many countries facing fiscal and balance of payments crises and sharp declines in growth. It is therefore important to understand how to make natural resources a blessing rather than a curse.

There are a number of economic and political reasons for the failure to benefit from natural resources. From an economic point of view, natural resources are difficult to manage (Venables 2016). Extraction is often technically complex and beyond the capabilities of developing countries. Thus, many countries welcome foreign investment. Relations between multinational companies and national governments can be fraught, and in some cases developing countries may not bargain effectively. In other cases, developing countries are so wary of foreign involvement that they prohibit or dissuade foreign investment, thus reducing their ability to exploit and earn income from their resources. This is the case with Turkmenistan for natural gas and Mongolia for mining, as discussed below.

Management of resource revenues, however, has proven to be the most significant problem. First, resource prices and revenues are highly volatile, making planning difficult. In principle, countries should save a large part of their income when prices and sales are temporarily high, perhaps into a stabilization fund and thus running current account and fiscal surpluses. Conversely, when prices are

below their long run level, countries can legitimately run fiscal and current-account deficits. In practice, however, even ignoring the political distortions discussed below, it is not always easy to determine when prices are above or below an equilibrium level and whether price changes are permanent or temporary. Second, booming natural resources tend to result in “Dutch Disease”: domestic currency appreciation and higher wages, harming other tradeable goods sectors, both traditional and non-traditional. For example, high oil revenues in countries such as Nigeria and Venezuela have crowded out agriculture and manufacturing (Ross 2012). This can be problematic for long run development because of the acute dependence that results on one or a few commodities. Third, even when windfall revenues are used for investment rather than consumption, the investments sometimes take the showcase monuments or inefficient public-sector enterprises that do not contribute to long-run growth.

Finally, and perhaps most importantly, natural resource extraction and distribution is capital-intensive and not conducive to shared growth and structural transformation. Manufacturing and agriculture contribute more to technological progress, forward and backward linkages with other sectors, and employment creation, including for women and youth. The employment issue is of critical importance in countries with young and rapidly growing populations, and empowerment of women is of central importance in its own right and as a way of fostering the demographic transition to lower birth rates. It is well known that the East Asian “miracle” was based on export-led growth of labor-intensive manufacturing. Export-oriented agriculture, fishing and tourism can also play a transformative role for much the same reasons: employment creation and quality upgrading through participation in global value chains (Golub, O’Connell and Du 2008; Golub, Bernhardt and Liu 2011). Even when they were growing rapidly in the 2000s, many commodity-exporting countries such as Angola experienced very high levels of inequality and widespread underemployment (Golub and Prasad 2016).

While these economic downsides of natural resource dependence are important, economists increasingly recognize that the political and institutional consequences are even more crucial. The problem is simple: large resource rents—revenues in excess of costs—can provide an irresistible temptation to engage in wasteful spending and corruption. It is difficult to restrain spending when revenues are high even for well-intentioned officials that recognize the temporary nature of price increases. Worse, with weak institutional restraints, resource rents occasion rent-seeking, i.e., battles over access to these rents. They also lead to patronage and corruption, sometimes even contributing to civil conflict and state failure (Collier 2007, 2010). Thus, revenues are often used by ruling elites in both democracies and dictatorships to enrich themselves and their families while buying support from the population with costly and inefficient subsidies. For example, some oil-exporting countries such as Nigeria have very low domestic prices of refined petroleum products, so much so that their refineries are

bankrupt and they have to import gasoline, some of which is smuggled into neighboring countries with lower subsidies and thus higher prices.

Furthermore, international financial markets may abet pro-cyclical fiscal policies by providing abundant loans in good times while pulling out abruptly when prices fall (Vegh 2015). Offshore financial markets also contribute to corruption by accepting and concealing plundered funds from elites in developing countries. Corruption and fiscal irresponsibility are also facilitated by off-budget management of resource revenues, often in the guise of a stabilization fund (Venables 2016).

Misuse of resource revenues and institutional dysfunctions can go hand in hand in a vicious circle. Countries with weak institutions find it most difficult to prevent corruption or wasteful use of revenues. Conversely, resource revenues can perpetuate institutional failures and poor policies by easing budget constraints and thus enabling avoidance or postponement of necessary reforms.

2. What can be done?

Reducing dependence on natural resource revenues involves both macroeconomic and microeconomic policies and strengthening governance and institutional capacity to implement such policies.

Macroeconomic policies. It is important to follow countercyclical spending policies, that is, saving resource revenues in boom times and reserving deficit spending for downturns in revenues. When prices are high, countries should run fiscal and current account surpluses, reducing public debt and accumulating foreign exchange reserves. As noted above, this is difficult due to political pressures to ramp up spending when revenues are high and credit is readily available. Establishing stabilization funds governed by spending rules can be a positive step, but only if these funds are operated transparently and the rule is followed. In addition to saving from windfalls, investment spending on infrastructure, education and other projects boosting long term development can be justified, but the investments must be driven by economic returns rather than political favoritism.

Limiting real exchange rate appreciation is also important to mitigate Dutch Disease effects. Accumulating foreign exchange reserves during booms can reduce pressure on the exchange rate to appreciate in both nominal and real terms. Countercyclical spending policies also are helpful in reducing appreciation.

A few countries have been quite successful in managing revenues, such as Botswana, as previously noted (Kojo 2016). Botswana leveraged its diamond revenues into very rapid growth and poverty reduction by following the above principles: countercyclical fiscal policies, limited real exchange rate appreciation and well-targeted investments in infrastructure, health and education. Strong institutions

and control of corruption are the keys to these relatively few success stories. Nevertheless, even in some successful cases such as Botswana, dependence on one or a few commodities remains a concern. Structural policies to promote economic diversification such as those discussed below are relevant.

Structural Policies to Spur Diversification. While sound macroeconomic management of resource revenues is necessary, it is also critical to create the microeconomic conditions that foster diversified economies. Extracting minerals can occur even in poorly functioning institutional environments due to the enclave nature of production and the large rents that accrue to firms and governments. Developing globally competitive manufacturing, agriculture and tourism sectors is much more challenging because firms can choose where to locate and source based on the quality of the business environment.

Furthermore, it does not necessary make sense to foster downstream processing industries. For energy and mining, downstream sectors such as petrochemicals and metals are capital-intensive and require a high level of technical sophistication. Conversely, labor-intensive manufacturing may be viable even if the country does not produce the raw material in question, as East Asian countries have demonstrated. The East Asian experience also suggests that low-income countries should start with the least skill-intensive products and gradually upgrade their production capabilities and the sophistication of their exports (Golub, O’Connell and Du 2008).

Increasingly, diversification into manufacturing and agriculture requires participation in global value chains (GVCs). Multinational producers and buyers seek the most favorable locations for production of components or niche products (Pomfret and Sourdin 2014). Well-functioning infrastructure, limited administrative red tape, transparency of government operations, labor with appropriate skills etc, determine whether or not a country can gain a foothold in manufacturing GVCs. As Golub, Jones and Kierzkowski (2007) put it, the quality of a country’s “service links” (ports, roads, customs administration) affect the competitiveness of its “production blocks”. For agriculture, fishing and tourism, local determinants of comparative advantage such as climate, soil conditions and historic monuments matter more, but these sectors are also very competitive and success depends on quality control as much or more than in manufacturing (Golub, O’Connell and Du 2008, Golub and McManus 2009, Golub and Varma 2014).

The difficulty of participating in global value chains is exacerbated in resource-rich countries for the reasons mentioned above. Furthermore, the countries considered here, as summarized in the next section, have a history of isolation from the global economy. For these reasons, this report pays particular attention to the business climate for domestic and foreign investment, closely examining strengths and

weaknesses of public services and infrastructure. Participation in regional value chains can be a positive intermediate step in many instances.

Quality of governance and institutions. Good macroeconomic and structural policies depend on institutions and governance (Collier 2007, Acemoglu and Robinson 2012). As Acemoglu and Robinson (2012) stress, inclusive rather than extractive institutions promote sustainable growth and improvements in living standards. Thus, we closely examine issues of governance, such as the level of corruption and the functioning of the education system.

Privatization. As former members of the Soviet Union or close connections to the latter, Kazakhstan, Turkmenistan and Mongolia have had extensive government involvement in the economy, including state ownership. There is no question that a favorable climate for private domestic and foreign investment is essential. Nevertheless, governments should proceed with caution in liberalizing and ensure that appropriate legal frameworks and social protections are in place. Privatization in particular has often had disappointing results (Roland 2008). If the market is competitive, privatization is likely to boost economic efficiency and growth. In markets characterized by high barriers to entry, privatization may lead to a private monopoly replacing state control, requiring regulation. If effective regulation is absent or weak, privatization may need to be postponed until the institutional environment is strengthened.

3. The Central/South Asian Context

This report focuses on four countries, Kazakhstan, Turkmenistan, Mongolia and Bhutan. All four of these countries are land-locked and face challenging geographical and historical circumstances, although in different ways. Kazakhstan and Turkmenistan were parts of the former Soviet Union and as such were almost completely planned economies until the Soviet Union imploded. They then faced an enormous task in reforming their economies and integrating into the world economy. Mongolia was not officially part of the Soviet Union but was so closely connected to it that it was sometimes referred to as the 16th republic of the Soviet Union (Pomfret 2011). Bhutan, a very small country in South Asia nestled between giants China and India, was never colonized but was long known as the “hermit kingdom” due to its self-imposed isolation from the world economy (Sengupta 2007).

These four countries are all highly dependent on one or several natural resources: oil for Kazakhstan, natural gas for Turkmenistan, minerals (particularly copper and gold) for Mongolia, and hydropower for Bhutan. They all prospered to varying extents from the boom phase of the commodity super-cycle during the 2000s and are now reeling from declining commodity prices and weakening demand for their primary exports. Even during the boom phase the capital-intensive nature of natural resource exploitation meant that relatively few jobs were created and inequality worsened. As for other

developing countries, creating employment opportunities for young people is an urgent priority. Thus, the imperative of economic diversification into more labor-intensive sectors is clear. The decline in commodity prices, although painful, can be viewed as an opportunity to advance structural transformation.

Figures 1.1 and 1.2, respectively, show the levels and changes of real GDP per capita, in international (purchasing-power-parity adjusted) dollars for the four countries since 1990. It can be seen from Figure 1.1 that Kazakhstan has a distinctly higher level of per capita income than the other three countries, and Bhutan has the lowest. In the former Soviet Republics and Mongolia, per capita GDP dropped considerably in the aftermath of the breakup of the Soviet Union, but has recovered strongly in the 2000s, especially in Kazakhstan. In terms of growth, however, Bhutan had the highest increase in GDP per capita over the 1990-2016, with a cumulative increase of 350 percent. The other three had cumulative increases of 150-200%, also quite impressive. The recent deceleration of growth for Kazakhstan and Mongolia is also visible in Figures 1.1 and 1.2.

The next four chapters of this report focus on each country in turn. While the structure of each chapter differs based on the particularities of that country, they all address the following issues: 1. The significance of natural resources in the economy, 2. Macroeconomic policy management of natural resource revenues, 3. The business environment, 4. Institutional structure and 5. Promising sectors for diversification.

Detailed policy recommendations are provided for each country, for each of the above topics. While the situation in these countries is undeniably challenging, in many cases governments are taking positive steps to improve macroeconomic stability, invest in infrastructure, upgrade the business climate and strengthen institutions. Agriculture and to a lesser extent manufacturing are very promising sectors for diversification, including niche products such as mandarin oranges (Bhutan), cashmere (Mongolia) and silk (Turkmenistan). The rich cultural heritage and varied geography of these countries are also conducive to tourism. There can also be synergies between tourism and improvements in the quality of some local food and manufacturing products. Further improvements in policies and institutions are necessary to realize this potential.

Figure 1.1
Real GDP Per Capita (purchasing-power-parity adjusted US dollars)
Bhutan, Kazakhstan, Mongolia, Turkmenistan, 1990-2016

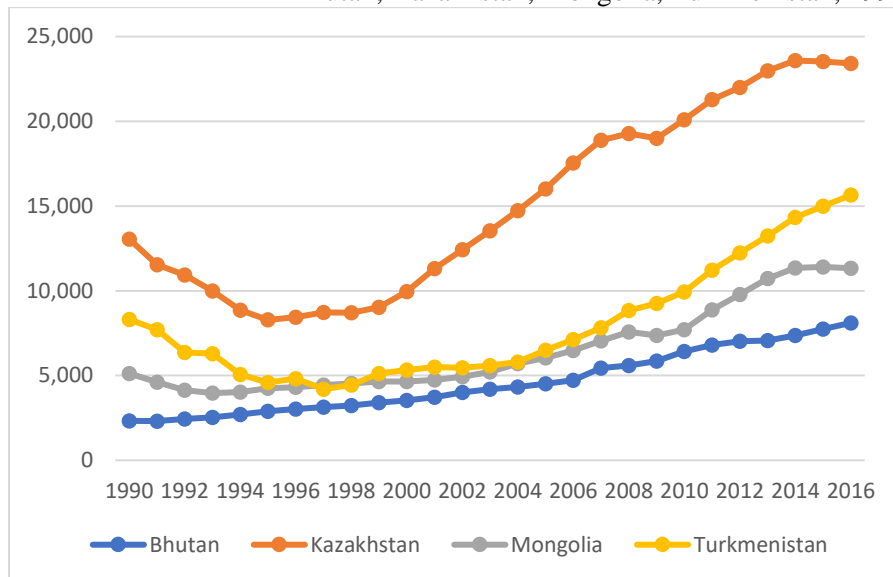
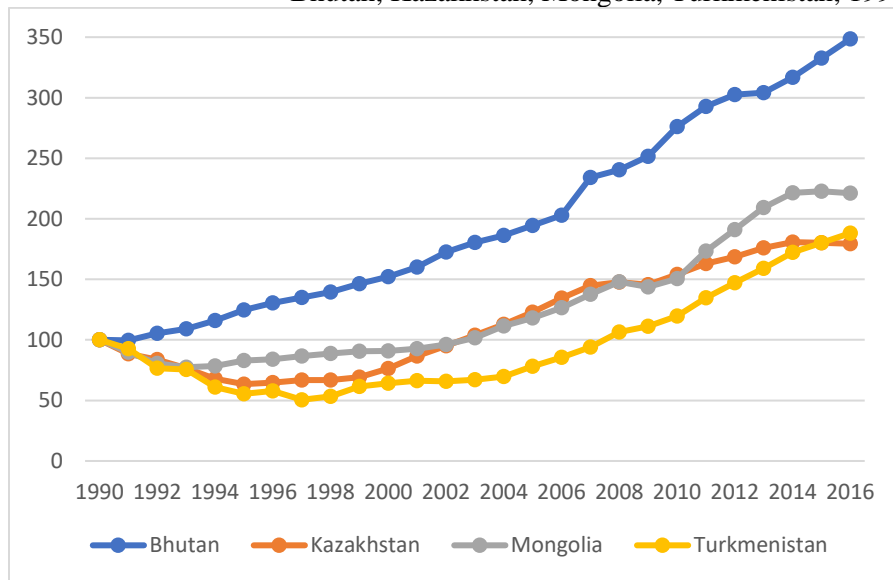


Figure 1.2
Real GDP Per Capita (PPP adjusted US dollars), Index 1990 = 100
Bhutan, Kazakhstan, Mongolia, Turkmenistan, 1990-2016



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II. Kazakhstan

1. Introduction

Kazakhstan is located in Central Asia, south of Russia and west of China. At the southern border, it neighbors three other Central Asian countries: Turkmenistan, Uzbekistan, and Kyrgyzstan. The land extends over about 2,700 thousand square kilometers, as large as Western Europe. While the country does not face any ocean, it borders the Caspian Sea, an enormous landlocked salt lake surrounded by Kazakhstan, Russia, Azerbaijan, Iran, and Turkmenistan.¹

Thanks to its huge oil reserves, Kazakhstan's economy grew rapidly during the energy boom in the early 2000s. After its independence from the Soviet Union in 1991, Kazakhstan has transitioned from lower middle-income to upper middle-income status in less than twenty years, and the GDP per capita (PPP adjusted) in 2016 reached about \$25,000. The oil-fueled growth has also led to a dramatic reduction of the poverty rate, from 46.7% in 2001 to 2.7% in 2015.²

A large part of the credit for this excellent performance reflects the favorable economic policies and institutional development since independence from the Soviet Union. Under a slogan "economy first, then politics" Kazakhstan has improved the business climate more successfully than other countries in the region and saved a large share of mineral revenues, thus maintaining macroeconomic stability and containing Dutch Disease (Pomfret 2011; Petrick and Pomfret 2016).

However, Kazakhstan has been struggling to overcome its over-dependence on mineral resources. Despite efforts to diversify the economy, Kazakhstan's exports have become increasingly concentrated on mineral products, especially oil (Table 2.1). While both exports of crude oil and manufactured products increased in absolute terms, the growth of oil exports far outpaced that of manufactured products; over 2001 to 2014, the average annual growth rate for mineral products was 21.6 percent, while that for manufactured products was 11.1 percent.³ As a result, the export share of crude oil increased from 21.3% in 1996 to 67.5% in 2014, whereas the share of manufactured products decreased from 47.8% to 15.4% over the period.⁴

¹ While some trades take place over the water, more important is the land route connecting Europe and China across the country, as we will discuss later.

² Measured based on national (i.e. country specific) poverty lines. World Bank, World Development Indicators.

³ Author's calculation based on UN Comtrade.

⁴ Manufacturing includes chemical and related products such as fertilizers, which heavily depend on subsoil resources like phosphate. If we exclude chemical and related products, the export share of manufactured products is even smaller.

Table 2.1 Total Exports and Export Shares of Selected Products			
	1996	2001	2014
Total Value of Exports	\$5.9 billion	\$8.5 billion	\$79.5 billion
Mineral products	32.9%	56.1%	76.4%
--Crude Oil	21.3%	50.1%	67.5%
Manufactured products	47.8%	29.5%	15.4%
--Chemical and related products	9.1%	1.4%	3.6%
Food and live animals	11.0%	5.0%	2.7%
--Cereals	8.5%	4.4%	2.2%

Source: UN Comtrade

A major challenge for Kazakhstan is to foster private sector development. The state-led development pushed by the President has enabled impressive growth but inevitably resulted in dominance of the public sector in the economy. State entities account for about 30-40 percent of the GDP, and a large national holding company controls assets worth more than half of the GDP in total (OECD 2016). The public sector is also a major employer, accounting for about one-third of non-agricultural employment (World Bank 2013). The enormous public sector crowds out private initiatives. The President recognizes the problem, and recently he has been leading various reforms to improve business environment. As a result, in World Bank's Doing Business 2017, Kazakhstan ranked 35th out of 190 economies, right after Japan. At the same time, the government has been advancing an ambitious privatization program under the President's order, although inadequate transparency and poor implementation hamper progress (World Bank 2017b).⁵ As noted in the introduction, successful privatization also requires accompanying institutional development, and privatization should proceed with caution.

In this context, this chapter identifies obstacles to diversification, and gives policy recommendations to overcome them. The chapter is structured as follows. Section 2 discusses macroeconomic policy and the management of oil revenues. Section 3 discusses the strengths and weaknesses of the business environment. Section 4 focuses on institutional development and governance. Section 5 identifies the country's potential in agro-business and manufacturing, emphasizing the importance of integrating into Global Value Chains (GVCs). Section 6 concludes that improving the business environment and spurring the private sector is the key for integration into the GVCs.

⁵ The authorities aim to privatize (either fully or partially) more than 780 state-controlled entities between 2016 and 2018.

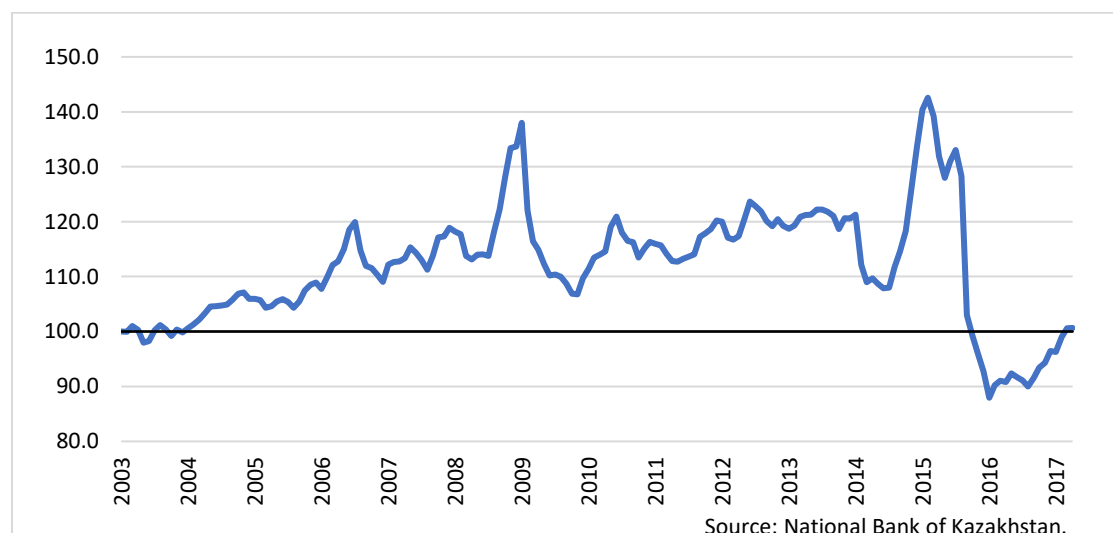
2. Oil and Macroeconomic Policy

The government has been managing tax revenues collected from the extractive sector prudently, saving most of them in the National Fund for the Republic of Kazakhstan (NFRK), established in 2000. During the 2008-09 global financial crisis, the NFRK savings allowed the government to launch the large “Nurly Zhol” stimulus package, which helped the economy withstand the downturn and a collapse of its own financial system. As of 2017, the NFRK assets amount to about 45 percent of GDP, and the public debt is projected to remain below 25 percent of GDP (IMF 2017).

While fiscal policy has been laudably prudent on the whole, as the economy recovers the authorities should scale back the stimulus. The government is also preparing a new tax code that will simplify and rationalize tax incentives and rely more on indirect taxation. These measures are praised by the IMF (IMF 2017). The Fund also recommends greater transparency on extra-budgetary expenditures.

Thanks to the fiscal prudence, real appreciation of the Kazakh tenge has been mostly contained within a moderate level despite the rapid mineral export growth (Figure 2.1). The movement towards greater flexibility has also been helpful in adjusting to shocks (IMF 2017) and restraining the current-account deficit.

Figure 2.1 Real Effective Exchange Rate of the Tenge (Excluding Oil, December 2003 = 100)



The collapse of oil prices in the second half of 2014 quickly threw the oil-reliant economy into trouble, exposing the country’s vulnerability to commodity price swings. The shock was exacerbated by falling external demand from China and Russia, Kazakhstan’s two main trade partners. Export revenues plunged by a staggering 42%, and Kazakhstan’s GDP growth slowed from 6.0% in 2013 to 1.2% in 2015 (Table 2.2). In response to increasing pressure on the currency, the authorities gave up the peg, and the tenge (Kazakhstan’s currency) depreciated sharply. While the introduction of floating exchange regime

helped absorb the trade shock, higher prices of imported goods drove up inflation (World Bank 2017b). The authorities undertook fiscal expansion to support the economy, and the public debt to GDP ratio jumped from 14.5 percent in 2014 to 21.9 percent in 2015 (which is nevertheless still quite low) (IMF 2017).

Table 2.2 Impact of Lower Oil Price on Kazakhstan's Economy			
	2013	2014	2015
GDP growth rate (%) [*]	6.0	4.3	1.2
Export Revenue (billion USD) ^{**}	84.7	79.5	46.0
Inflation (%) [*]	4.8	7.4	13.6
Exchange Rate (y-o-y percent change; Tenge/USD, end of period) ^{6*}	2.2	18.7	86.2

Source: IMF 2017(*), UN Comtrade (**).

By the end of 2016, the economy has bottomed out: growth is projected to pick up gradually; the exchange rate is stabilizing; FDI inflows are recovering; and inflation has come down (World Bank 2017b, IMF 2017). Yet, oil prices are likely to remain low, and Kazakhstan urgently needs to diversify the economy in order to sustain development and prepare for potential future shocks.

Summary of Policy Recommendations

- Continue to follow a pragmatic and countercyclical fiscal policy.
- Pursue tax reforms to simplify the tax system and rationalize incentives.
- Improve transparency of fiscal policy by reporting off-budget expenditures in the budget process.
- Continue to allow exchange-rate adjustments to external shocks.
- Foster diversification as analyzed in the remainder of this document.

3. Private Sector Development

3.1. Overview of recent reforms

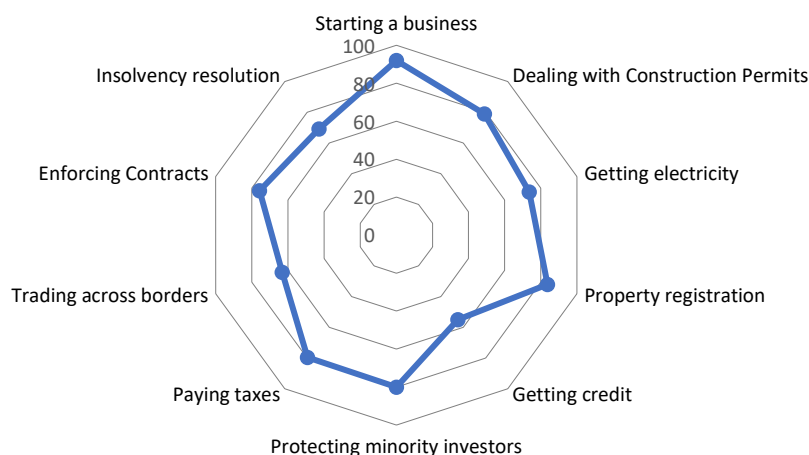
Kazakhstan has recently implemented a number of reforms and made outstanding progress in creating a business-friendly environment. The main driver of the reform was the State Program of Accelerated Industrial-Innovative development of Kazakhstan for 2010-2014 (SPAIID), launched in 2009. The program aimed to establish the foundations for industrialization by 1) creating an appropriate

⁶ Positive value indicates depreciation of the tenge.

legal framework, including new legislation on investment and amendments on more than fifty laws, 2) resolving the issue of energy shortages and updating transport infrastructure, and 3) providing business support programs and tools, such as subsidized loans for small and medium enterprises (Konkakov and Kubayama 2016).

The program led to substantial progress. The manufacturing sector attracted 2.9 times more FDI over five years of SPAIID than in the five years preceding it; furthermore, for the first time in recent history, the manufacturing sector of Kazakhstan began to grow at a faster pace than the mining sector (Konkakov and Kubayama 2016). While SPAIID ended in 2014,⁷ the government continues to make progress, which is visible in World Bank's Doing Business Index. In Doing Business 2017 (DB2017), Kazakhstan improved its rank by 16 positions,⁸ and now ranks at 35th out of 190 economies; in that year, Kazakhstan was the second top reformer in the world (World Bank 2017a).

Figure 2.2. Kazakhstan's Distance to Frontier Score in Doing Business 2017



Distance to Frontier score is indicated on a scale from 0 to 100, where 0 represents the worst performance and 100 the frontier.

Source: World Bank, Doing Business 2017.

However, reforms are far from being complete. The economy continues to depend heavily on oil, and manufacturing accounts for merely a little more than 10% of GDP.⁹ It is therefore essential to keep improving the business environment, especially in areas where the advance has been slowest. The Doing

⁷ State Program of Industrial and Innovative Development for 2015-2019 (SPIID) was launched to succeed SPAIID.

⁸ The improvement is measured not relative to the published ranking in 2016, but to a comparable ranking for 2016 that captures the effects of such factors as data revisions and the changes in methodology.

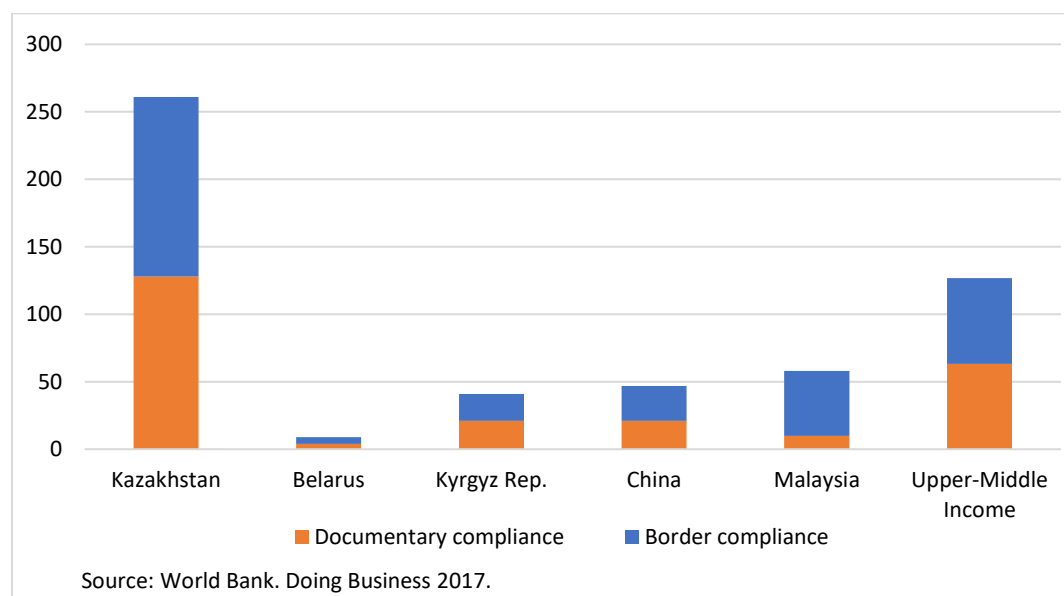
⁹ Source: World Bank, World Development Indicators. The figure includes chemical related manufacturing, which relies on subsoil reserves of phosphate, etc.

Business Index suggests that progress is lagging behind for “Trading across borders” and “Getting credit” (Figure 2.2). Other indicators like The Global Competitiveness Index point out weaknesses in institutions. This section analyses each of these areas, and discusses ways to make further improvements.

3.2 Trading across borders: Customs procedures

Although land-locked, Kazakhstan is located at a strategically important position between Europe and China, with overland corridors crossing the country. Moreover, China’s New Silk Road project¹⁰, announced in 2013, offers Kazakhstan an opportunity to become a transit hub bridging Europe, Asia, and the Middle East. The New Silk Road route through Kazakhstan can potentially reduce the delivery time from Asia to Europe from the current 40-60 days (via sea route) to 13-14 days (World Bank 2017c). Faster than sea-transport and cheaper than air-transport, the overland route has clear potential. Furthermore, as the New Silk Road project becomes a major transport route, Kazakhstan may become a more attractive participant in GVCs.

Figure 2.3. Time to Export, based on Doing Business 2017

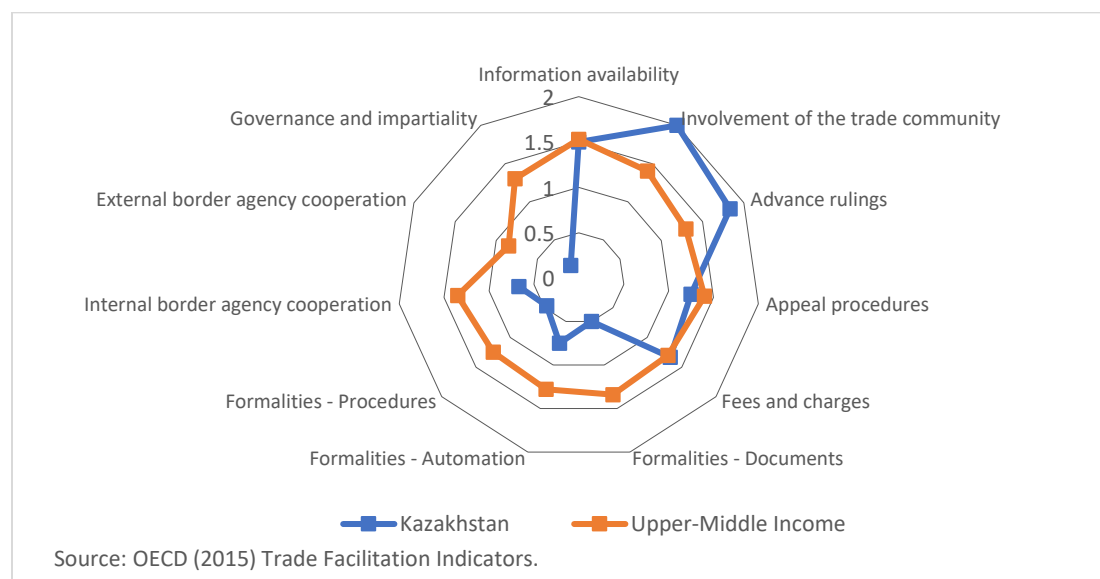


However, Kazakhstan’s poor performance in trade facilitation poses serious impediments to such development. World Bank’s Doing Business 2017 (DB2017) ranks Kazakhstan 119th out of 190

¹⁰ Also known as One Belt, One Road. The name, New Silk Road Economic Belt, alludes to the ancient trade route across Central Asia through which China used to export silk to Europe. It aims to strengthen over-land transport routes connecting China, Europe, and the Middle East and establish trade ties.

economies for “Trading across borders”. In particular, exporting from Kazakhstan is time-consuming, in terms of both border and documentary compliance (Figure 2.3).¹¹ Resulting delays create high opportunity, inventory, and warehousing costs, and render Kazakhstan uncompetitive both as a transit country and as a value chain participant. OECD’s Trade Facilitation Indicators provide a further insight into the obstacles to cross-border trade (Figure 2.4): Kazakhstan scores poorly in three indicators related to custom formalities in particular, along with “Governance & Impartiality” and “Internal Border Agency Cooperation”. Five reforms must be taken to streamline the customs formalities and improve transparency.

Figure 2.4. Kazakhstan: OECD Trade Facilitation Indicators



First, the number of documents required for import/export clearance should be reduced. Currently Kazakh traders need to prepare at least six customs documents in order to export a product to China, as well as a few additional forms for other government agencies depending on the product (World Bank 2017c). In total, the average number of required documents adds up to 10 for exports and 12 for imports. Simplifying customs regulations and documentary requirements would make customs procedures more efficient.

Second, an online portal that summarizes information on all required documents and fees must be established. Additional delays and fines due to improper documentation are common, and they create significant uncertainty for traders. The authority is currently in process of establishing a Single Window,

¹¹ Note that border compliance and documentary compliance partially overlap, and the sum overstates the total time or costs involved. Nevertheless, the sum provides a good cross-country comparison.

a single entry point to all regulatory authorities and agencies. The Single Window could coordinate information from different agencies and provide it online. The Single Window can potentially also improve internal border agency cooperation, another weak point in the Trade Facilitation Indicators.

Third, the entire customs process must be automated, and pre-arrival processing of documents should be introduced. While customs control and transit declarations are electronic, the clearance process is still paper-based and there is a 100 percent manual check of documents. Electronic payment of duties, taxes, fees and charges is not possible, either. To address the issue, the authorities are currently implementing ASYCUDA World, UNCTAD's customs management system. The new system is expected to be operational by mid-2017, and it can improve customs automation (World Bank 2017c). As a part of the automation, the authorities should seriously consider pre-arrival processing of documents. Pre-arrival processing is a common international practice that can greatly improve efficiency of custom clearance by reducing documentation errors. Each truck usually carries a huge variety of products, and there is a good chance that customs declarations for some goods are improperly prepared. Such errors can easily result in a delay of a few days, as the driver needs to contact the freight forwarder and wait until errors are corrected (CAREC 2014). Automated pre-arrival processing will reduce such delays, as it allows freight forwarders to detect many errors in advance.

Fourth, risk management (i.e. selective customs controls) must be fully adopted. While a general risk management system was implemented in 2010, the principle of selective control has not been fully adopted in reality, and a large proportion of consignments continue to be physically inspected at the discretion of customs officers. Customs officials estimate that around 24 percent of goods crossing the border are physically inspected; traders say that up to 50 percent of goods are actually subject to physical inspection (World Bank 2017c). Developed economies commonly adopt risk management using advance manifest, whereby more than 90% of shipments can be pre-cleared. Kazakhstan should try to implement a similar mechanism; with automated pre-processing of documents, this should become easier. Another way to make progress is to recognize Authorized Economic Operators (AEOs, i.e. traders who present a low risk of non-compliance) and offer them pre-approved clearance (CAREC 2015). Currently there are no AEOs in Kazakhstan, as a level of guarantee for customs payment and taxes is prohibitively high for most Kazakh firms (World Bank 2017c).

Last, interpretation and application of customs clearance procedures must be made consistent. Operations like speed of clearance, physical inspection, and administration of customs value vary significantly depending on customs officers and locations of border crossing points (World Bank, 2017c). Furthermore, CAREC (2015) suggests prevalence of unofficial payments in exchange for benefits, such as expedited processing of documents, waiver of penalties, or jumping queues to avoid long waiting time.

Resulting unpredictability due to such inconsistencies is likely to discourage business. The low “Governance & Impartiality” score in the Trade Facilitation Indicators reflects lack of mechanisms to ensure consistency and transparency. The authorities should make customs procedures clear to all border officials by providing guidelines, and introduce internal audit mechanisms for border agencies. In addition, it should establish effective sanctions against demand for or acceptance of unofficial payments by border agents.

In November 2015, Kazakhstan joined the WTO after 20 years of negotiation. Hence, Kazakhstan will be working to satisfy the obligations under the WTO Trade Facilitation Agreement (TFA), which will help reduce trade costs. However, there were three provisions Kazakhstan did not commit under the TFA: the creation of separate infrastructure for trade in transit; the possibility to provide guarantees for multiple transactions for the same operators or renewal of guarantees without discharge of subsequent consignments; and the appointment of a national transit coordinator to which enquiries and proposals relating to the good functioning of transit operations could be addressed (World Bank 2017c). It is strongly recommended that Kazakhstan implement these provisions if it wishes to be a successful regional transit hub.

Summary of Policy Recommendations:

In order to streamline the customs procedures and ensure transparency, following reforms must be taken:

- Reduce the number of documents required for exporting/importing.
- Create an online portal summarizing all information on documents required by any agencies.
- Automate the entire customs process.
- Introduce automated pre-arrival processing of customs documents.
- Ensure full adoption of risk management.
- Make customs procedures clear to all border officials, for example by providing guidelines.
- Introduce internal audit mechanisms for border agencies
- Set effective sanctions against misconduct of border agents to reduce unofficial payments.
- Implement all the provisions under the WTO Trade Facilitation Agreement.

2.3 Trading across borders: Infrastructure and logistics at border crossing points

Poor infrastructure and logistic at border crossing points are another impediment to trade facilitation. Especially, infrastructure constraints significantly limit speed at which goods travel through Kazakhstan. The speed of rail transport along the corridor connecting China and Europe would be 48

km/h in absence of delays; however, when delays at border crossing are considered, it reduces to 17 km/h (CAREC 2015).

The capability to handle cargoes should be improved at BCPs (border crossing points). Table 2.3 shows the duration of various types of delays at Dostyk, a BCP at the Kazakh-Chinese border. ‘Restriction on Entry’, the most time-consuming delay, occurs when terminals are full and cannot admit additional incoming trains. The major constraint is the need to trans-load cargoes at the border, which results from different gauge standards between Kazakh and Chinese railways. Inadequacy of facilities for transloading slow the process, causing “Restriction on Entry” as the terminals become full (CAREC 2015). Long delays associated with “Busy Reloading Facilities” also reflect the limited capability of facilities at the BCP. An attempt to address the congestion was opening of a new railway route connecting Altynkol (Kazakhstan) and Khorgos (China) in 2012. The new route is 200 km shorter than the route passing Dostyk, and the authorities had hoped to divert traffic from the Dostyk route. However, trans-loading capability at Altynkol is currently inadequate, and many freight forwarders continue to use the Dostyk BCP (CAREC 2015). Resolving capacity constraints at Altynkol will lower the burden on Dostyk, and allow traders to enjoy merits of the shorter Altynkol-Khorgos route.

Table 2.3 Duration of delays at Dostyk BCP (Rail, Inbound traffic) in 2015	
Cause	Duration when it happens (hours)
Restriction on Entry	32.7
No wagons available	19.0
Busy Reloading Facilities	8.0
Marshalling	7.3
Other Reasons for Waiting	6.0

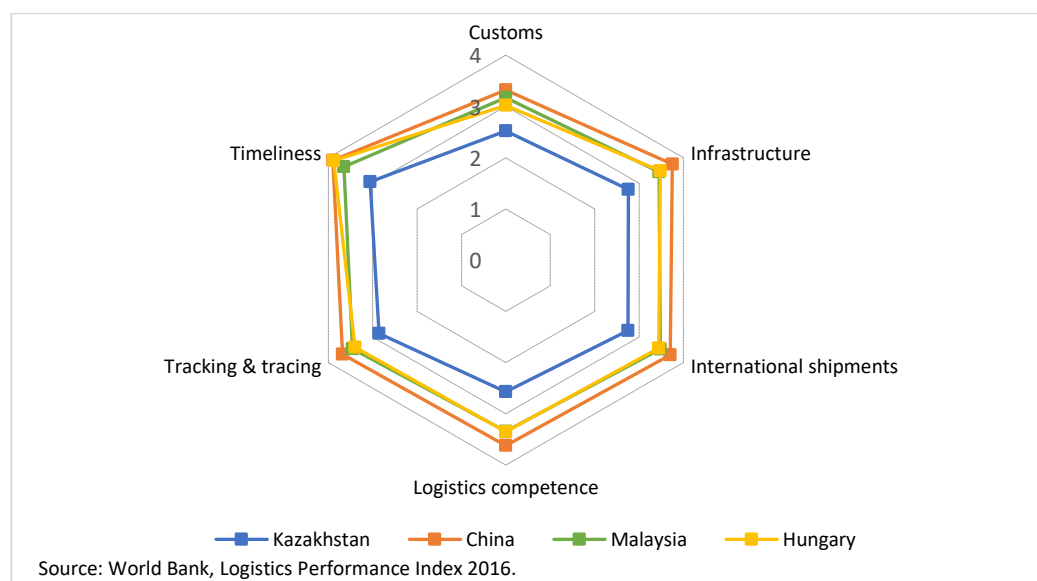
The data on the frequency of each type of delays were not available. Source: CAREC (2015)

Border-crossing fees associated with trans-loading must be lowered as well. The fee for trans-loading has been expensive and volatile; at the Dostyk BCP, it was \$285 in 2013, went down to \$135 in 2014, but surged up to \$327 in 2015 (CAREC 2013; CAREC 2014; CAREC 2015). Together with customs fees, the total cost of crossing the border at Dostyk BCP added up to \$432 in 2015 on average (CAREC 2015). Expensive border crossing fees make Kazakhstan less attractive both as a transit hub and as a potential participant in GVCs. The volatility of the fees can create uncertainty and discourage businesses as well. Enhancing private sector participation in the rail industry (for example through private

public partnerships) could help make the pricing of border crossing fees (and railway tariffs in general) competitive.

In road transport, the need to store cargoes in bonded warehouses at the Kazakh-Chinese border creates a bottleneck in the supply chain. In theory, if a truck can transport goods directly, shipment from Urumqi (the customs office in China) to Almaty (in Kazakhstan) will take only 1-2 days. However, most Chinese trucks are not permitted to carry goods directly to Almaty. In practice, goods transported from Urumqi must be unloaded and stored in private bonded warehouse at Khorgos (in China) until custom clearance is complete and Kazakh trucks come to collect them (CAREC 2014). The process could reach days. While a major breakthrough would be to arrange permission for bonded carriers to move goods directly from Urumqi to Almaty, it is unlikely given the different customs regimes between the two countries (CAREC 2015). Nevertheless, Kazakh and Chinese authorities should consider mutual recognition of AEOs in each country that can provide the bonded carriage.

Figure 2.5. Kazakhstan's Logistic Performance Index, 2016



Poor logistics is another serious impediment to trading across borders. Kazakhstan ranks at 77th out of 160 countries in World Bank's Logistics Performance Index 2016, and lags behind its peers in Asia and Eastern Europe in every sub-indicator of the index (Figure 2.5). In particular, it does very poorly in "Logistics competence", ranking at 92nd out of 160. Three reforms would improve the country's logistics performance.

First, Kazakhstan lacks quality storage facilities and modern logistic centers. The country is in process of making progress in this respect. Modern facilities that can support multi-modal transport are being built at the Kazakh-Chinese International Centre of Boundary Cooperation at Khorgos,¹² a major BCP for the Kazakh-Chinese border; furthermore, the government plans to establish several transport and logistics centers by 2020 (CAREC 2015). Kazakhstan should continue its effort to improve logistics infrastructure. Private public partnerships (PPPs) in management of logistics facilities can be effective.

Second, highly integrated logistics services overseeing the entirety of the supply chain need to be established. Fragmentation of supply chains at the border is a major issue in Kazakhstan's logistics. Border transit involves several transport and warehousing providers; private operators' access to the railway system and intermodal transportation is limited (World Bank 2017c). The authority has appointed Kazakhstan's national railway company (Kazakhstan Temir Zholy) as the country's integrated logistics operator (World Bank 2017c). Yet, the public sector tends to lack incentive to increase efficiency; development of private logistics services is essential to increase the competitiveness and lower the cost of the country's logistics. The authority should accelerate liberalization of the transport sector and creation of appropriate legal frameworks to foster development of private logistics operators that oversees the entire supply chain, from warehousing to transport, rail or road. Furthermore, given the lack of familiarity to modern logistics management methods among local providers, Kazakhstan should encourage entry of international third-party logistics (3PL) companies into the market in order to transfer know-how; their operation will also help Kazakhstan's logistics better integrate with the international network. Here again, improving transparency of the customs procedures would be important; uncertainty, inconsistency, and corruption discourage the entry of international 3PL companies.

Last, greater use of Information and Communication Technology (ICT) must be promoted. Little information exchange between supply chain participants limits tracking and tracing of shipments, and causes inefficiencies such as overstocking of inventories and suboptimal load factors in trucks. Better ICT infrastructure and information sharing will reduce fragmentation of the supply chain and increase its efficiency.

Summary of Policy Recommendations:

- Expand the capacity to handle cargoes at BCPs, especially for trans-loading.
- Lower border crossing fees associated with trans-loading, and keep it stable.

¹² A special economic zone has been established here.

- Consider mutual recognition of AEOs with China that can provide bonded-carriage across Kazakh-Chinese border.
- Build more quality storage facilities and modern logistic centers.
- Consider private public partnerships (PPPs) in railway and logistics sectors.
- Accelerate liberalization of the transport sector and creation of appropriate legal frameworks to foster development of private logistics operators.
- Encourage the entry of international third-party logistics companies into the market.
- Promote greater use of ICT to address the fragmentation of the supply chain

2.4 Getting credit

Together with trading across borders, getting credit is the weakest point in Kazakhstan's business environment. Kazakhstan ranks 104th out of 138 economies in "Financial market development" sub-indicator of The Global Competitiveness Index 2016-2017 (World Economic Forum 2017). Credit to GDP ratio is around 40% in 2015, far below the upper-middle income countries average and even below the lower-middle income countries average (Figure 2.6). Out of outstanding loans, consumer-oriented borrowing (households, trade, services) dominates with over 70 percent, while most businesses are cut off from bank credit entirely (IMF 2015). According to the latest Enterprise Surveys by World Bank (2014), less than 20 percent of firms have a bank loan or a line of credit. Lack of access to credit impedes private sector-led growth and diversification. 15.4 percent of manufacturing firms identified lack of access to finance as a main obstacle to doing business in Enterprise Surveys 2013; it was the largest impediment for manufacturing firms together after inadequately educated workforce (Table 2.4).

Figure 2.6 Domestic Credit to the Private Sector (% of GDP), 2015

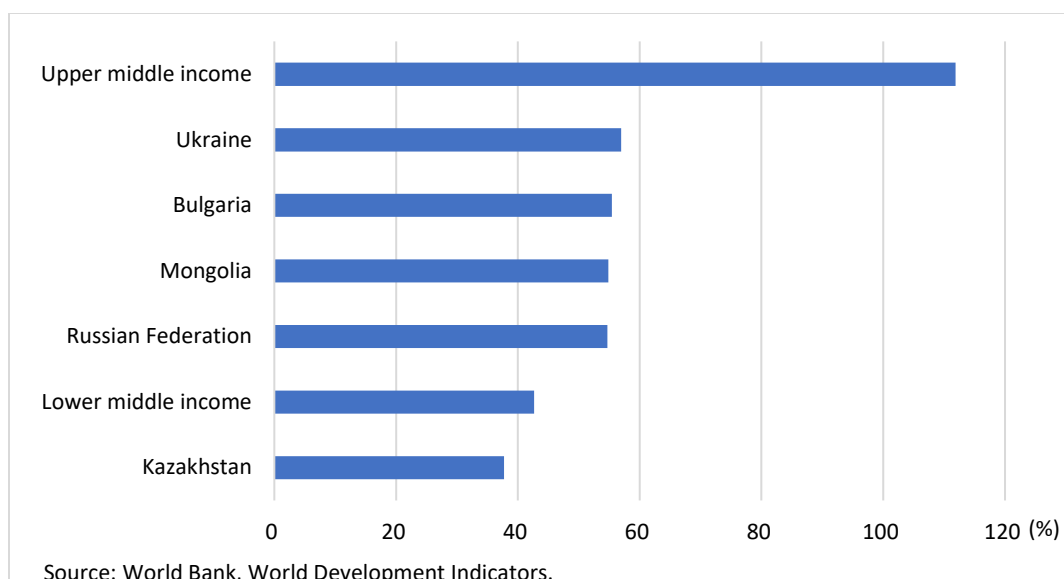


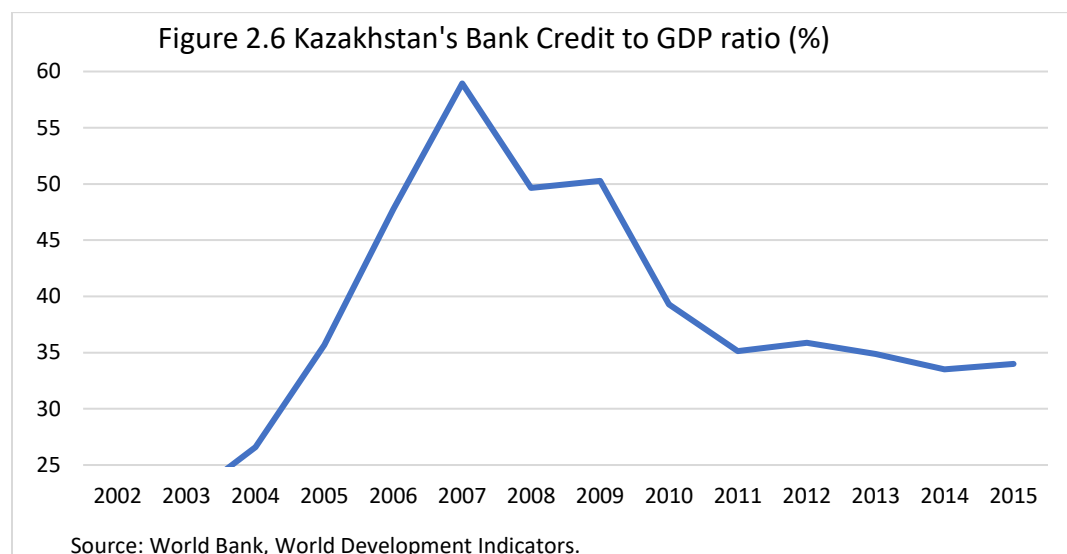
Table 2.4 Main obstacles to doing business for manufacturing firms in Kazakhstan, according to Enterprise Surveys 2013	
Problem	% of firms identifying the problem as an obstacle
Inadequately educated workforce	15.9
Access to finance	15.4
Corruption	13.6
Electricity	12.4
Practices of the informal sector	9.6
Tax rates	8.8
Transportation	6.4

Source: World Bank 2014

A major issue underlying the low credit availability is persistence of problem loans on bank balance sheets. The problem stems from the boom prior to the 2008-09 financial crisis. A strong country credit rating under favorable economic conditions allowed Kazakh banks to borrow substantial sums abroad and make quick profits by lending domestically. Easy lending (partly due to lax regulations) fueled a real estate bubble domestically, and foreign debt amounted to over 90 percent of GDP by 2008 (Pomfret 2011). Once the global financial crisis hit Kazakhstan, the banking sector collapsed. The real estate bubble burst, and many domestic loans turned bad. A 20 percent devaluation of the tenge in February 2009 further increased the cost of paying back foreign debts. In the first semester of 2009, the

Kazakh banking sector suffered astronomical losses of 1.6 billion dollars and a negative net worth of 3.1 billion; the largest bank at the time, BTA, lost capital worth three-quarters of its portfolio in the first three quarters of 2009 (Laruelle and Peyrouse 2013). Bank credit plunged after the crisis, and it remains low (Figure 2.7). Despite repeated capital injections and government interventions after the crisis, problem loans continue to constrain the bank balance sheets.¹³

Figure 2.7 Kazakhstan's Bank Credit to GDP Ratio (%)



While the official non-performing loans (NPLs) to total loan ratio decreased from over 20 percent in 2014 to below 10 percent in 2015, the figure does not reflect the true state of the bank balance sheets. Two reasons accounted for the decline in the official NPL ratio, neither of which actually reduced problem loans. First, the BTA Bank was delicensed in June 2015 and its NPLs were no longer included from the figure. Nonetheless, the NPLs were not written off and they remain in the system. Second, lack of consolidated reporting requirement encouraged banks to underreport NPLs and to keep them off-balance sheet. Loan restructuring is free of provisions and additional capital charges; restructured loans have increased from 10 to 25 percent of total loans in 2016. Agreement among banks to exchange problem loans and record them as new loans also takes place (IMF 2017). Also observed are a dramatic increase in the sale of problem assets into special-purpose vehicles (SPVs) and leniency in loan

¹³ IMF (2017) estimates that the authorities injected \$11.6 billion into the banking sector during 2008-14, equivalent of 5.3 percent of 2014 GDP.

classification (World Bank 2017b). Overall, IMF (2017) estimates the actual problem loan level to be over 40 percent of total loans.

The authorities have been taking measures to address the issue, including establishment of Problem Loan Funds in 2012 and adoption of more detailed capital requirements. They have also been facilitating acquisition of troubled Kazkommertzbank (KKB), the current largest bank in the system, by Halyk, the second largest (IMF 2017).¹⁴ However, progress has been slow and hardly enough to reduce problem loans in the system. Three actions must be taken to restore the health of the banking sector.

First, a consolidated reporting requirement must be reinstated in order to identify problems in the system. The authorities have been moving to the opposite direction: In July 2015, they relaxed prudential regulations, including those calling for consolidated financial reporting in line with the International Financial Reporting Standards. The relaxation played a part in the aforementioned drop in the official NPLs ratio (World Bank 2017b). The move must be reversed. Lowering the official NPL figures by relaxing regulations not only fails to reduce the actual problem loans, but also makes it hard to assess real risks. A consolidated reporting that covers off-balance entities (such as SPVs) must be established and strictly enforced to enable better monitoring. Successful completion of Asset Quality Review, which have been delayed, will also help better assess the banks' health more accurately (IMF 2017).

Second, the authority should force shareholders to recapitalize banks, and weak banks should be closed. To this end, additional legislation must provide more intervention power to the National Bank of Kazakhstan (NBK). Under the current legal framework, NBK has inadequate power to force shareholders to recapitalize their banks or to close weak banks (IMF 2017). Legal changes to give the NBK more authority as a regulator will enable decisive and quick actions needed to fix the banking sector.

Last, the Problem Loan Fund (PLF) must be fully utilized. So far, the PLF has been used merely as a means to place public deposit at banks rather than to resolve bad assets (IMF 2017). However, given the sheer size of the problem, the PLF must play a more active role in problem loan reduction. To this end, the authorities must capitalize the PLF and provide more resources (staffing, etc.). Nonetheless, the PLF must operate in a transparent and independent manner and with a clear mandate to maximize value recovery. Especially, bank shareholders must fully bear losses before public funds are used. Besides utilizing the PLF, changes in tax laws that facilitate loan-loss recognition and write-offs would also be effective to reduce problem loans.

¹⁴ KKB has faced increasing difficulties since purchasing BTA from the state in 2016. The authorities should ensure that the merger of KKB-Halyk would not end up creating another large troubled bank that requires further state support. IMF (2017) stresses that the KKB-Halyk transaction should proceed only after robust due diligence.

A sound banking sector is essential for private-led growth and diversification. Reduction of NPLs will restore bank confidence and improve credit availability to businesses, especially small and medium-sized enterprises. Aside from tackling the problem loans, the authorities should continue their efforts to improve prudential regulations to limit exchange rate risks and credit concentration. Introducing new regulations in these areas will reduce the banking system's vulnerability to future shocks and oil price volatility.

Summary of Policy Recommendations:

- Establish a sound banking sector by reducing problems loans. This can be achieved by:
- Reintroduce a consolidated reporting system (covering SPVs) to monitor the system better.
- Force shareholder capital injection, and close weak banks if it cannot raise capital.
- Give the National Bank of Kazakhstan (NBK) more intervention power.
- Utilize the Problem Loan Fund (PLF) to resolve problem loans (but only after shareholders fully bear losses).
- Change tax laws to facilitate loan-loss recognition and write-offs.
- Besides reducing problem loans, continue improving the details of macro prudential policies to limit banks' exposure to exchange rate and concentration risks.
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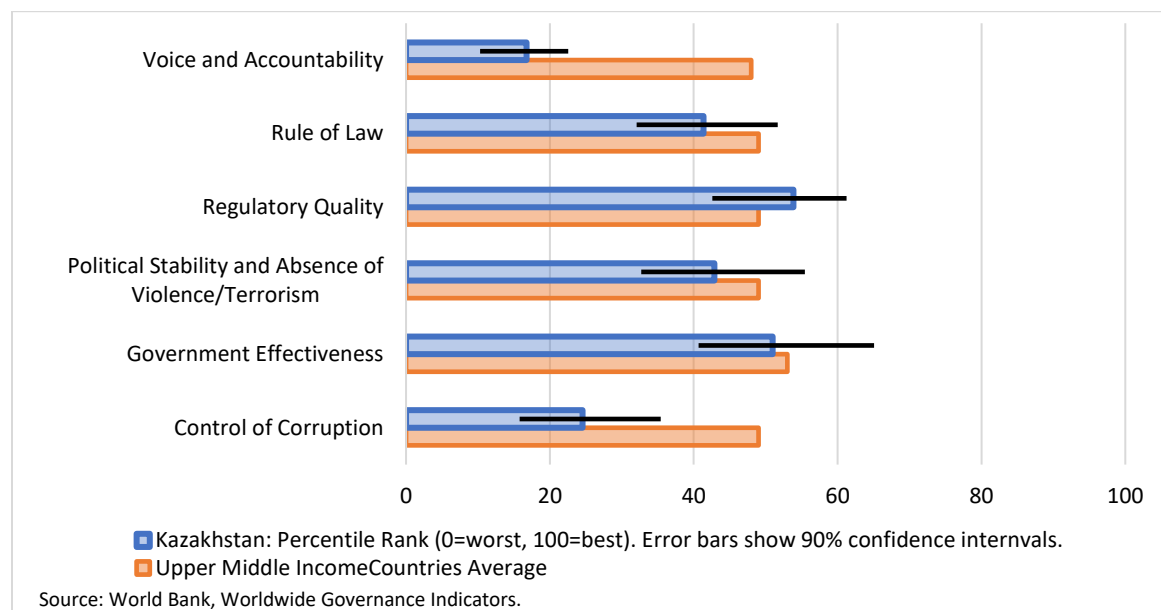
4. Institutions and Governance

4.1. Control of corruption and the rule of law

Corruption remains a major obstacle to doing business in Kazakhstan. While Kazakhstan performs more or less on par with other upper-middle income countries in terms of regulatory quality and government effectiveness, it lags far behind in control of corruption (Figure 2.8).¹⁵ Transparency International (2017)'s Corruption Perception Index 2016 ranks Kazakhstan at 131st out of 178 countries. Firms in Kazakhstan see corruption as a major impediment to their business. In Enterprise Surveys 2013, corruption ranked as the top problem for doing business, with nearly 20 percent of firms identifying it as an obstacle (World Bank 2014). The Global Competitiveness Index 2016-2017 also lists corruption as one of the most problematic factors, along with inflation, tax rates, and access to financing (World Economic Forum 2017).

¹⁵ Another area where Kazakhstan performs poorly is voice and accountability. The indicator measures the level of democratization. Kazakhstan is an autocratic country, and therefore the poor performance in this indicator comes as no surprise. While interesting, the indicator may not be as relevant here as other indicators like as rule of law.

Figure 2.8 Kazakhstan's Scores on World Bank Worldwide Governance Indicators



The authorities identify control of corruption as one of the key priorities, yet progress has been minimal. The government did undertake several anti-corruption measures, including establishment of The Civil Service and Anti-Corruption Agency in 2014 and launching of several anti-corruption programs (OECD 2016). However, despite having set numerous provisions to criminalize corruption, the government did not implement these laws in practice, and public officials continue to engage in corruption with impunity. Corruption charges have been used mostly as a tool for political maneuvering among elites or for punishing those who challenge President Nazarbayev's authority (GAN Integrity 2016). While corruption is rampant almost everywhere in the public sphere, three areas are of particular importance for improving the business environment: public services, judiciary, and public procurement.

Table 2.5 Expectation of irregular payments in various activities of public services	
Activities	% of firms expected to give gifts
Tax Inspection	24.7
Getting a Construction Permit	28.8
Getting an Import License	28.4
Getting an Operating License	16.7
Getting an Electric Connection	34.4

Getting a Water Connection	26.5
“Getting Things Done”	20.4

Source: World Bank (2014), Enterprise Surveys 2013.

Irregular payments are common in the public services. More than one in four firms expects to give bribes during tax inspection, and close to 30 percent of firms expect to give gifts for getting construction permits and import licenses (Table 2.5). Furthermore, public officials often apply laws and regulations in an inconsistent and arbitrary manner in efforts to extort bribes (U.S. Department of State 2016). Such practices not only add costs to business operations, but also create uncertainty and discourage investment. In order to address the problem, the Kazakh authorities must urgently enforce laws that criminalize corruption, and introduce an internal inspection mechanism. In addition, introducing transparent and merit-based recruitment and remuneration in public administration would be helpful. OECD (2016) shows that weaker belief in meritocracy tends to be associated with high perception of corruption; lack of fairness and inequality of opportunities breed a culture of corruption. Making salaries for civil servants competitive with the private sector could reduce incentives for corruption, too; this would also reduce turnover of top civil servants, which is also adversely affecting the efficiency of public services.

Corruption is deeply entrenched in the judicial system. In a recent survey by Transparency International (2013), 63 percent of respondents answered that the judicial system was corrupt or extremely corrupt, and thus it ranked as the second most corrupt institution in Kazakhstan. Bribes are often exchanged to win favorable court decisions (GAN Integrity 2016). Besides corruption, lack of judicial independence is a serious impediment to business; in the Global Competitiveness Index 2016-2017, Kazakhstan ranks at 68th out of 138 in this respect (World Economic Forum 2017). The interests of ruling elites influence court decisions, and firms do not trust the system in regards to the settlement of commercial disputes and challenging government regulations (GAN Integrity 2016). The unreliability of judicial system deters foreign investment, which Kazakhstan desperately needs for development of the manufacturing sector. Solutions are similar to the case of public service: enforcement of laws to criminalize corruption; introduction of internal audit mechanism; and merit-based recruitment and

remuneration.¹⁶ In addition, the authorities should implement a legal framework to strengthen the judicial independence. Being open to the use of foreign arbitration could reassure foreign investors, too.¹⁷

Public procurement is another area of concern, with one in five firms expecting to give gifts to secure a government contract according to Enterprise Surveys 2013 (World Bank 2014). There has been significant progress in this area, including enactment of Public Procurement Law (PPL) in 2007 and introduction of e-mandatory procurement procedures from 2012 (OECD 2016). The e-procurement ensures that the officials do not manipulate the records, and that the records are easily accessible. However, the PPL does not cover a significant part of the public sector, including government holdings and state-owned enterprises (World Bank 2013). This includes Samruk-Kazyna (SK), Kazakhstan's largest national holding company that manages state-owned companies in the oil and gas, energy, mining, transportation, information and communication sectors. By some estimates, the SK controls more than half of the economy, and is the largest buyer and seller in the economy (GAN Integrity 2016; U.S. Department of State 2016). In addition, SK has been given a special right to conclude large transactions between its holdings without public notification (U.S. Department of State 2016). The PPL must be amended to cover SK (and state-owned enterprises in general), given the sheer size of the public sector in Kazakhstan. The use of standardized e-procurement procedures is desirable. Furthermore, information about all the transactions that take place between national holdings within the SK must be made public in order to reduce the room for fraud and embezzlement.

In general, cultivating a culture of integrity is essential to fight corruption. Transparency International (2016) reports that fewer than 40 percent of respondents feel that it is socially acceptable to report corruption they witness, showing that corruption is currently a norm in Kazakhstan. The authorities must strive to reverse this and make absence of corruption the norm. Apart from corruption, foreign investors frequently complain of arbitrary implementation and application of laws and regulations, especially at the local level (World Bank 2013; U.S. Department of State 2016). Preliminary findings of the sub-national Doing Business assessment show that there is a gap between Almaty, the reference point for the national level assessment, and other regions of the country (World Bank 2017b). The central authorities should ensure that the local authorities implement legislations and regulations enacted at the center. Ensuring judicial independence and shielding the court from pressures from local authorities will be a key to reassure investors.

¹⁶ GAN Integrity (2016) reports that current recruitment is plagued with corruption, and becoming a judge requires giving bribes to high-level officials and court administrators.

¹⁷ Firms have expressed reluctance to seek foreign arbitration for fear of straining relations with the government (U.S. Department of State 2016).

Summary of Policy Recommendations:

- Introduce transparent and merit-based recruitment and remuneration for civil servants and judges.
- Make salaries for civil servants competitive with private sector.
- Extend the Public Procurement Law to cover government holdings and state-owned enterprises, including Samruk-Kazyna (SK).
- Disclose information about the transactions taking place between national holdings within the SK
- Cultivate the culture of integrity in the public sector.
- Ensure consistent implementation and application of laws and regulations at the local levels.
- Establish judicial independence to shield the court from pressures from local authorities.

4.2. Human capital

One area where Kazakhstan needs to improve in order to attract investment in manufacturing is human capital. Skills mismatch currently hampers the development of manufacturing sector; according to ERBD (2017), 20.1 percent of manufacturing firms identified skills as a major constraint on their growth in a survey undertaken in 2013-14. There is a deficit of 61-77 percent in technical specialists, with the largest categories of unfilled vacancies being “higher skilled experts” (25.8 percent of total) and “skilled workers qualified in industrial engineering, construction, transport, communications and geology” (15.6 percent). However, the problem is not a result of lack of access to education; 80 percent of workers in manufacturing firms have received training or education before or after joining the firm, and thus can be considered as skilled. Furthermore, enrollment in tertiary education and vocational training is high; about 38 percent of youths were in some form of post-secondary education in 2013 (ERBD 2017). This implies that the education system is failing to equip students with job-relevant skills and competences.

The authorities must enhance the quality of education and ensure that skills and knowledge offered in the education system align with those demanded by the economy. Recommended policies include updating skills standards and verification mechanisms, revising the incentive structure for teachers, and getting input from employers when developing course offerings and curricula (OECD 2016; EBRD 2017).

Summary of Policy Recommendations:

- Address skills mismatch by improving the quality of education and by ensuring skills and knowledge offered in the education system align with what is demand. To this goal:
- Improve skills standards and verification mechanisms.
- Revise the incentive pay structure for teachers.

- Get employers' input when developing course offerings and curricula.

5. Diversification strategies

Agri-business, and to lesser extent, manufacturing and tourism, are the sectors where Kazakhstan has the greatest potential outside the extractive sector. This section discusses each sector's strengths and weaknesses, and offers a few policy recommendations. Fostering growth of the private sector in ways previously detailed and attracting foreign direct investment will be emphasized. Overall, Kazakhstan must aim to integrate into global value chains (GVCs) in order to reduce the dominance of minerals in its exports.

5.1 Agribusiness

Agribusiness encompasses the entirety of the agro-food supply chain, from agriculture to food processing and food retailing. Overall, the strategy for successful agribusiness development will entail two goals: improving the productivity of agricultural production and developing competitive food processing and food retailing industries that are well integrated in the global market. Both agriculture and food processing/retailing are labor-intensive, and have important roles in poverty reduction, especially in rural areas.

Kazakhstan has a clear comparative advantage in agriculture. Kazakhstan is the largest landlocked country in the world, and has the second highest availability of arable land per capita. Its total cultivated area of 23.28 million hectares and 181 million hectares of rangeland is one of the largest in the world (World Bank 2017b). The main products are cereals (representing 19% of total production in 2012), horticultural crops (17%), dairy cattle (16%), and beef cattle (14%) (OECD 2015). Kazakhstan is a major exporter of grain, ranking 11th in the world for wheat exports in 2015.¹⁸ However, productivity in agriculture remains low. Despite employing nearly one fifth of the working age population, value added by agriculture accounts for only about 5 percent of GDP. Yield remains low across major commodities, and household plots, a non-registered subsistence form of agricultural production, are estimated to produce nearly three quarters of total milk and meat production (World Bank 2017b). The agro-food trade balance is negative; with the quality of local beef and dairy being low, urban consumers tend to prefer imported, industrially processed products, while domestic products mostly serve rural consumers and urban bazaars (Petrick and Pomfret 2016).

¹⁸ Author's calculation based on UN Comtrade.

Food processing and food retailing are expected to grow rapidly in coming years. With Kazakhstan's economy rapidly growing and disposable incomes increasing, demand for higher value and quality food products is increasing (OECD 2013a). These consumer trends tend to translate into development of a market for packaged foods and branded products. Kazakhstan's agribusiness segment is currently undercapitalized and competition is low, so the market is potentially attractive for new entrants. Moreover, given the strategic location of the country, Kazakhstan can become a platform for accessing the entire region. "Ink-spot strategy" – selection of a country as a springboard for accessing a region – is a common approach to international retailer expansions (OECD 2013a). Development of food processing and food retailing industries will increase agricultural value-added. In most OECD countries, the ratio between farm and retail prices amounts to 220 to 340 percent for meat and dairy products and up to 720 percent for fresh vegetables (OECD 2013a). In France, the food industry is the largest industrial employer and the second largest exporter (World Bank 2017b).

Attracting FDI is crucial for development of food retailing and processing. Especially, entry of global food retailers in the market will be essential to obtain know-how about food retailing logistics and to integrate the domestic supply chain with the global retail network. In order to attract global retailers, the authorities should consider providing tax incentives for them and easing profit repatriation. Even if some profits are remitted to their home countries, entry of established international food retailers will benefit domestic food processors and farmers, as they commonly source a large number of products from local producers (OECD 2013a). Their distribution network will allow small producers whose products were previously consumed locally to access new markets in other parts of the country or even abroad. The retailers will hire local people to run the stores and the distribution system, creating jobs. The know-how they bring may be utilized by Kazakh entrepreneurs in the future, too. The same is true for food processing, even though domestic producers are more likely to dominate in the food-processing sector.

Despite the ample potential, food retail investors face two main constraints. First, the quality and efficiency of the transportation infrastructure is low. While the authorities have been updating railways and major road corridors, investment and maintenance in regional and local roads lag behind (EBRD 2017). In the Global Competitiveness Index 2016-2017, Kazakhstan ranks 108th out of 138 in terms of quality of roads.¹⁹ Transport logistics in Kazakhstan are also poor (see Section 3.3). Improving the transport infrastructure is essential for development of the entire agribusiness sector (not only food retailing but also food processing and agriculture) given the perishable nature of many agricultural products. Development of better regional and local transport systems will also alleviate widening gaps

¹⁹ This is an area where private public partnership can be effective as discussed in section 3.

between urban and rural development. Second, availability and quality of local supplies are limited. Large scale and reliable local suppliers are few, and quality of local products are often low; retail chains have to import meat supplies from Germany and Poland because of the low quality of locally produced meat (OECD 2013a). If retailers cannot source products from local suppliers, benefits for domestic food processors and farmers will be significantly limited. The authorities therefore need to take measures to improve the reliability of suppliers and quality of their products, in both agriculture and food processing. In particular, state policies towards agriculture need two fundamental changes.

First, authorities should switch their focus from increasing output to increasing value-added of products. Currently evaluation of policies focuses primarily on quantitative targets, mostly output (Petrick and Pomfret 2016). Subsidies, that usually have little effect on productivity (and may even sustain inefficiency), dominate the state spending on agriculture. Given the current low productivity level, return from investing more in R&D activities and other measures to improve productivity and quality (for example development of modern phytosanitary and veterinary laboratories) will be high. In 2016, the spending on agriculture R&D represented only about 2 percent of the agriculture ministry's budget (World Bank 2017b). This needs to be increased. The authorities should also provide better extension and advisory services to farmers, so that they can benefit from knowledge gained from R&D activities. Updating plant and animal health systems will greatly augment the productivity and product quality, too. Improving the quality of agriculture products is essential for Kazakhstan's agribusiness sector to be competitive in the global market, in particular Europe.

Second, the state should incentivize creation of co-operatives among small- and medium-sized farmers. Organizing small farmers into co-operatives can potentially be a breakthrough for improving productivity and quality of meat and dairy production, where household plots and small individual farms dominate.²⁰ Co-operatives can address a number of areas where small farmers face constraints, including marketing, input supply, packaging and processing, agriculture extension, access to farm machinery, access to finance, and management of water distribution and irrigation (OECD 2015). Sharing farm equipment, machinery, and various facilities will lower cost of production, while coordinating production and distribution together increases efficiency and reduces fragmentation of supply chains. Yet, the greatest improvement hinges on improving access to finance. Small farmers face prohibitively high interest rates and stringent collateral requirements, because transaction costs for issuing small loans are high and banks usually have little information about the farmers to assess their credit-worthiness (OECD

²⁰ In 2012, households and individual farms accounted for over 90% of the production of milk, vegetables, potatoes, cotton and wool, as well as the majority of meat and oilseed production (OECD 2015).

2013b). Organizing small farmers into large co-operatives can lower transactions costs and make assessing creditworthiness easier for lenders. Retailers will also find it easier to communicate and transact with few, well-coordinated co-operatives than to deal with each individual supplier. The authorities should promote creation of co-operatives through reduced the tax burdens and simplified registration procedures. They should also raise awareness about co-operatives in rural areas and provide technical assistance for setting up co-operatives.²¹ In addition, the authorities should employ policies that encourage input suppliers, processing facilities, and retailers to work with co-operatives.

As for food processing, three policies are recommended to improve quality and reliability. First, develop public quality standards and food safety systems to ensure availability of high-quality products for retailers. Second, provide incentives to support investments in new technologies to improve the quality of the products. Last, develop a database of local suppliers that the retailers can utilize. The database will help local suppliers integrate into the value chain. It has to be regularly updated and maintained, however, to be effective (OECD 2013a). In addition, inclusion of relevant food processors into aforementioned co-operatives could be helpful to improve coordination of supply chains and access to finance for them.

Summary of Policy Recommendations:

- Food retailing
 - Attract international food retailers.
 - Improve the quality and efficiency of transport infrastructure, especially regional and local roads.
- Agriculture
 - Switch the focus of agricultural policies from raising output to increasing value-added of products.
 - Increase investment in R&D activities.
 - Create more modern phytosanitary and veterinary laboratories.
 - Offer more extension and advisory services.
 - Incentivize creation of agricultural co-operatives. (Co-operatives may include food processors.)
- Food processing

²¹ A unique challenge in Kazakhstan is to build trust in co-operatives among farmers. They associate the term “co-operative” with a production co-operative, a remnant of the Soviet collective farm system. For more discussion and policy recommendations for developing co-operatives in Kazakhstan, see OECD (2015).

- Develop public quality standards and food safety systems.
- Provide incentives to support investment in new technologies.
- Develop a database of local suppliers for retailers.

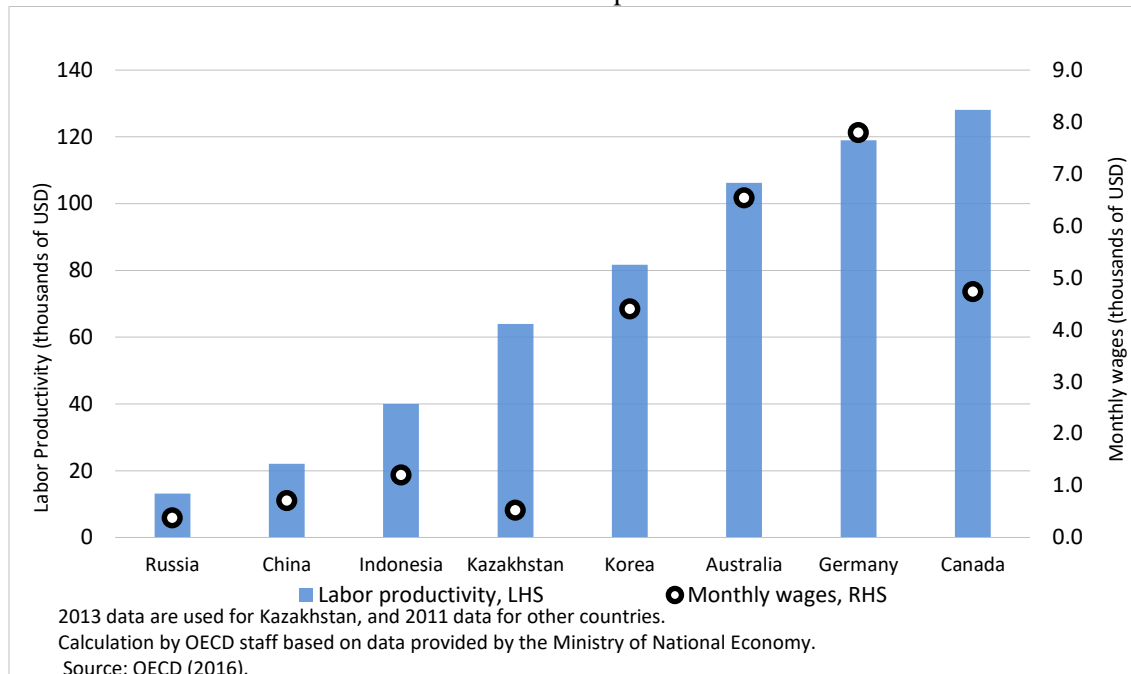
5.2 Manufacturing

Currently, Kazakhstan's manufacturing sector represents only about 10 percent of GDP. However, if the business environment improves sufficiently, Kazakhstan has a potential to develop a competitive manufacturing sector through attracting FDI and integrating into the GVCs. Thanks to the ample energy resources, Kazakhstan's electricity supply is relatively stable. According to Enterprise Surveys 2013, the average number of power outages per month was 0.5, as opposed to the upper middle-income countries average of 1.9; value lost due to power outages is only 0.4 percent of sales, as opposed to 0.7 percent for the upper middle-income average (World Bank 2014).²² The labor market is very efficient, and Kazakhstan ranks 20th out of 138 economies in Global Competitiveness Index 2016-2017 for labor market efficiency (World Economic Forum 2017). Labor productivity in key manufacturing sectors is above its peers such as China and Indonesia, although lagging behind developed countries; cross-country comparison of labor productivity and wages by OECD (2016) seems to suggest that Kazakhstan's manufacturing sector can be competitive (Figure 2.9).²³

²² However, Kazakhstan's power sector is not without problems. While danger of electricity shortage that was imminent in early 2010s (the capacity margin fell to 4 percent in 2012) has been resolved for the time being, the authorities have reversed previous reforms and increased their control on the sector in addressing the issue, despite the need for more private participation. With price unreflective of costs and heavy state regulations inhibiting private initiatives, the long-term prospect of the power sector is uncertain. See Aldayarov, Dobozi and Nikolakakis (2017) for further discussion on Kazakhstan's power sector.

²³ However, reliability of the data can be questioned. OECD (2016) calculates the figures based on data received from Kazakhstan's Ministry of National Economy. Due to possible methodological differences, the cross-country comparison (especially that of wages) may not be entirely valid. OECD (2016) also compared figures for 'food and related manufacturing' and 'chemicals and pharmaceuticals', which showed a similar trend as do 'transport and equipment' figures, but did not present comparison for other manufacturing sectors such as textile and machinery.

Figure 2.9. Labor Productivity and Wages for Transport Equipment, Kazakhstan and Selected Comparators



Kazakhstan should aim to integrate into GVCs, finding niches of comparative advantage in production processes, rather than to set up industries on its own through import-substitution industrialization (ISI) strategy. For example, as part of diversification strategy, Kazakhstan has been trying to establish a car industry through ISI within protected domestic market (and within the custom union with Russia and Belarus) (Pomfret and Sourdin 2014). However, the authorities should recall the experience of Malaysia, where it tried to establish a car industry and produced a national car, Proton, which failed to become competitive in the global market. In today's world where production is increasingly fragmented and each step is sourced where it can be performed best, Kazakhstan stand no chance unless it participates in the GVCs (Pomfret and Sourdin 2014). By joining the GVCs, Kazakhstan can focus on particular steps in value chains (for instance assembly or production of parts) where it turns out to have a comparative advantage, without having to set up the entire production process on its own. In order to attract FDIs and participate in the GVCs, Kazakhstan must facilitate trade further and create a business-friendly environment where private sector can prosper, as outlined in Section 3. Benefits from technological transfers will be significant for Kazakhstan, given its lack of technological sophistication.²⁴

²⁴ In The Global Competitiveness Index 2016-17, Kazakhstan ranks 90th for 'availability of latest technologies' and 95th for 'FDI and technology transfer' out of 138 countries (World Economic Forum 2017).

Joining regional value chains (RVCs) can be a useful intermediate step. China's "One Belt One Road" initiative, involving infrastructure investments in Central Asia to boost regional trade, could have an important effect on integrating Kazakhstan and other countries in the region. In particular, China has built the "Ghorgos Gateway", the largest dry container port in the world, connecting China and Kazakhstan by rail.²⁵

World Bank (2013) suggests a number of possible manufacturing products and clusters in which Kazakhstan could develop comparative advantage. Natural-resource based manufacturing, such as fertilizer or other petroleum products is one possibility. However, many of these products are quite capital- and technology-intensive and Kazakhstan's more immediate opportunities may lie in agro-processing, as discussed in the next section.

Summary of Policy Recommendations:

- Aim to participate in global and regional value chains (GVCs and RVCs).
- Facilitate technological transfers by creating a business-friendly environment as outlined in Section 3.

5.3. Tourism

Tourism is relatively underdeveloped in Kazakhstan but the number of visitors has risen steadily in recent years and the country has considerable potential to become a significant destination for business and leisure travelers seeking new destinations. Tourism contributes about 3% of global GDP but only 1.6% in Kazakhstan (Kennedy 2015). As the ninth largest country in the world, Kazakhstan has a range of natural settings, including mountains, lakes and deserts, as well as some unique cultural attractions reflecting the country's multifaceted historical development, shaped by Islamic and Soviet influences. The latter include the legacy of the historic Silk Road trading route in Asia, the largest mosque in Central Asia and the remnants of a huge Soviet era gulag. 2017 has been a watershed year for tourism in Kazakhstan, hosting EXPO 2017 in June 2017 and the announcement of an updated tourism strategy, the "Concept of Tourism Development until 2023". As part of the process of boosting tourism, the government announced further easing of visa regulations for visitors in July 2017.²⁶

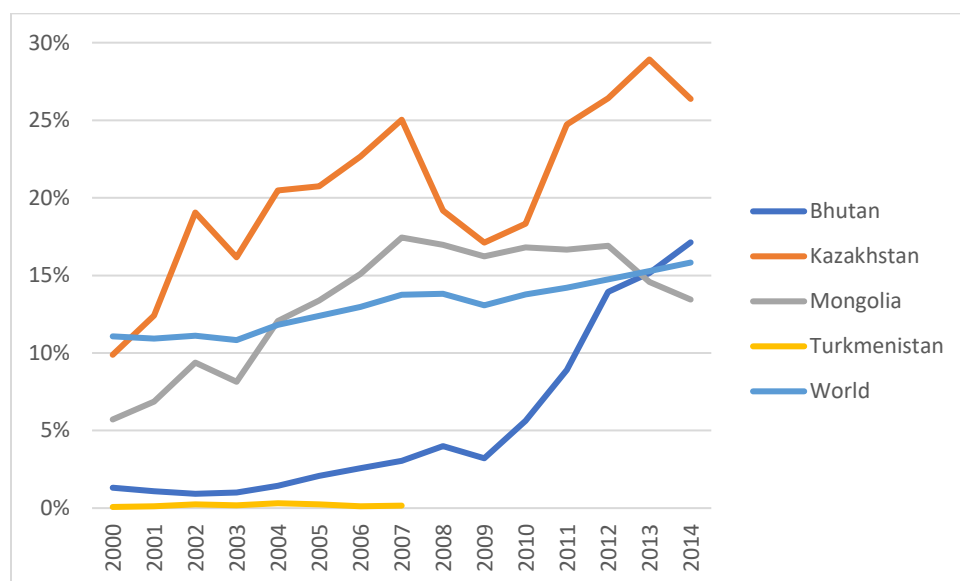
Figure 2.10 shows tourist arrivals as a ratio of the country's population in Kazakhstan and the other three countries of this study, and the world. Figure 2.10 reveals that arrivals have increased sharply

²⁵ <https://www.forbes.com/sites/kenrapoza/2017/07/18/kazakhstan-bets-big-on-chinas-silk-road/#102994f85805>

²⁶ Dana Omgazy "Kazakh government approves tourism development concept" *Astana Times* July 6, 2017.

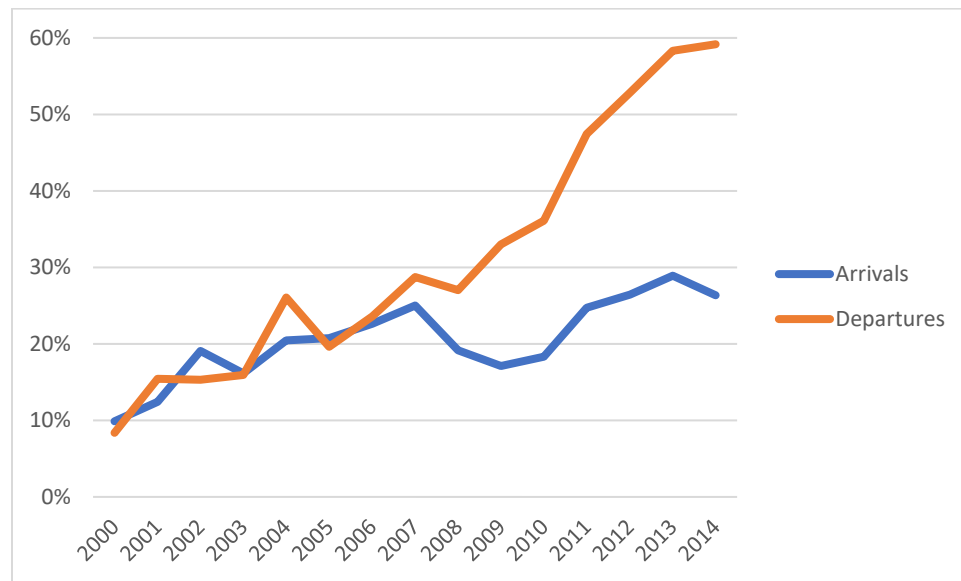
in Kazakhstan and have reached a high level compared to other countries in this study and the world as a whole. However, outbound travelers have grown even faster, as Figure 2.11 shows. In interpreting these figures, it should be noted that arrivals and departures data are compiled by the United Nations World Tourism Organization (UNWTO) from national data based on differing methodologies, and may count anyone who enters the country, including citizens returning, so it is a very imperfect measure of tourism, particularly for cross country comparisons. Much of this movement in and out of Kazakhstan may reflect short-term travel within the Central Asian region, particularly migrant workers. Indeed, most arrivals are from neighboring countries. In 2011, the vast majority of visitors were from three countries: Uzbekistan (34%), Kyrgyz Republic (27%) and Russian (24%) (Zhomartova 2013). Despite these limitations, it is clear that Kazakhstan is receiving additional visitors and the contrast with its neighbor Turkmenistan is striking.

Figure 2.10 International “Tourist” Arrivals in Kazakhstan, Bhutan, Mongolia, Turkmenistan, and the World (Percent of National Population)



Source: World Bank, based on World Tourism Organization data.

Figure 2.11 International Tourist Arrivals and Departures in Kazakhstan, (Percent of National Population)



Source: World Bank, based on World Tourism Organization data.

At Expo 2017, the head of the UNWTO Taleb Rifai lauded Kazakhstan’s promise in tourism but noted several steps that the country needs to take in order to realize this potential. First, he proposed simplification and speeding-up the visa application process. Second, he suggested that the country should gradually increase the frequency of international flights through reduced regulatory barriers. Third, Kazakhstan should engage in an international marketing campaign to improve its image. Fourth, training of skilled tourism personnel should be promoted. These recommendations are similar to those of other studies. Zhomartova (2013) also proposes that entry of small travel agencies be facilitated, improved domestic as well as international transport infrastructure, establish modern electronic systems for reservations and information, and improved data collection on the tourism sector. Kennedy (2015) observes that there is a shortage of mid-range (three star) hotels and a surplus of luxury (five star) hotels. Environmental preservation efforts must also be strengthened if Kazakhstan is to develop high-end ecotourism. In some cases, ecotourism can conflict with sports tourism such as skiing.

The government has moved to support tourism in recent years (Kennedy 2015). In 2014, the Tourism Industry Committee was replaced by the Department of Tourism. The government has created a helpful website for visitors, <http://visitkazakhstan.kz>, available in English and Russian. The new Tourism Development plan identifies five clusters for tourism with different sorts of attractions and activities. The Astana cluster has two parts, the “urban” component in the city itself named “Heart of Eurasia” and the rural component named “Unity of Nature and Nomadic Culture”, which includes the Ulytau State Nature

Reserve. Several other clusters are identified, including ones associated with the Silk Road, beaches along the Caspian Sea, and nature parks in different regions. The tourism development measures to be implemented in two phases, 2017-2019 and 2020-2023.

The government has been gradually easing visa requirements since 2014, extending visa free entry to citizens of more countries and extending the time they can stay without visas.²⁷ However, there are complaints about high prices, poor service and bureaucratic hassles from government, such as having to register with the migration police.²⁸

Summary of Policy Recommendations

- Refine and implement the Concept of Tourism plan, emulating successful tourism development strategies in other countries such as Morocco and Malaysia.
- Reduce bureaucratic hassles for tourists such as having to register with the Migration Police.
- Remove barriers to foreign airlines serving Kazakhstan.
- Encourage visitors from Europe through additional marketing efforts, reduced costs and improved quality of service.
- Develop training of skilled tourism management personnel, perhaps through a hotel school.
- Upgrade the importance of preserving the natural environment to spur ecotourism.
- Provide additional data and analysis on the tourism sector.

6. Conclusion

Kazakhstan has recently made significant progress in improving the business environment, but has yet to overcome its dangerously high dependence on the extractive sector. It needs to diversify the economy and exports in order to sustain the impressive growth and improvement in living standard it enjoyed in the previous decade, and to reduce its vulnerabilities to commodity price swings. The key sectors for diversification are agribusiness and, to lesser extent, manufacturing. In the former, Kazakhstan has a potential become an exporter for agricultural products and processed food, as well as a regional pivot for the international food-retailing network. In the latter, Kazakhstan should aim to join global value chains. Either way, the key for export diversification is to integrate into the global market and value chains by attracting FDI. To achieve this goal, it must implement a number of reforms that help create a

²⁷ <https://www.euractiv.com/section/global-europe/news/kazakhstan-lifts-visa-requirements-to-boost-tourism-investment/> January 3, 2017.

²⁸ <https://www.theguardian.com/world/2014/jul/17/kazakhstan-eases-visa-restrictions-attract-tourists>.

business-friendly environment. Areas that require further progress include trade facilitation, access to credit, control of corruption, infrastructure, and human capital.

It is important that Kazakhstan strive for growth led by private initiatives, rather than by public spending and intervention. State-led industrialization entails two dangers. First, public policies and initiatives tend to suffer from both bureaucracy and inefficiency, resulting in resource misallocation. This is especially likely for Kazakhstan, where corruption is prevalent and capacity of public services is limited. Second, high spending by the government and public entities places upward pressures on wages and prices, and thus risks exacerbating Dutch Disease. Given the sheer size of the public sector in Kazakhstan's economy, there is a high risk that state-led industrialization would end up damaging the non-oil tradable sector, in particular manufacturing industries. Therefore, the authorities must focus on spurring the private sector through lowering barriers to doing business, rather than attempting top-down industrialization. Even where presence of the state is essential, such as provision of public goods, the authorities should seriously consider private-public partnerships (PPPs); it can introduce market mechanism and ensure efficient operation and cost-reflective pricing. PPPs would be effective in areas like transport infrastructure (e.g. construction of roads and maintenance), logistics, power sector, and communication. The ongoing effort to privatize national holdings is also welcomed, as long as it is kept transparent and competitive.

Once an efficiency-oriented environment that fosters private initiatives is established, FDI will naturally flow in where Kazakhstan turns out to have a comparative advantage. The state's main role will be to eliminate constraints that discourage private initiatives (e.g. streamline licensing processes) or introduce mechanisms that help overcome these constraints (e.g. promote formation of agricultural co-operatives). In particular, trade facilitation is crucial for Kazakhstan to be an active participant in the GVCs. The New Silk Road project led by China offers a great opportunity for Kazakhstan to transform its geographic location that always posed as a constraint (i.e. no access to open sea) into an advantage (i.e. strategic location between China, Europe and the Middle East) and integrate into regional and global production networks. If Kazakhstan keeps up the current pace of reforms, it is likely that the diversification efforts are going to pay off in the near future.

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III. Turkmenistan

1. Introduction

Turkmenistan's economic growth has been impressive, with real GDP per capita tripling between 2000 and 2015, moving the country to upper middle-income status, thanks largely the exploitation and export of natural gas. While data on poverty levels are unavailable, it is clear that the standard of living of the population has improved considerably (World Bank 2014). Natural gas revenue enables the government to provide electricity, gas, and water to the entire population free of charge. Prices of other basic consumer goods are also subsidized. Despite resulting distortions, low prices have generally improved the standard of living and secured the approval of the administration among the citizens. In addition, natural gas exports allowed Turkmenistan to accumulate large foreign exchange reserves, although their magnitude is difficult to ascertain, and thus to maintain a currency peg to the US dollar. Investment has been high too, although many of the projects are of questionable usefulness in promoting diversification and inclusive growth.

Despite strong economic growth, a close analysis of a variety of economic and social indicators shows that the recent increase of GDP falls short of a structural transformation of Turkmenistan into a more developed economy. Turkmenistan faces many challenges in expanding the role of the private sector, diversifying the economy and thus becoming a fully developed nation. Despite rapid growth of aggregate output and investment, a large share of the population ekes out a meager living in subsistence farming and poverty remains widespread, although once again no specific figures are available. Unemployment and underemployment are reported as high as 60 percent (Bhor 2016).

The high level of dependence on natural gas is not a solid foundation for long-term development. In 2013, natural gas accounted for 35 percent of GDP, 85 percent of fiscal revenues, 90 percent exports and almost all inward foreign direct investment (FDI) (World Bank 2014). High volatility of output, low levels of employment creation and lack of linkages to the rest of the economy are among issues that typify dependence on fossil fuels. Furthermore, natural gas is more difficult to transport than oil, as it requires expensive investment in pipelines. In addition, Turkmenistan's potential markets in Europe can only be reached after traversing politically unstable or hostile regions such as Afghanistan and Russia. These factors make regional diversification of exports challenging. At present, exports of Turkmen gas are precariously dependent on a single destination—China. The recent downturn in energy prices has

brought these issues to the fore. The fiscal balance has deteriorated, international reserves are declining and wage payments are in arrears for many workers.²⁹

The government of Turkmenistan's "National Program for Socio-Economic Development for 2011-2030" sets ambitious targets for continued growth and rising living standards through a rising role of the private sector and economic diversification. As this report points out, Turkmenistan has promising areas of diversification in tourism, textiles, and agriculture. The government recognizes the importance of privatization, liberalization and institutional development to realize its potential (World Bank 2014). On the other hand, various analyses agree that Turkmenistan is lagging in implementing reforms. While less information is available for Turkmenistan than other countries in the region, a number of indicators rate Turkmenistan's business climate as among the worst of the world, as described below. The barriers to economic diversification include nontransparent political institutions and the Soviet legacy of tight state control of the market, including the financial system. Tight restrictions of the private sector, poorly developed property rights, and corruption constrict the growth of agriculture and manufacturing. Insufficient progress towards democracy and concern about human rights abuses can also deter some foreign investment and international trade, as well as discourage the support of international organizations like EBRD and World Bank. Furthermore, despite the professed goal of diversification, the natural gas sector absorbs a disproportionate share of government investment.

This chapter begins by introducing the economy's dependence on natural gas and describing Turkmenistan's macroeconomic policies. The chapter then turns to a detailed assessment of the challenges related to the business environment, stressing the central importance of increasing liberalization and transparency. Barriers to both domestic and foreign investment are considered in detail. The paper then examines Turkmenistan's most prominent diversification opportunities in agriculture, manufacturing, and tourism. Notwithstanding the limited information available and the major deficiencies in the business climate, it is clear that Turkmenistan has great potential if it can enact and implement the reforms outlined in this document.

2. Dominance of Natural Gas

Turkmenistan possesses the fourth largest natural gas reserves after Russia, Iran, and Qatar and has the second largest single deposit, Galkynish, from which extraction started in 2013 (World Bank 2014; Bohr 2016). Though there remains considerable uncertainty about their exact size, Turkmen reserves are expected to last at least 250 years. The main challenge at present is extraction of gas from

²⁹ "Shrinking Exports spell trouble for Turkmenistan," *The Economist*, December 15, 2016.

onshore and offshore fields, which is technically complex. In 2013, the country produced about 62 billion cubic meters (bcm) of gas, far below its potential and lower than the 81 bcm in 1989 at the end of the Soviet era, although up considerably from the 1990s. On the supply side, Turkmenistan's capacity is held down by its unwillingness to allow foreign energy companies to participate in onshore production, with the exception of Chinese companies. Shutting out Western firms results in lack of domestic technical expertise and managerial skills and antiquated pipeline and drilling infrastructure. On the demand side, Turkmenistan has limited ability to access the European market due to the inability or unwillingness to construct the requisite pipelines. Turkmenistan's lack of geographical diversification has made it vulnerable to fluctuations in demand in its main customers, formerly Russia and now China. The deterioration of the Turkmen external position in 2009 reveals the country's vulnerability to natural resource price shocks (EBRD 2014). The plunge in European demand, which was a significant destination of Turkmen gas export before the crisis, and tensions with Russia led to a sharp drop of gas exports (World Bank 2014).

Furthermore, lack of regional diversification undermines Turkmenistan's bargaining power in setting gas prices, and the prices it previously received from Russia and recently from China have often been well below world levels. Until 2010, Russia was the single biggest buyer of Turkmen gas, in part for transshipment to Europe. Pricing was a contentious issue in Turkmen-Russian relations, with Russia paying below world prices. A pipeline explosion in 2009 exacerbated tensions in the Russian-Turkmen trade relationship³⁰. The conflict with Russia forced Turkmenistan to shift its exports to China, with which a new pipeline had recently been constructed, fortuitously (Bohr 2016). Today, China is by far Turkmenistan's most important export market; trade between these two countries grew by twenty times between 2007 and 2012. In the first 10 months of 2016, Turkmenistan exported 25.6 bcm of natural gas to China, far more than to any other country. However, the price of Turkmen gas for China is significantly lower than it was for Russia. The dependency is exacerbated by the fact that China financed the construction of the Turkmen pipelines leaving Turkmenistan in a large debt. It is thus advisable for Turkmenistan to diversify further its markets to the Middle East and Europe, though the latter may require allowing multinational companies as full partners in production as well as improving its human rights record.

Unfortunately, however, increasing dependence on China remains the most realistic prospect. Russian Gazprom is not dependent on Turkmen gas, and hence it will only make purchases if

³⁰ "A New Customer for Turkmen Natural Gas" *Stratfor*, Feb 13 2017 <https://worldview.stratfor.com/image/new-customer-turkmen-natural-gas>

Turkmenistan allows the company to access its gas fields directly, a privilege so far awarded only to a few Chinese companies. Expansion to the Middle East, in particular the Turkmenistan-Afghanistan-Pakistan-India pipeline is severely constrained by the escalating political conflict in Afghanistan. By 2030, the Turkmen government plans to increase its natural gas production from 45 to 180 bcm per year but it is unclear who will purchase the tripled amount of gas even if such an increase were feasible³¹. China remains the only destination that has plausible rationales both to increase its consumption of Turkmen natural gas and the ability to finance pipeline construction. China's recent commitment to environmental improvement encouraged the Chinese to switch away from the coal to natural gas. A second pipeline to China is currently under construction (Bohr 2016).

The Turkmen government has clearly favored the extractive sector by implementing fee exemptions, reducing taxes, and simplifying licensing procedures for foreign and domestic companies involved in natural resources. As a result, in 2012, 46.1% of public and 85.2% of foreign investment was directed to hydrocarbons. The vast majority of the sector remains state-owned. Virtually no progress has been achieved in privatizing Turkmen oil and gas due to the state's commitment to maintaining control over this politically important industry. Turkmenistan could potentially benefit from allowing private domestic and foreign companies to participate in hydrocarbon extraction. The management of revenues is also regarded as highly non-transparent, as discussed in the following section. Partial privatization of natural gas would increase competitiveness, improve technology, and raise effectiveness of investment.

At the same time, governmental support should be shifted towards other sectors. Though extractive industries constitute over a third of the country's GDP, they provide only 2% of employment (World Bank 2014). With 45% of the population under the age of 25, the Turkmen workforce is expected to increase by at least a third, increasing the urgency of creating more employment opportunities. Given the high rate of underemployment and projected increase in the labor force, the country must prioritize more labor-intensive sectors like manufacturing and agriculture.

Nevertheless, even with successful diversification, natural gas will continue to be an important pillar in the Turkmen economy. With more advanced technology, Turkmenistan has the potential to discover additional reserves and use the revenue to support the development of other sectors. It's important to recognize that though the physical amount of natural resources is fixed, the ability to extract and distribute the resource is heavily influenced by the quality of management and institutions in place (World Bank 2014). Turkmenistan's rich natural gas endowment would be exploited a lot more efficiently

³¹ "Why China will remain Turkmenistan's main gas buyer" *Russia Beyond the Headlines*, Jan 26 2017
https://www.rbth.com/business/2017/01/26/why-china-will-remain-turkmenistans-main-gas-buyer_689386

if it were managed by transparent institutions with a mix of public and private control, as almost everywhere else in the world. Finally, as Turkmenistan develops, it will need to address the issue of energy sustainability. State energy subsidies result in very low tariffs that fail to account for environmental costs and have large fiscal opportunity costs (EBRD 2014). Turkmenistan must establish a legal framework to support energy efficiency and introduce tariffs that are reflective of environmental costs.

Summary of Policy Recommendations

- The government can retain a majority stake and oversight but must permit private sector participation in natural gas and oil extraction. The industry should be included in Turkmenistan's privatization program. Participation rights should be transparently and fairly allocated to the most competitive private domestic and foreign companies. Allowing Western companies to participate will also make them more willing to invest in pipeline construction and maintenance.
- Turkmenistan should develop policies to support sustainable energy use, gradually reducing subsidies.

3. Macroeconomic Management

3.1. Output, Saving and Investment

As noted earlier, Turkmenistan's growth performance has been exemplary. In the decade following the breakup of the Soviet Union, per capita GDP dropped sharply in Turkmenistan as in most other transition economies but it subsequently rose dramatically, moving the country into upper middle-income status. Average GDP growth between 2005 and 2015 was 11.8%; the growth rate slowed to a still solid 6.2% in 2016. Data on poverty and other social indicators are lacking, but living standards have also risen.

Though inflation is partially constrained by state control of prices of essential products, it remained around 5-6% for the last several years. The government made substantial progress in fostering market competition by gradually liberalizing prices, specifically of meat and wheat products. That inevitably led to higher prices of food, notably the threefold increase of bread prices in July 2012 (EBRD 2014). Large increases in government wages and pensions also contribute to higher inflation.

Despite high gross savings, adjusted net savings are much lower, possibly negative, after allowing for depreciation of natural capital (World Bank 2014). Likewise, gross investment rates have been very

high, surpassing 50% of GDP around 2010.³² Much of this investment is concentrated in the natural gas sector and in public works of often-questionable productive value, such as mausoleums and stadiums (Bohr 2016). Foreign Direct Investment (FDI) has also been high in recent years, at around 10% of GDP but is overwhelmingly concentrated in the natural gas sector, and much of that is from Chinese state-owned companies, given the restrictions on Western companies. With falling natural gas revenues, raising the productivity of public and private investment becomes even more important. In order for Turkmenistan to support the current level of investment, it must increase gross national saving by cutting down inefficient governmental expenditures including energy subsidies and public sector payrolls.

Reliance on natural gas revenue inevitably leads to high economic volatility. In an attempt to insulate the economy from shocks and to manage the fiscal balance, foreign exchange reserves and public investment over time, the government has created three institutions in recent years (World Bank 2014). Firstly, in 2007, the government instituted the Foreign Exchange Reserve Fund (FERF) to manage fluctuations in the balance of payments and maintain exchange rate stability. Secondly, in 2008 the Stabilization Fund (SF) was instituted to stabilize the government budget through accumulating assets in good times and spending them down in bad times. Finally, the State Development Bank of Turkmenistan (SDBT) was created in 2011 to fund public investments in priority sectors. These three institutions are intended to smooth spending of natural gas revenues and to fund priority investment³³. In practice, the operation of these institutions has been criticized as highly non-transparent and arbitrary (EBRD 2014, Bohr 2016). Turkmenistan needs to publicly identify and implement objective and transparent criteria for the operations of SF, FERF and SDBT as well as timely and full reporting of their activities.

IMF (2017) notes that the government budget deficit has remained commendably low, but that the overall balance hides large non-hydrocarbon deficits. The overall budget deficit has been maintained low due to painful reductions in investment and a rise in utility charges. This underlines the importance of diversifying the economy and broadening the tax base.

3.2. Balance of Payments and Exchange Rate

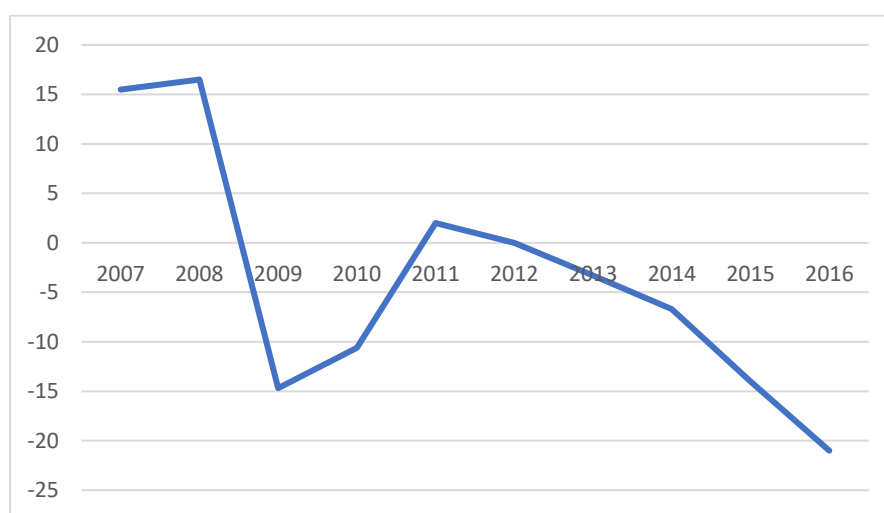
As in other areas, information on the balance of payments is lacking. Data from the IMF show that the current account balance has swung widely in response to price and demand shocks affecting natural gas (Figure 3.1). In the mid-2000s, when prices of natural gas were booming, Turkmenistan ran massive current account surpluses of near 20% of GDP. The global recession led to falling demand in Europe and Russia for Turkmen gas and pushed the current account into deficit. Following a recovery of

³² These figures are based on data from World Bank, World Development Indicators.

³³ “President Berdymukhammedov refers to the stabilization fund in Turkmenistan” *Chronicles of Turkmenistan*, Dec 13 2016 <http://en.chrono-tm.org/2016/12/president-berdymukhammedov-refers-to-the-stabilization-fund-in-turkmenistan/>

prices after 2010, the current account again moved into surplus. The renewed decline of energy prices since 2015 has pushed the current account into wide deficits of 10-20% of GDP. No information is available on how these deficits are financed, but they surely entail large changes in foreign exchange reserves.

Figure 3.1 Turkmenistan's current account balance (% of GDP)



Source: IMF.

Following the exchange rate unification in 2008, Turkmenistan fixed the exchange rate at 2.85 manat per one USD in early 2009. In early 2015, in response to the deteriorating balance of payments following the drop in natural gas prices, the manat was devalued to 3.50 manat per one USD. At the same time, domestic inflation averaged about 5% over 2010-2015. This implies a cumulative real appreciation given the fixed exchange rate of about 30 percent vis-a-vis the US dollar. The 2015 devaluation largely but not completely offset the previous real appreciation. As previously discussed, real appreciation associated with natural resource exports, known as the Dutch Disease, is a common problem in resource-exporting countries. In Turkmenistan, real appreciation has been relatively limited and is not the major factor impeding export diversification.

The debate on whether or not Turkmenistan would benefit from a floating exchange rate is ongoing. On one hand, a fixed nominal exchange rate promotes confidence towards the manat, which attracts foreign investment, and insulates the economy from external monetary shocks. A stable currency encourages saving; thus, deposits denominated in manats grew by over 6 times between 2009 and 2013 (World Bank 2014). The fixed exchange rate stabilizes prices of imported consumer goods and thus plays an important role in maintaining social stability. After all, Turkmenistan appears to have sufficient foreign

reserves to maintain the peg credibly. The accumulation of reserves also has proven effective in limiting currency appreciation. On the other hand, a floating exchange rate would enable Turkmenistan to make use of exchange rate adjustments to stabilize the current account and the economy. Given the present state of Turkmenistan's heavily controlled economy, the fixed exchange rate is on balance beneficial, but flexibility should be introduced gradually.

Summary of Policy Recommendations

- Information on basic macroeconomic indicators is lacking. The government should work with international organizations to improve data on the Turkmen economy.
- The government must cut back on the excessive expenditures and subsidies in order to finance investment in physical capital such as infrastructure, machines, and housing.
- Turkmen officials need to improve transparency of the various off-budget government funds. Increased accountability of the state entities will contribute to a more effective conversion of revenues into productive investment.
- Turkmenistan should gradually move towards greater exchange-rate flexibility to boost competitiveness and offset external shocks.

4. Obstacles to Private Sector Development

Turkmenistan is among the few countries that are excluded from the World Bank Doing Business Index, the benchmark indicator of the local business environment. We rely on several alternative sources to evaluate Turkmenistan's business climate: the World Bank Logistic Performance Index (LPI), the Heritage Foundation Index of Economic Freedom (IEF) and World Bank Governance Indicators.

4.1. The Overall Business Environment for Private Enterprise

The Heritage Foundation's 2017 Index of Economic Freedom³⁴ estimates the level of market openness by analyzing four vital aspects of the economy: rule of law, government size, regulatory efficiency, and openness of markets (Figure 3.2). Each of these four dimensions is sub-divided into 3 topics that receive a score between 0 and 100 (100 being the best). In order to obtain separate scores for the four basic categories, as displayed in Figure 3.2, we took the average score of the respective sub-areas. Finally, the overall score is the average of the four main dimensions.

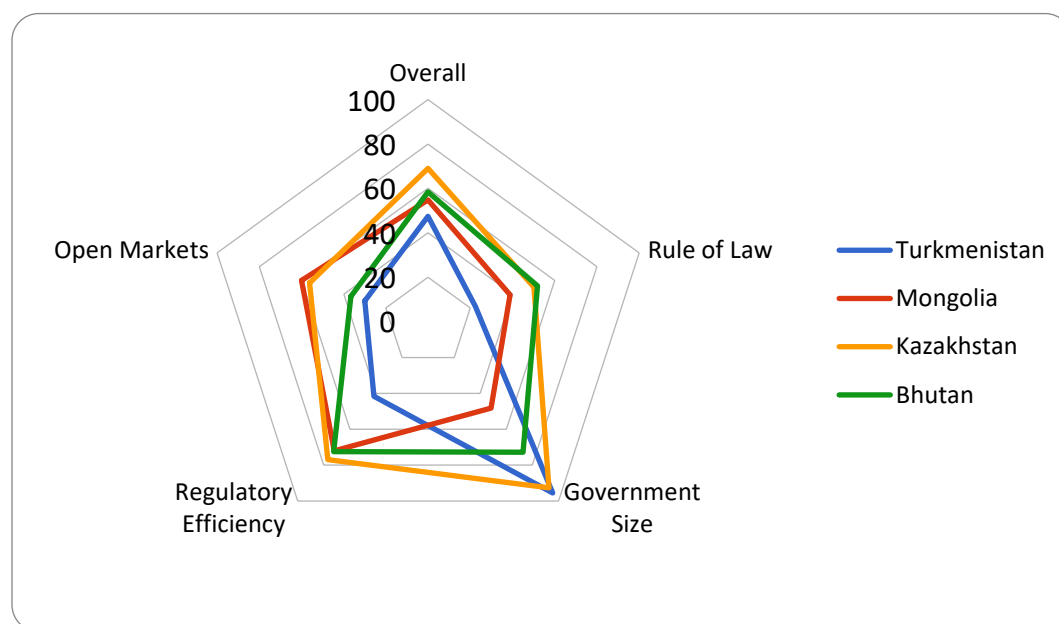
Turkmenistan is ranked at the very bottom of the list as one of the most restricted economies. With the overall score of 47.4, Turkmenistan was rated 170th out of 180 countries, lower than any other

³⁴ "Index of Economic Freedom 2017", *Heritage Foundation* 2017 <http://www.heritage.org/index/country/turkmenistan>

Central Asian country. Rule of law, with a score of 22.3, appears to be Turkmenistan's greatest weakness. Subcategories of this section--property rights, governmental integrity, and judicial effectiveness--received scores of 32.4, 29.6, and 5.0 respectively. The commentary further noted that this poor performance could be explained by the governmental monopoly on land, tight presidential control of the judicial system, and underdeveloped laws. Judges are appointed and removed directly by the president, contracts are rarely properly enforced, and bribery is common among government officials. By contrast, Turkmenistan received a nearly perfect score in the government size category that assessed taxes and government spending. Government Spending, Tax Burden, and Fiscal Health were awarded 92.3, 95.3, and 98.9 points respectively. The aggregate tax burden amounted to a relatively low 17.4% of total domestic income.

Regulatory efficiency was awarded 41.6 points. Its components, business, labor, and monetary freedom, scored 30, 20, and 74.8 respectively. Absence of effective law enforcement, bureaucracy, and concentration of employment opportunities in the public sector were reported as the main constraints of regulatory efficiency. Turkmenistan scored 30 in the open markets category. Specifically, it received 80, 0, and 10 in trade, investment, and financial freedom in that order. These findings highlight Turkmenistan's lack of trade barriers but tight state control of the financial system and restrictions on investment. Figure 3.2 compares Turkmenistan's score on the four main economic indicators with the other countries from this study, showing that Turkmenistan scores consistently lower than the other three except for Government Size.

Figure 3.2 Index of Economic Freedom indicators, 2017



Source: Heritage Foundation, 2017

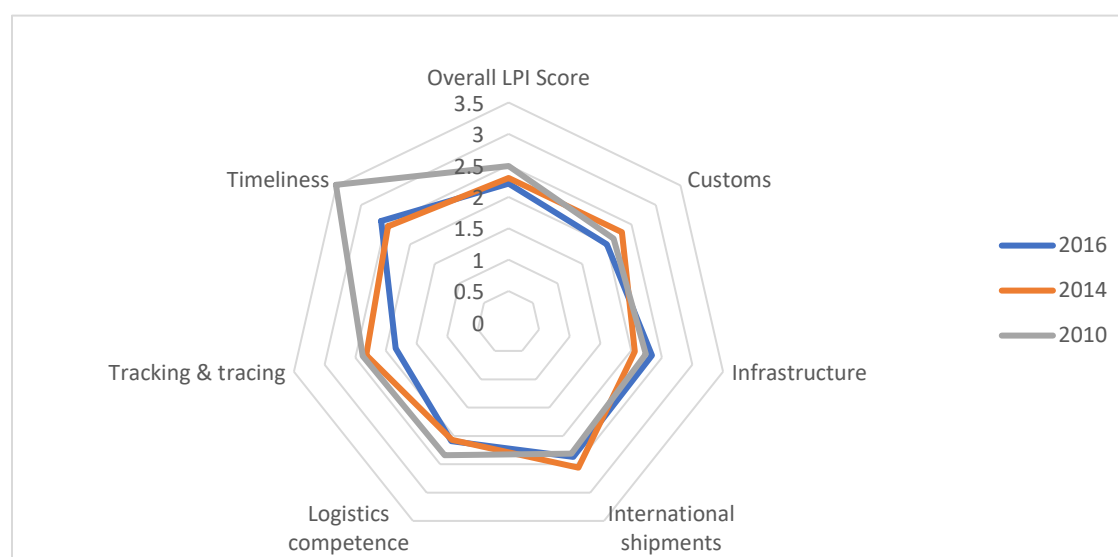
4.2. International Trade Logistics

LPI focuses on trade-related institutions, with rankings of customs, port infrastructure, handling of shipments, logistics competence, tracking, and timeliness.³⁵ High performance in these six areas is essential for integrating successfully into the world economy. The six dimensions of trade logistics are assessed separately and their average value is taken to obtain the aggregate LPI score. The data is based on reports of local logistics professionals; it is recoded as an index with 5.0 being the highest and 1.0 the lowest scores.

In 2016, Turkmenistan ranked 140th out of 160 participating countries. Worse, its LPI score has declined steadily in recent years to 2.21 in 2016, from 2.30 in 2014 and 2.49 in 2010 (Figure 3.3).

³⁵ The World Bank, Logistics Performance Index, 2016: <https://lpi.worldbank.org/international/global>

Figure 3.3. Logistic Performance indicators for Turkmenistan in 2016, 2014, and 2010



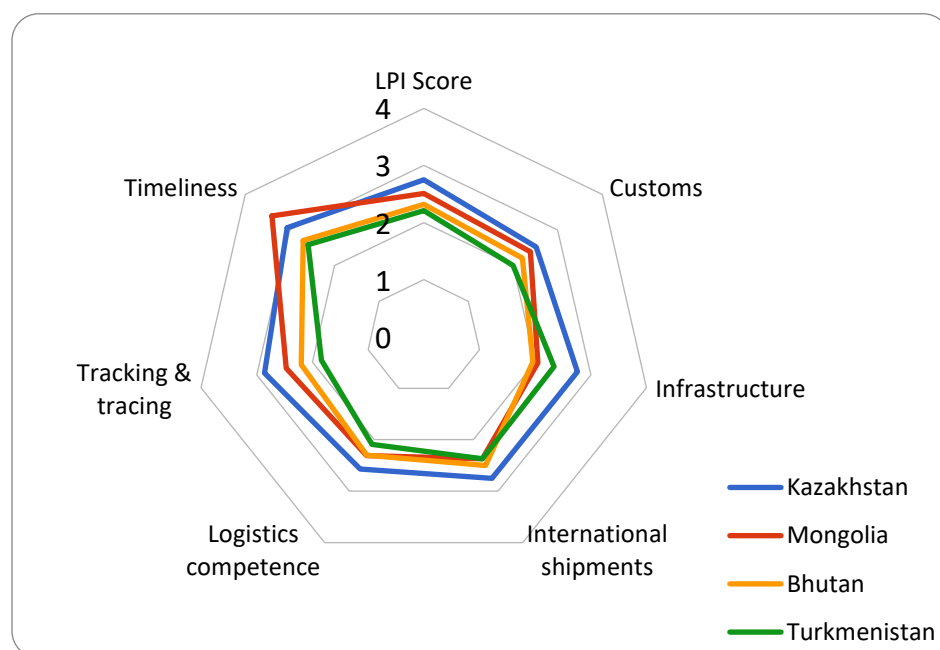
Source: World Bank Logistics Performance Index

In 2016, Turkmenistan scored a low 2.0 for efficiency of customs clearance. The list of documents required by the Main State Inspectorate “Turkmenstandartlary” varies by sector and may include, among others, permission from the respective local ministry³⁶. Trade and transport infrastructure was awarded the score of 2.34. While Turkmenistan has a relatively developed transportation system, most road networks were designed to benefit the extractive industries, and rural areas are often underserved (US Department of State 2016). Ease of arranging competitively priced international shipments was given 2.37 points which highlights the necessity of private investment in the delivery and shipment sector. Quality of logistics services, including customs brokerage, trucking, and forwarding, is estimated to be 2.09. Turkmenistan’s lowest score of 1.84 corresponds to the ability to track consignments. It would be helpful to implement an automated tracking service that would allow registration of the shipment at all stopping points and provide traders an online access to the location of their cargo. In addition, reliable insurance services could reduce the perceived risk of loss of shipments. Timeliness, with a score of 2.59, is Turkmenistan’s most successful dimension of LPI. Nevertheless, it is important to further increase the on-time delivery of shipments.

³⁶ “Turkmenistan’s Customs Information” *Logistics Capacity Assessment*, Dec 10 2013
<http://dlca.logcluster.org/display/public/DLCA/1.3+Turkmenistan+Customs+Information;jsessionid=1EA439D3E274989D65D8BF01A9E9A4BA>

Turkmenistan scores below the other three countries covered in this study in 2016 in almost all categories of the LPI (Figure 3.4).

Figure 3.4. LPI indicators for Turkmenistan, Kazakhstan, Mongolia, and Bhutan in 2016



Source: World Bank Logistics Performance Index

4.3 Privatization

As for the other former Soviet Republics, state-control of the economy was nearly total until the dissolution of the Soviet Union. Turkmenistan is moving more slowly towards privatization than most other Central Asian nations. Between 1994 and 2012, 2123 enterprises were denationalized (World Bank 2014). The majority of the companies privatized during that period were in non-essential services such as food services and parts of agriculture. In 2010, the Turkmen government announced their plan to take privatization to the next level by denationalizing small and medium enterprises (SMEs) as a part of the National Program for Socio-Economic Development of Turkmenistan (US Department of State 2015). Subsequently, in 2012, Turkmenistan adopted the State Program for Privatization of Enterprises and Objects of State Property in Turkmenistan for 2013-2016, which outlined the steps and goals of the privatization initiative³⁷. This program was designed to help Turkmenistan to move away from its

³⁷ "Turkmenistan to Launch Large Scale Privatization" *The Central Asia-Caucasus Analyst*, Dec 12 2012
<http://cacianalyst.org/publications/analytical-articles/item/12623-analytical-articles-caci-analyst-2012-12-12-art-12623.html>

inherited Soviet central command system to become a functioning market economy, with a goal of achieving a 70% private sector share of GDP by 2020 excluding the natural gas sector.

There are a number of restrictions regarding what entities are subject to privatization. For example, natural resources, research and academic institutions, institutions of cultural importance, and public transportation, among others, are excluded from the privatization program. Nevertheless, the program has led to a significant increase in the share of the private sector. In some cases, privatization has moved beyond smaller-scale services and agriculture to include industrial firms. Larger enterprises are privatized through direct sales or auctions to domestic and authorized foreign investors. Many state enterprises were transformed into joint stock companies. In 2014, the private sector was estimated to occupy a 40% share of GDP excluding the fuel and energy sector (World Bank 2014). Other sources have reported that by 2016 the share of private sector reached 62% of GDP, including 90% for retail trade and over 70% in construction and communications³⁸; however, the credibility of the source is questionable.

Due to the relatively low domestic income, successful privatization inevitably requires foreign support. While officials announced that 36 facilities were successfully privatized in 2015, inadequate infrastructure and obsolete technology resulted in weak participation of foreign investors in privatization of the targeted sectors (US Department of State 2016). Extractive industries and transportation tend to attract significant foreign investment and loans. Since 2009, Turkmenistan has received a number of loans from the Chinese Development Bank, Islamic Development Bank, and Asian Development Bank; the largest of these loans amounted to USD 4.1 billion. The majority of these funds went towards railroad construction and natural gas field development (US Department of State 2015). While this investment is beneficial, it would be desirable to attract more FDI to other sectors (see Section 4.5).

The main criticism of the privatization program remains lack of transparency and bureaucratic procedures. Allegations persist that the lack of transparency allows officials to make privatization decisions based on their personal ties to investors (US Department of State 2015). The process is even more burdensome and time-consuming for foreign investors since they must be preapproved by the State Agency of Protection from Economic Risks. Privatization also requires development of regulatory institutions, particularly in industries subject to high barriers to entry that inhibit competition.

4.4. Starting a business

In addition to privatizing state-owned businesses, Turkmenistan has attempted to encourage creation of new private enterprises. Due to the top-down governmental structure and the lack of

³⁸ "Share of private sector up in GDP of Turkmenistan" *AzerNews*, April 22 2016. <https://www.azernews.az/region/95587.html>

institutional resources and information, Turkmen entrepreneurs face an array of challenges as they attempt to start their own company. While many developed countries provide the opportunity to register a business and obtain a license online for a small fee, Turkmen businessmen must undergo lengthy and bureaucratic procedures to register their company (US Department of State 2016). For different types of business entities, there is a specified minimum charter capital; for instance, individual entity charter capital requirement is 1250 manat but it may reach up to 10,000 manat for other types of organizations (Baker Tilly International 2016).

The governmental departments responsible for business registration often require a massive amount of paperwork. Applications for state registration are to be submitted to the Ministry of Economy and Development of Turkmenistan. While the Ministry is required to issue the registration decision within two weeks after the submission of all the required documentation, the government officials may request additional documents that will prolong the registration procedure (Baker Tilly International 2016). Some types of enterprises such as representative offices and branches of foreign companies are required to update their registration every two years. Newly created companies are required to register with the Turkmen tax authorities within 10 days after their state registration. Reducing the number of steps and fees would facilitate enterprise creation.

4.5. Foreign Direct Investment Regulations

While Turkmen officials claim to welcome foreign investment and have instituted a number of incentive schemes, in practice tight state control and restrictive visa regulations create a difficult investment environment for foreign firms (US Department of State 2015). Foreign investment is subject to regulations of the Foreign Investment Law. The ostensible privileges enjoyed by foreign investors that conduct their businesses in specifically designated free trade zones include exemptions from export and import license requirement for certain products, registration fees, and customs charges on imported inputs (Baker Tilly International, 2016). Companies that operate under the Petroleum Law or contribute to the development of the Awaza National Tourist Zone are eligible for additional benefits.

Nevertheless, the foreign investment environment remains highly adverse. Since all main enterprises are state-owned, ties with government officials tend to play a significant role in gaining access to opportunities in the local market and Turkmenistan has a reputation for lack of transparency and heavy bureaucratic obstacles (US Department of State 2013). Lack of protection of property rights and contract enforcement also discourages foreign entities from pursuing investment opportunities in Turkmenistan. Foreign investors also cite lack of information arising from confusing and disorganized provisions in legislation, publically unavailable by-laws, as well as the scarcity of high quality English translation of legal documents.

The constraints for foreign investment also include the lengthy and tedious process of FDI approval and the difficulties of obtaining business visas. The State Agency for Protection from Economic Risks (SAPER) was established with the stated goal of streamlining the approval process but in reality it only further complicated the already convoluted and cumbersome procedures. Registering a foreign business may require approval from five or more governmental entities and could take up to 6 months (US Department of State 2015). Application for a business visa to Turkmenistan requires an invitation letter from a local business partner making it harder to organize an exploratory visit³⁹.

Government retains the power to closely monitor foreign firm activities through additional tax examinations, customs controls, and judicial procedures. 80% of the workforce of a foreign-owned company is required to be comprised of Turkmen citizens. For all other firms, foreign workers can't make up more than 30% of the employees (Baker Tilly International, 2016).

Though there are no official restrictions on the foreign ownership of companies, in practice, foreign investment is almost exclusively limited to the hydrocarbon sector (US Department of State 2015). Construction, chemicals, and communications are also receiving an increasing amount of foreign investment but the promising agriculture and textile industries are not. The lack of FDI in agriculture and manufacturing is problematic for the economy's diversification.

4.6 Land rights

All land is considered state-owned and only a few dwellings have been privatized authorizing citizens to sell and rent apartments (US Department of State 2015). While private citizens possess certain land usage rights, the legislation prohibits sale and mortgage of land making inheritance the only way to transfer these rights. More specifically, the Land Code permits private citizens to use up to three hectares of land without any right to sell, exchange or transfer this property to anyone but their children. Foreign citizens and companies can only lease land. Generally, neither domestic nor foreign companies can be granted long-term rights to land with the exception of agricultural use. In 2007, the Land Code was amended to authorize up to 40-year leases of land for hotels in National Tourist Zones, but land and all the newly built facilities must be transferred to the state upon the expiration date of the lease (US Commercial Service 2015). On the positive side, the Law on Foreign Investment bars nationalization and requisition of foreign-held land.

³⁹ "Foreign Travel Advice. Turkmenistan" *UK Department of International Trade* <https://www.gov.uk/foreign-travel-advice/turkmenistan/entry-requirements>

Lack of property rights to land inhibits creation of businesses directly and indirectly by preventing land use as collateral. As a result, state ownership of land discourages diversification, reduces foreign investment, and undermines financial intermediation.

4.7 Taxes

Taxation is not a major impediment to business creation and operations. The standard value added tax in Turkmenistan is 15%, corporate income tax is 8% for domestic and 20% for foreign companies, personal income tax is flat 10% for all income levels and is usually withheld at source⁴⁰. Resident companies are taxed on worldwide income, while non-resident enterprises are only taxed on the income derived in Turkmenistan⁴¹. Withholding corporate tax rate is 15% for both residents and non-residents but a number of countries have separate agreements that may reduce that rate. There are a number of additional taxes that may apply, including advertising levy, property tax, and subsurface-use tax (22% on gas extraction and 10% on oil). SMEs are exempt of VAT and property tax (Baker Tilly International, 2016). Companies operating under the Petroleum Law, as well as some businesses related to tourism, education, religion, and disability support, enjoy substantial tax exemptions.

In terms of taxation, Turkmenistan is relatively open to trade with 0% export tax (except for gas and oil) and a 2% import tax. About 50 items are subject to a specific customs duty that ranges from 5 to 100% depending on the product. A customs clearance fee of 0.2% also applies.

Despite the generally high levels of corruption, tax administration has the reputation of one of the less corrupt government entities. There do exist some incidents of abuse by tax officials. Excessive tax examination could be used as a way to discriminate against investors, which plays a significant part in discouraging foreign investment (US Department of State 2015). Tax officials are authorized to carry out unscheduled tax audits that cover up to five years preceding the start date of a given audit (Baker Tilly International, 2016). However, in spite of these incidents, Turkmenistan has been largely successful at establishing a stable and well-functioning tax system.

Despite this favorable design, non-hydrocarbon tax revenues are low. An increase in financial literacy among the population is needed to encourage greater compliance in filing taxes. A number of tools such as an online tax calculator, an educational portal with video tutorials on financial literacy, and a platform for paying taxes online would make filing taxes more accessible.

⁴⁰ “Turkmenistan” *Tax Summaries*, 2017 <http://taxsummaries.pwc.com/ID/Turkmenistan-Overview>

⁴¹ “International Tax. Turkmenistan *Highlights*” *Deloitte*, 2017

<https://www2.deloitte.com/content/dam/Deloitte/cn/Documents/international-business-support/deloitte-cn-ibs-turkmenistan-int-tax-en-2017.pdf>

4.8. Access to credit

Providing access to credit for small and medium enterprises (SME) is essential for increasing the share of the private sector in the economy. Though the government has taken steps to improve access to credit, the deficiency of the legal framework significantly limits its positive impact. Turkmenistan has made some progress in establishing an appropriate legal framework; since 2010, the country adopted a number of new laws designed to regulate lending, microfinance, and financial reporting standards (EBRD 2014). So far, however, low institutional capacity has prevented these laws from being properly enforced.

The banking sector in Turkmenistan is small and predominantly state-owned; out of 11 banks operating in the country, only one is privately owned (EBRD 2014). Meanwhile, the six largest state-owned banks account for more than 90% of total lending. The assets of Turkmenistan's largest bank were estimated to be around \$3.15 billion in 2013; all other banks are believed to be much smaller (US Department of State 2015). Credit to the private sector amounted to only 4% of GDP in 2012 but is growing rapidly. One of the main obstacles remains the absence of clear property rights, as described above. In 2009, the Turkmen government established a lending program with a subsidized interest rate of 5% (US Department of State 2015). However, the majority of banks demand collateral, which many enterprises are unable to provide due to property rights restrictions. As a result, many Turkmen entrepreneurs rely on informal sources of credit from friends and family.

The government heavily restricts domestic banking activity; for instance, commercial banks are not allowed to provide loans to state enterprises. Furthermore, the market is heavily distorted by state-directed lending that comprises over 50% of all loans. The impressive 30% credit growth in 2011 and 2012 reflects an increase in subsidized lending to government-run enterprises rather than the private sector. There is no securities market in Turkmenistan.

Turkmenistan is not included in most major credit rating agencies rankings. One exception is Dagong⁴², a credit ranking agency based in Beijing that evaluated Turkmenistan's credit rank to be BBB+. Turkmen enterprises have access to some outside credit sources such as the US Export Import Bank, which recently decreased Turkmenistan's risk assessment from nine to eight. EBRD established SME credit lines (EBRD 2014). Currently, EBRD works with three local banks and conducts policy dialogue with the government regarding the establishment of an appropriate regulatory framework for microfinance. Privatization of the banking sector and creation of a consulting industry are among EBRD's highest priorities for their operations in Turkmenistan.

⁴² Dagong Global Credit Rating: <http://en.dagongcredit.com/>

Establishing competitive financial markets requires that the government-owned banks terminate their traditional practice of financing state-enterprises at artificially low interest rates. It is essential to increase competition between banks for private sector projects. Turkmenistan should concentrate on privatizing banks, reducing regulation of the banking sector where appropriate, finding additional channels to finance SMEs, updating property rights legislation to ensure the use of collateral, and establishing a coherent credit guarantee scheme (EBRD 2014).

4.9. Infrastructure

Turkmenistan's strategic location between Asia, Europe, and the Middle East positions it well to become a major transit country. Turkmenistan already has a relatively developed transportation system, though it is designed mainly to meet the needs of extractive industries. TAPI and Lapis Lazuli corridor are the two biggest international railroads that cross Turkmenistan (CAREC, 2015). The Turkmen government has made major investments in transport infrastructure to boost the country's role as a transit hub. Construction of railways and roads in Turkmenistan receives substantial amounts of foreign financial support. Current projects include the Turkmenbashi-Ashgabat highway and an international North-South railway. Road quality in the capital Ashgabat is relatively good; roads in rural areas need significant upgrading (EBRD 2014). There are almost 60,000 km of roadways in Turkmenistan but a large portion of them requires substantial upgrades. By 2020, Turkmenistan plans to create at least 20,000 km of new roads.

The transportation sector is characterized by lack of competition and distortionary policies. Fuel prices are very low, and road construction is controlled by the state-owned monopoly and often politically driven. To improve efficiency and promote economic diversification, Turkmenistan should increase private sector involvement and promote competitive pricing, as well as ensuring that transportation networks are designed to serve key labor-intensive sectors such as agriculture and manufacturing.

Power infrastructure requires significant reforms. The energy sector is a state-owned vertical monopoly with no private sector involvement (EBRD 2014). Inefficient generation and distribution of electricity results in frequent power outages that hamper businesses. In addition, unstable voltage is harmful to both business equipment and household appliances.⁴³ Foreign investment should be encouraged and excessive consumption reduced. These require an increase in tariffs, improvement of the

⁴³ The energy minister was recently dismissed due to frequent power outages. "Turkmenistan energy minister-sacked", *Radio Free Europe*, <https://www.rferl.org/a/turkmenistan-energy-minister-sacked-president/27203788.html>, August 23, 2015 <http://en.chrono-tm.org/2015/11/ashgabat-in-the-dark/>, *Chronicles of Turkmenistan*, November 24, 2015.

regulatory framework, reduced subsidies and privatization, subject to ensuring adequate oversight and competition.

Summary of Policy Recommendations

- Overall, the government must implement its own strategic mission statement by accelerating the transition to a private-sector driven economy by reducing state ownership, burdensome regulations and lack of transparency.
- Turkmenistan needs to simplify its customs clearance procedure. Reorganization of border management should involve relaxing some of the most tedious document requirements.
- Turkmenistan must develop a strong privatized shipment industry in order to increase the connectivity between domestic and foreign market agents.
- Turkmenistan must increase transparency of privatization by avoiding assigning major enterprises through presidential decrees. The privatization procedure must be made less cumbersome and the pre-approval process for foreign investors needs to be simplified.
- Creation of a strong private sector requires an easier way to register a company. Turkmen entrepreneurs should not have to face such high barriers to enter the market in form of tedious paperwork and high initial capital requirement. There needs to be an online business registration portal available to both domestic and foreign entrepreneurs.
- Turkmenistan should empower local authorities to grant business licenses in order to make the registration procedure faster and less tedious. There is a need to increase its regulatory efficiency through professionalizing governmental institutions and creating more cohesive legislation.
- Turkmen government needs to update land rights legislation. A dynamic business environment requires domestic and foreign market agents to be able to rent, buy, and use land as collateral.
- Turkmenistan needs to create a strong private-led banking sector. There is a need for additional credit lines for SMEs, especially outside of the extractives sector.
- The authorities should improve availability of legal information and business consultation.
- The Turkmen government should simplify FDI registration procedure.
- Requirements for business visas should be eased
- Turkmenistan should open promising sectors such as agriculture and manufacturing to FDI.

5. Institutions and Governance

5.1. Quality of governance

Turkmenistan's political regime has been subject to international controversies since its independence in 1991. The country is frequently criticized for lack of democracy and human rights violations⁴⁴. While the focus of this analysis is on economic rather than political reforms, the quality of governance and political freedom have important implications for economic progress for several reasons.

First, inclusive political systems characterized by the rule of law, control of corruption, government effectiveness and accountability of government officials are generally recognized as essential for promoting the domestic private sector and attracting foreign investment—stated goals of the Turkmenistan government (Acemoglu and Robinson 2012). Turkmenistan performs very poorly on these criteria, even compared to other transition economies, according to the World Bank's World Governance Indicators (Figure 3.5). Widespread corruption and lack of transparency are particularly detrimental. In 2016, Transparency International ranked Turkmenistan 154th out of 176 participating countries awarding it 22 out of a 100 possible points, confirming the World Bank assessment. A corrupt and inefficient judicial system in particular creates a big red flag for international investors who only invest in countries where their property rights and contracts are protected. The president appoints all Turkmen judges for a renewable term of 5 year, and authorities possess the power to prevent defendants from gaining access to attorneys and public trials (EBRD 2014; Bohr 2016). Many international organizations have also voiced complaints regarding the scarcity of publicly available data. Data on Turkmenistan in World Bank and IMF databases are far less complete than for other Central Asian countries.

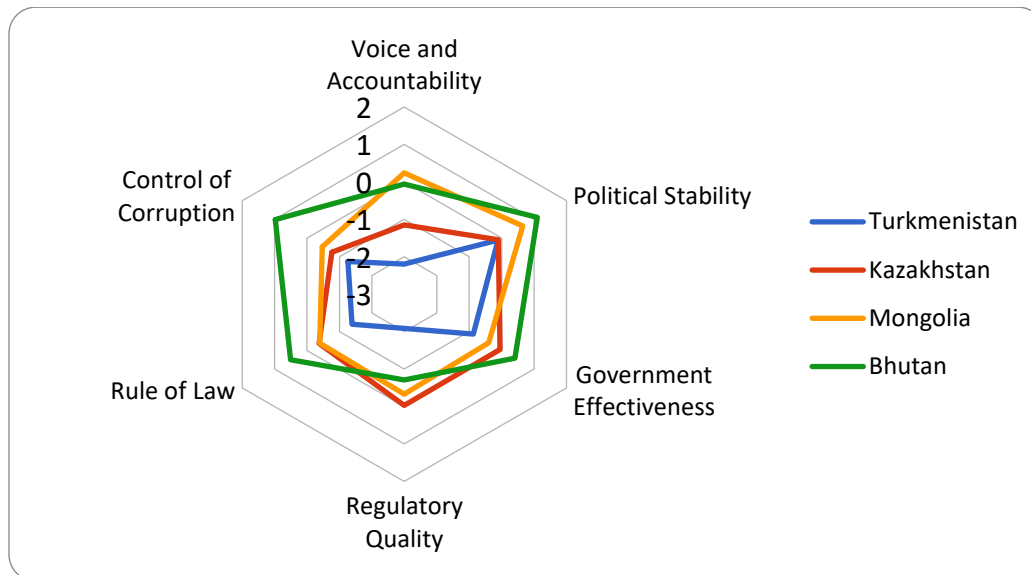
Second, a reputation for abuse of human rights and political repression can be harmful for foreign investment and international competitiveness in some important sectors, notably tourism and textiles. Activists in Europe and the US organize campaigns to boycott companies that continue to buy cotton from Turkmenistan and other countries with poor human rights record.⁴⁵ While Turkmenistan's human rights record has not received the same level of attention as in Uzbekistan, some campaigners are targeting Turkmenistan's cotton sector. For example, H&M, Europe's largest clothes retailer, refused to use Turkmen cotton after reports of the use of child labor on Turkmen cotton fields⁴⁶. The experience of Uzbekistan shows that boycotts and derogatory press reports can put intense pressure on the government (Golub and Kestelman 2016). Furthermore, tourists from high-income European countries are less likely to visit countries known for flagrant abuses.

⁴⁴“Turkmenistan. Events of 2016” *Human Rights Watch Report*, 2016 <https://www.hrw.org/world-report/2017/country-chapters/turkmenistan>

⁴⁵ “Campaign Protests IKEA, Big Clothing Chains Selling Turkmenistan Cotton” *OCCRP*, Feb 16 2016 <https://www.occrp.org/en/daily/4944-campaign-protests-ikea-big-clothing-chains-selling-turkmenistan-cotton>

⁴⁶ “A Number Of Companies Put Aside Turkmen Cotton” *East Time*, Feb 21 2016 <http://easttime.info/news/turkmenistan/number-companies-put-aside-turkmen-cotton>

Figure 3.5. World Governance Indicators for Turkmenistan and other countries, 2015



Source: World Bank World, World Governance Indicators.

Third, freedom of the press promotes exchange of information and accountability. Reporters without Borders⁴⁷ ranked Turkmenistan 178th on their list of countries with free media, above only North Korea and Eritrea. Government controls the vast majority of press, television, and radio making them unlikely platforms for marketing and commercials. Empowerment of the private sector demands some media liberalization, creation of private channels that could serve as outlets for advertising, and increase of internet coverage for a more effective communication between business partners. In fact, telecommunications could become a thriving area of diversification. Relaxing the control of the Ministry of Communications over the sector and challenging Telecom's monopoly on public telephone and Internet services would open multiple business opportunities for domestic and foreign companies, improve the quality of services and encourage growth of Internet coverage (EBRD 2014).

On the other hand, one must recognize the severity of the challenge of moving away from the Soviet tradition of central planning so deeply rooted in all major institutions of the Soviet Union. The apparent popularity of the current leadership signals that Turkmen authoritarian regime has been able to satisfy at least some of the population's social needs.

⁴⁷ Reporters without Borders: <https://rsf.org/en/turkmenistan>

5.2 Health and Education

Turkmenistan's dramatic increase in GDP per capita has largely failed to manifest itself as an improvement in education and health care. For its level of income, Turkmenistan scores surprisingly low on most social parameters. Thus, the country is ranked 111th on the 2015 Human Development Index (HDI), despite a considerably higher ranking in Gross National Income (GNI) per capita (79th). This reflects the fact that average income per capita (in 2011 USD, PPP) for the group is 6,300 USD, less than half of Turkmenistan's income per capita of 14,000 USD while Turkmen life expectancy at birth, 65.7, and expected years of schooling, 10.8, are below the average for the group: 68.6 and 11.5 respectively. Only four other countries have a larger negative gap between their income level and HDI rank.

Despite the relatively low human development, the government enjoys high approval ratings, which can be attributed to the tight price control of essential staples and provision of free education, healthcare, and utilities to the entire population (US Department of State 2016). While this may be an effective way to gain support of the public, Turkmen social policies create massive market distortions. Prices for bread, water, and electricity, among others, are heavily subsidized (EBRD 2014). State employees receive substantial discounts on transportation, rents, and mortgages. The IMF estimated that utility subsidies that provoke wasteful and inefficient energy use amounted to 20% of Turkmen GDP in 2010. Meanwhile, there are still a lot of gaps in Turkmen education and healthcare. The Turkmen government should scale back inefficient subsidies and redirect the funds towards education and healthcare, and projects such as the "National Programme on Improving Social and Living Condition" that focuses on raising living standards in Turkmenistan's rural areas. Though social spending has increased by at least 50% between 2007 and 2010, its relative share in the state budget continues to fall.

While literacy rates are nearly perfect and mandatory schooling has recently been increased to 12 years, the quality of education in Turkmenistan is far short of international standards (World Bank 2014). The Soviet legacy may have ensured universal access to education but resistance to Western influences resulted in an outdated curriculum and failure to incorporate contemporary teaching techniques. Turkmen schools should undergo a formal, internationally recognized assessment, such as OECD PISA⁴⁸, in order to identify the most problematic areas in their school program and use the results of this assessment and help of international consultants to develop a more modern curriculum. The Turkmen economy would benefit from international knowledge exchange. This may include sending domestic students to study abroad or inviting foreign specialists in management, communication, and technology.

⁴⁸ OECD PISA: <http://www.oecd.org/pisa/>

Lack of job-relevant skills indicates a need for vocational training programs. Turkmenistan has already made substantial progress in this area. In 2012, there were 129 registered vocational schools and training centers that provide training in 268 occupations (World Bank 2014). However, vocational schools receive no state funding, and hence the tuition is paid by students themselves or by the companies that plan to hire them. Since aligning workers' skills with employers' demands is crucial for creating a dynamic private sector, the government should consider financially supporting the vocational training program.

A positive Soviet legacy is the celebration of healthy lifestyles. Turkmenistan has the lowest levels of smoking in the world and many state TV and radio channels promote active and healthy practices⁴⁹. Still, the quality of health care needs to be improved. The lack of trained specialists and up-to-date technology results in a weak healthcare system that is unable to meet the needs of the population.

Summary of Policy Recommendations

- Improve impartiality of the judicial system and ensure that it meets modern accountability standards.
- Turkmen government must increase transparency. Turkmenistan must fight corruption and bribery by imposing more effective sanctions.
- There is a need to privatize media outlets and reduce control over news channels.
- Turkmenistan must improve its human rights record for the well-being of its own citizens and for preventing boycotts from developed countries.
- The Turkmen government should redirect funds from distorting and costly energy and subsidies to health and education.
- The educational system should be reformed in line with international standards.
- The Turkmen government should provide financial support to vocational schools.

6. Diversification Strategies

6.1. Agriculture

As hydrocarbon and construction sectors became the main drivers of economic growth, resource reallocation away from agriculture and services led to a 50 and 30% decline in these sectors' share of GDP, respectively (World Bank 2014). Various sources estimate that agriculture accounts for 10-13% of

⁴⁹ "Turkmenistan the World's Most Non-smoking Country: WHO" SAMAA, Jul 21 2015
<https://www.samaa.tv/health/2015/07/turkmenistan-the-world-s-most-non-smoking-country-who/>

GDP but almost half of employment. Data for 2012 shows that agriculture received 11.7% of total investment. The state recognizes the importance of the agricultural sector and intends to develop policies to support its growth; as an example, in 2013 the government introduced concessional loans with 1% yearly interest and 10-year repayment period in order to expand the agricultural sector.

With about 50-60% of the population living in rural areas, expansion of agriculture would be highly beneficial for poverty reduction and rural development, yet the concentration of resources in extractive industries and excessive state control prevents agriculture from evolving at a more rapid pace. As a result, this sector plays a much smaller role in Turkmenistan compared to its more agrarian neighbors like Uzbekistan and Kyrgyzstan (FAO 2012). Turkmenistan has preserved some aspects of the Soviet system of collective farms along with production quotas and controlled prices. The government controls four strategic crops: cotton, wheat, sugar beets, and rice. They are produced mainly by public enterprises to fulfill state orders.

Following its independence, Turkmenistan attempted to implement a number of reforms to boost competitiveness of its agricultural sector. A series of presidential decrees laid out the foundation of the new agricultural order while preserving the main elements of the command system inherited from the Soviet Union. As a result, three types of producers now dominate Turkmen agriculture: individual households, daikhan (peasant) farms, and peasant associations comprised of leaseholders (FAO 2012). Peasant associations are tightly regulated by governmental orders, and they are compelled to sell their output and buy their inputs through state channels. The leaseholders have virtually no influence over the time of harvest, seeds they use etc. Daikhan farmers and peasant associations can sell their surplus output and non-strategic products on the market at competitive prices; yet, land leases from the government may be terminated if farmers repeatedly do not fulfill state orders. There are no large private enterprises involved in agricultural production.

Unfavorable climate and geography present a major constraint to agricultural development. The Karakum desert, one of the driest deserts in the world, covers over 80% of the country. Altogether, agricultural land occupies 72% of Turkmenistan's area though 67.8% of all land is dry pasture, leaving only 4.1% of land arable⁵⁰.

Agriculture is highly reliant on irrigation mainly supplied by the Karakum canal, the largest irrigation canal in the world that draws almost 30% of the total flow of Amur Darya River. Karakum and other primary canals divert water from the rivers, secondary canals deliver water to large peasant

⁵⁰ "Turkmenistan" *The World Factbook CIA*, Jul 13 2017 <https://www.cia.gov/library/publications/the-world-factbook/geos/tx.html>

associations, and tertiary canals distribute water to individual farms (FAO 2012). Though it has an impressive coverage, flaws in the irrigation system are the single biggest cause of inefficiency in agricultural production, making Turkmenistan the largest user of water per capita in the world (Bohr 2016). The irrigation system is state-owned and is maintained in a bureaucratic fashion with little concern for financial, technical or ecological efficiency; in fact, most water services are provided free, creating incentives for wasteful water consumption (EBRD 2014). Lack of investment and maintenance has led to deterioration of the Turkmen irrigation system. The open-air system leads to up to 70% evaporation while the absence of adequate drainage system results in increased salinity and degradation of soil quality. The outdated drainage system led to contamination of soil with agricultural chemicals and pesticides and soil fertility has declined. Turkmenistan has yet to adopt modern techniques such as drip irrigation, lining the canals, sprinkling etc. (FAO 2012). It is essential that Turkmenistan direct more resources to renovating the irrigation system.

The composition of agricultural output has shifted somewhat since the Soviet era. Before 1991, cotton occupied over 50% of cultivated land followed by 30% for feed crops. After the dissolution of the Soviet Union, Turkmenistan increased its production of wheat and some other food crops in an attempt to achieve food self-sufficiency. Today, wheat and cotton are by far the most important products; wheat is mainly consumed domestically, while cotton is the largest agricultural export. Other crops include melons, grapes, potatoes, and various vegetables. Household plots and daikhan farms produce the majority of fruit and vegetables. Cotton and grains that are considered strategically important are mainly grown by the state sector.

Despite a significant decrease of the relative share of cotton production, Turkmenistan remains to be one of the largest cotton producers in the region. The long tradition of cotton farming ensures the excellent quality of Turkmen cotton. However, Cotton production suffers the most from inefficient irrigation and stifling government control. Its yields are only about a third of those of Mexico and Egypt. Moreover, scandals involving forced and child labor are increasingly detrimental to the reputation of Turkmen cotton. Turkmenistan has the potential to become a world-class cotton producer if it addresses the several obstacles that limit its development: an inefficient irrigation system, outdated technology, stifling of private initiative, distortionary pricing and abusive labor practices.

Livestock production has experienced a dramatic expansion in recent years. Private farms are responsible for over 90% of livestock output (FAO 2012). Sheep, cattle, and poultry constitute the majority of livestock in Turkmenistan. Meat, milk, leather, and wool are the sectors in which Turkmenistan has the potential to establish an export-oriented policy. Turkmenistan is known for its Astrakhan wool in particular. Although the private sector plays a larger role than in cotton, the promising

livestock, dairy and wool sectors suffer from excessive government intervention, outdated technology and poor infrastructure, including inadequate storage and transport (Kerven, Russel and Laker 2002).

Turkmenistan's agriculture suffers from the difficulties of transitioning to a market economy: the breakup of the Soviet Union entailed a decline in investment and research, while heavy involvement of the Turkmen government in production and distribution has inhibited private sector growth. Agricultural competitiveness requires a combination of greater public investment in infrastructure and technical assistance and liberalization that harnesses the skills and initiative of farmers.

6.2. Textiles

The Soviet Union imposed a cotton monoculture in Turkmenistan; being a raw cotton powerhouse, the Turkmen SSR was not responsible for processing of raw cotton. After 1991, Turkmenistan was no longer fulfilling state orders to supply cotton to the rest of the Soviet Union. Thus, the existing cotton production capability enabled the development of the previously insignificant textile industry as the next logical step in the product value chain. Turkish companies provided significant support to the industry by establishing partnerships and direct investment⁵¹. Collaboration with Turkish enterprises has boosted quality standards and helped textiles become the second largest export after extractives. Trading partners include the US and China, but about 70% of exports go to the former Soviet countries.

Currently, there are about 70 textile enterprises, over 30 cotton spinning factories, 17 garment plants, 7 silk enterprises, and a few wool processing and knitting companies.⁵² Together they produce 177,000 tons of various yarns, 186 million square meters of cotton fabric, 11,000 tons of knitted fabrics, 7 200 tons of terry fabrics, and 80 million pieces of garments. Turkmen bed linen, carpets, silk products, scarves, and a number of special fabrics like velvet, ketene, and rayon are internationally celebrated for their good quality. Bright colors and patterns of its products are another strength of the Turkmen textile industry. On the other hand, knitted garments and sportswear quickly lose their shape and become unusable; hence, domestic consumers often choose to buy Turkish imported clothing.⁵³

The government recognizes the importance of the textile industry for Turkmenistan. Over 30 factories were constructed since independence, which, according to official reports, resulted in a 15-fold

⁵¹“Turkmenistan-Textiles” *Export.gov*, Aug 15 2016 <https://www.export.gov/article?id=Turkmenistan-Textiles>

⁵² “A glimpse of Turkmenistan’s textile potential” *Fibre2fashion*, 2017 <http://www.fibre2fashion.com/industry-article/7427/a-glimpse-of-turkmenistans-textile-potential?page=1>

⁵³ Source: “Turkmen Textiles” *Chronicles of Turkmenistan*, July 25 2015 <http://en.chrono-tm.org/2015/07/turkmen-textiles/>

expansion of the textile industry. The government created the 2011-2020 State Program for Development of the Textile Industry to support the sector by attracting FDI and allocating government investment. The program agenda includes increasing the number of workers employed in textiles to 36,000 by 2020, upgrading facilities, and building new factories. Turkmenistan has a skilled human capital foundation, which is requisite for development of a successful textile industry. Upgrading knitting, sewing, and dyeing equipment, experimenting with new fabrics like denims, and implementing new fabric designs would facilitate the development of the industry and, most importantly, provide jobs.

Further expansion of the textile industry could be highly beneficial for Turkmenistan. Simplifying bureaucratic procedures, improving infrastructure and easing restrictions on FDI, as described above, are essential for the industry's success. Foreign firms with expertise and market access to Europe can transfer state-of-the-art technology and improve access to the European market. The government could assist by establishing representation offices selling Turkmen textiles abroad and advertising the industry through similar initiatives as the international exhibition of textile products that took place in June 2016⁵⁴.

Modern day Turkmenistan is located along the ancient Silk Road - the legendary route that was used to transport silk, among other goods, from Asia to Europe. Turkmenistan can trace its silk production far back and a recent revival of the industry is encouraging. In 2015, a CCTV crew visited Ashkhabat's oldest silk filature and interviewed the workers about their sector. They reported that the factory processes over 500 tons of cocoon a year making enough silk to produce over 2000 dresses⁵⁵. Turkmen silk is of a very high quality and is directed to both domestic and international markets. So far, silk exports have reached South Korea, Iran, Dubai, and India. The excellent product quality certainly meets standards of developed countries such as Europe and the US. Beautiful and elegant silk apparel, mainly traditional scarfs, meet a large demand in Ashgabat but also have a potential to succeed as an export product. Revival of the silk industry was financed with Chinese concessional loans; a large share of equipment is also imported from China. Turkmenistan has the necessary human to become an even greater presence in the global silk industry.

While it is important to avoid state domination of the sector, governmental policies should facilitate attraction of FDI and create a favorable environment for business by reducing regulatory burdens and investing in infrastructure. It will also be increasingly important to improve human rights to avoid escalating boycotts of Turkmen cotton and textile products as has occurred in Uzbekistan.

⁵⁴ "Turkmenistan to hold an Int'l exhibition of textile products this June" *YNFX*, May 31 2016
<http://www.yarnsandfibers.com/news/textile-news/turkmenistan-hold-int%E2%80%99l-exhibition-textile-products-june#.WW12qNPYv-Y>

6.3. Construction

Construction remains one of the most controversial sectors in the Turkmen economy. Following the independence, Turkmen leader Niyazov directed a large amount of funds to renovate governmental buildings in Ashgabat. Much of spending was on showcase projects such as the \$2.4 billion new airport in Ashgabat and the \$5 billion sports center for the Asian Martial Arts tournament⁵⁶. While the usefulness of many of the projects is questionable, the boom created a group of highly skilled construction workers. After energy prices plunged, construction declined though it remains the second largest recipient of FDI and public investment after the extractive industry. Instead of grandiose monuments, the Turkmen government should focus on investments with higher social returns, such as upgrading the agricultural irrigation system, constructing more roads in underserved areas, and other improvements in infrastructure. Encouragingly, the Turkmen government has stated a priority on construction of schools and hospitals, as well as upgrading facilities like gas and water pipes⁵⁷.

Turkmenistan would benefit from development of a strong non-governmental construction sector by empowering private construction companies, material producers, and consulting services as well as a commercial real estate industry that at present are still largely controlled by the government. Reducing red tape, introducing more modern production technologies and effective enforcement of contracts and property rights are crucial for the sector (EBRD 2014). One of the positive recent developments in the sector is the establishment of the annual international construction conference. In 2016, 228 construction companies from 18 countries participated in the conference establishing partnerships and discussing implementation of modern urban development programs in Turkmenistan. Turkmenistan should continue to open up the construction sector to foreign companies, although with regulations that ensure that buildings and other projects satisfy safety and other quality standards. The abundance of skilled construction workers in Turkmenistan and the drop in domestic construction jobs encourages temporary workers migration, often illegal, to richer countries, especially Russia. Turkmenistan should also explore the opportunities that will allow its private construction firms to legally access foreign markets.

6.4. Tourism

⁵⁶ “Shrinking exports spell trouble for Turkmenistan” *The Economist*, Dec 15 2016

<https://www.economist.com/news/asia/21711943-authoritarian-president-pins-his-hopes-turkmen-las-vegas-shrinking-exports-spell>

⁵⁷ Source: “Turkmenistan-Construction” *Export.gov*, Aug 15 2016 <https://www.export.gov/article?id=Turkmenistan-Construction>

Tourism is another growing sector that is increasingly prioritized by the government⁵⁸. In 2012, Turkmenistan established the State Committee for Tourism, officially declaring its intention to develop this sector and attract foreign tourists. The top destination, Awaza National Tourist Zone, is advantageously located on the Caspian Sea and is attracting an increasing number of tourists every year. The construction of this tourist zone was very expensive but it is now equipped with over 60 world-class hotels, shopping and entertainment centers. The government is attempting to attract FDI to the tourist zone by providing incentives that include exemption from some of the most burdensome registration procedures, reduced fees, and concessional loans. FDI is needed for construction of hotels, restaurants, and spas, as well as provide entertainment, catering, and tourist services.

Turkmenistan has substantial potential to succeed as an international tourist destination. It has a number of marvelous historic sites remaining from the old Persian civilization including three World Heritage sites connected to the ancient Silk Road. The warm Caspian Sea makes a great coast resort although the quality of the beaches is not on par with most of the European resorts. Natural sites include a burning gas crater and the Karakum natural reserve with many rare animals.

However, there are many government-created obstacles to the development of a competitive tourism sector. The main one is certainly the restrictive visa regime. A visa is required for citizens of all foreign countries (with the exception of short visits of citizens of bordering Kazakh and Uzbek provinces) and the cumbersome application procedure involves providing a letter from an accredited Turkmen travel agency.⁵⁹ If Turkmenistan wants to develop its tourist sector, it must significantly simplify the visa issuance procedures, and ideally create special visa exemptions for strategic countries such as Russia, China, Iran, and other Central Asian countries. In addition to the visa impediment, a number of arbitrary regulations complicate a vacation to Turkmenistan. For example, travel agencies may require visitors to sign up for expensive guided tours. Constant presence of police, bans on entering with some prescription drugs, required registration with migration services, and restricted photography discourage foreigners from visiting the country. No passenger trains are allowed to cross the Turkmen border; buses get stuck at border crossings for up to several hours; all entering cars require a special liability insurance; and plane tickets are not available online. Turkmenistan must ease these regulations to create a successful tourism industry.

⁵⁸ “Turkmenistan-Travel and Tourism” *Export.gov*, Aug 15 2016 <https://www.export.gov/article?id=Turkmenistan-Travel-and-Tourism>

⁵⁹ *Turkmenistan Embassy*, 2015
<http://www.turkmenistanembassy.org/>

In addition, Turkmenistan's poor human rights reputation dissuades some tourists from more developed countries. Reports of forced labor, poor ranking on gender equality indexes, imprisonment of political opponents, restrictions on civil liberties and censorship are not enticing to Western tourists.

In short, Turkmenistan must choose between tourism development versus tight controls on visitors. Along with addressing the barriers to tourism development, Turkmenistan should launch an extensive marketing campaign that presents the country as an attractive tourist destination. This may involve participating in international tourist rankings like World Economic Forum's Travel and Tourism Competitiveness rankings, neither of which currently includes Turkmenistan.

Summary of Policy Recommendations

- The Turkmen government must introduce a series of reforms to relax control over agricultural production. Farmers should be allowed to buy their inputs and sell their outputs to channels of their choice for market prices, as well as have the agency to decide on the type and quantity of crops they produce. It is crucial to encourage privatization of agriculture.
- Turkmenistan must upgrade its irrigation system to diminish inefficiency in water use. The government should offer favorable terms to foreign investors who are willing to finance new irrigation technology.
- Rural transport and storage infrastructure should be improved.
- Turkmenistan must abolish forced labor practices and reduce political repression to avoid boycotts of its cotton and textile sectors as well as to improve the country's reputation as a tourist destination.
- Turkmenistan has substantial unexploited potential in textiles, in particular, silk products and wool.
- Turkmenistan must support greater textile industry privatization and welcome foreign investment to obtain modern managerial skills, equipment, technology and market access.
- The Turkmen government must finance construction projects with high social or economic value.
- It is essential to privatize construction services and build a strong commercial real estate industry.
- Turkmenistan must simplify issuance of tourist visas. It may be useful to establish no-visa agreements with some of the strategic countries like China or Turkey to encourage inflow of tourists.
- Other regulations impeding tourism should be identified and removed.

- The Turkmen government needs to create a comfortable atmosphere for tourists by addressing its human rights record.
- Turkmenistan must market itself as a location for tourism through establishment of representation offices abroad and implementation of modern marketing techniques.

7. Conclusion

Concentration of resources in the extractive industries had an adverse effect on Turkmenistan's development but recent reforms have started to lay the foundation to support economic diversification. Turkmenistan has shown impressive improvements on several macroeconomic indicators, which allowed the country to accumulate reserves, raise investment and increase the general standard of living. The main obstacles to further progress remain the totalitarian state control of the economy and extensive administrative burdens that constrain private sector participation and dampen competition. Establishment of export-oriented industries outside of the natural resource sector requires significant market liberalization, attraction of foreign financing, and improvement of infrastructure and technology. Given the establishment of a favorable institutional and social environment, Turkmenistan has the potential to become a world-class producer of a number of agricultural and manufactured products and become a significant tourist destination. It is essential that the Turkmen government reduce its interference with the market while establishing a strong legal and institutional foundation that supports domestic and foreign companies operating in Turkmenistan.

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IV. Mongolia

1. Introduction

Mongolia is a large, sparsely populated country that lies between China and Russia, and vast deserts cover a large part of the land (the Gobi desert to the south and extending into northern China). The country is endowed with substantial mineral resources such as copper, coal, gold, uranium and other rare metals, and as such, it is one of the lowest-cost mineral producers in the world. In particular, it has one of the largest copper and gold mines and coal deposits. However, most of the reserves remain unexploited and unexplored. The government's demands for a large share of the resource rents has been deterring major mining companies (although recently there has been some progress). Overall, proven reserves are valued at around \$1 trillion, and much of the country is yet to be prospected (IMF 2017).

Unlike Kazakhstan and Turkmenistan, Mongolia was an independent country before the Soviet dissolution in 1991, but the economy was so closely integrated into the Soviet economy that it was called the sixteenth republic of the Soviet Union (Pomfret 2011). After the Soviet assistance terminated, Mongolia's economy contracted drastically through the early 1990s. Yet, after it enacted the Minerals Law in 1997, the country started to attract FDI in the extractive sector. Thanks to the mineral boom in 2003-08, FDI increased rapidly from less than \$10 million annually in the early 1990s to \$844 in 2008. The GDP growth rate in the 2003-2008 period averaged around 9 percent, with total export value in 2008 reaching 4.7 times the value in 2000.⁶⁰ However, the 2008 financial crisis hit the mineral-dependent economy hard, as the price of copper (Mongolia's principal export) dropped by approximately 70 percent. Slowing demand from China, then the destination for about 90 percent of Mongolia's export, also aggravated the situation (World Bank 2014). The GDP growth rate dropped from impressive 10.2 percent in 2007 and 8.9 percent in 2008 to -1.3 percent in 2009.

The economy's difficulties persist. While the economy stabilized thanks to IMF's \$229 million balance-of-payment support package in 2009 and growth surged to 17.3 percent in 2011, the economy soon faced a renewed slow-down (World Bank 2010; IMF 2015). FDI dropped sharply as renewed disputes between the government and mining companies cast a shadow on the investment climate; falling prices of coal (and more recently copper) compounded the difficulty. The GDP growth rate in 2015 was only 2.4 percent, and non-mineral real GDP growth was negative (IMF 2017). The government responded to the shocks with loose fiscal and monetary policies, which resulted in mounting public debt and increasing pressure on the current account. With large fiscal deficits and sharp depreciation combined, the

⁶⁰ Author's calculation based on World Bank, World Development Indicators.

general government debt reached nearly 70 percent by the end of 2016. The government again turned to the IMF, which approved a \$440 million Extended Funded Facility in May 2017, with conditions on fiscal consolidation, monetary policy tightening and banking sector reforms. Other international financial institutions such as the World Bank and Asian Development Bank are also expected to provide budget support loans on a concessional basis with a total financing package of around \$5.5 billion (ERBD 2017).

Mongolia has a functioning democracy with two major parties, the Mongolian People's Party (MPP) and the Democratic Party (DP), although susceptible to pre-election spending booms. The ex-communist MPP was the dominant political party in parliament until the June 2012 elections, when the DP won a majority. However, fiscal profligacy of the coalition government formed after the election exacerbated the economy's difficulty during 2012-2014, and the DP lost popularity. As a result, in the June 2016 election, the MPP won a landslide victory, securing 65 out of 76 parliamentary seats in a single-chamber legislature, and quickly formed a single-party government (ERBD 2017). The new government is expected to be more committed to reform than the previous unstable coalition government. Nevertheless, fiscal consolidation programs by the new government (with assistance from IMF) have been unpopular; in the latest presidential election that took place in July 2017, Khaltmaa Battulga of the opposing DP won the election over the ruling MPP.⁶¹

Overall, mineral wealth management and export diversification are the two major issues the country faces. Fiscal spending, which is dependent on mineral rents, remains highly pro-cyclical despite multiple IMF interventions. Lack of export diversification - in terms of both products and trade partners - makes the economy vulnerable to commodity price swings and decline in external demands. Minerals account for around 80 percent of all exports, and over 80 percent of these are bound for China.⁶² As a result, while the country has been one of the fastest-growing country in booms, its economy collapsed whenever commodity prices fell. Another development challenge for Mongolia is a high level of regional disparities; the incidence of poverty is eight times higher in rural areas (22.2 percent) than in urban areas (2.8 percent) (ERBD 2017).

This chapter, which discusses these developmental challenges, is structured as follows. Section 2 discusses the exploitation of Mongolia's natural resource endowment. Section 3 reviews macroeconomic policy management of natural resource revenues. Section 4 analyses the major barriers to doing business in Mongolia, and gives some policy recommendations for improving the enabling environment. Section 5

⁶¹ Nonetheless, the President in Mongolia has limited power vis-a-vis the parliament, and hence Battulga's assumption of office does not bring immediate changes to the new government's policies and reforms. While the president holds veto power over legislative actions, the parliament can overrule those vetoes with supermajority (Nikkei Asian Review 2017).

⁶² UN Comtrade.

discusses institutions and governance. Section 6 discusses sectors with potential, namely livestock and cashmere production, taking into account the need for more inclusive growth. Section 7 concludes that utilizing the resource wealth for the development of non-extractive sectors and rural poverty alleviation while maintaining fiscal discipline is the key to development.

2. Converting Mineral Wealth into Development

Despite its immense potential, most Mongolian mineral reserves remained unexploited through the 2000s, as the restrictive and changeable attitude of the Mongolian government towards FDI in mining deterred foreign investors. In particular, disputes over development of the Oyu Tolgoi (OT) copper and gold mine, Mongolia's first major mining project, kept investors alarmed for a long time. Canadian company Ivanhoe discovered the mineral deposits in 2001 and started negotiating with the government as early as 2003. However, among other demands, the government's insistence on controlling a 51 percent share prevented the deal from being signed. While majority domestic ownership is not in itself normally a prohibitive hurdle to foreign investment, it is more significant in Mongolia because of the country's general suspicion of foreign investment and investors' concerns about the investment climate. Furthermore, while the negotiation was in progress, Mongolia passed laws placing punitive taxes on foreign companies, exacting a 68 percent tax on copper sold above \$2,600 per ton and gold sold above \$500 per ounce (in 2009 copper traded around \$6,470 ton and gold sold above \$960 per ounce). Finally, in October 2009, Ivanhoe and its partner Rio Tinto signed an investment agreement, after the government accepted a 34 percent stake in OT and revoked the windfall profits tax as well as some other mining laws (Pomfret 2011). The long disputes over the OT negotiation, together with the punitive taxes on mining revenues, discouraged other investment projects. Thus, while the authorities aimed to ensure that the state gained a large share of the country's mineral wealth, they ended up missing the 2003-08 commodity boom.

Mongolia's attitude towards FDI remained inconsistent even after the settlement of the OT negotiations, and soon reversed the temporary improvement of the investment climate. A year after the completion of the OT negotiation, in 2010, Mongolia's National Security Council abruptly declared a moratorium on issuing new mining licenses, citing inadequate protection of the environment and local communities (UNCTAD 2013). The moratorium remained in effect until revoked in 2014. Furthermore, intense "foreigner bashing" took place during the 2012 parliamentary election campaign, leading to adoption of a FDI-d discouraging Entities Foreign Investment Law (SEFIL). SEFIL made private company business decisions in certain sectors including mining, banking, and insurance subject to government review. While SEFIL was repealed in October 2013, Mongolia's resource nationalism continues to scare

away investors. The second phase of the OT development (OT-2) was also delayed because of a shareholder dispute between the government and Rio Tinto (IMF 2017).⁶³

There are some signs of progress. The authorities and Rio Tinto reached an agreement to launch OT-2 worth \$6 billion in May 2015. In addition, the redevelopment of the Tavan Tolgoi (TT) coalmine - one of the largest in the world - is expected to begin in 2019, and together brighten prospects for Mongolia's mineral sector development (IMF 2017). Yet, investors remain cautious; in The Global Competitiveness Index 2016-17, 'government instability' and 'policy instability' rank among the top problematic factors for doing businesses (World Economic Forum 2017). Further improvement will depend on future actions of the new government.⁶⁴

Mongolia's authorities should understand that investment in natural resources entails large risks. Firms need to recoup their costs, make a normal profit, and self-insure for possible failures (Pomfret 2011). The authorities should keep the mining investment environment open, transparent, stable, and predictable. Volatile and restrictive policies influenced by resource nationalism discourage foreign investment, which is essential to realize development fueled by mineral wealth. If the government pushes too hard in negotiations, there will be no exploitation and the resources will remain idle underground. Mongolia may end up missing the next commodity boom if the government does not modify its stance. Beyond the negotiation stage, respecting foreign arbitration decisions is a key to restore investor confidence, given lack of independence of Mongolia's judicial system. Section 3 and 4 provide more discussion and recommendations on the general investment climate.

Summary of Policy Recommendations:

- Allow more FDI into the mining sector to exploit the reserves.
- Do not implement restrictive policies on foreign investment; contain resource nationalism.
- Keep mining environment open, transparent, stable, and predictable.
- Continue to respect foreign arbitration decisions.
-

3. Macroeconomic Policy and Management of Mineral Wealth

One of the important tasks for the government of a resource-rich country is to manage the mineral wealth to alleviate commodity price volatility, contain Dutch disease, and promote development of non-extractive sectors. However, the Mongolian authorities have shown little fiscal discipline and planning.

⁶³ As a result, FDI declined by 95 percent from \$4.7 billion in 2011 to \$232 million in 2015 (U.S. Department of State 2016).

⁶⁴ Worryingly, the election campaign brought about by Khaltmaa Battulga, the Mongolian President newly elected in July 2017, was marked by a nationalist tone (Nikkei Asian Review 2017). Nationalistic calls are still popular among the population.

While much of the mineral reserves remain unexploited, some mines have been operating in Mongolia since the Soviet era, and the country enjoyed the benefits of higher mineral prices during the 2003-08 commodity boom. Mineral rents as a share of GDP increased from 6.7 percent in 2003 to 30.3 percent at their peak in 2006 (World Bank 2014). However, the government did little to save the windfall revenue for the future. The influx of government revenue led to euphoric spending, including public sector salary increases, poorly planned infrastructure investments, and badly targeted social transfer schemes (World Bank 2010; World Bank 2014). In particular, Mongolia's budget for subsidies and transfers, which amounts to some 8 percent of GDP, largely disregards recipient income levels, instead targeting only according to different categories of the population (mothers, children, the elderly, the disabled, etc.) (IMF 2015). Election cycles also influenced spending decisions, with both major parties promising cash handouts in election campaigns. Hence, despite increased mineral revenues during the boom, the government ran fiscal surpluses of only 2-3 percent from 2005-2007 (World Bank 2014).

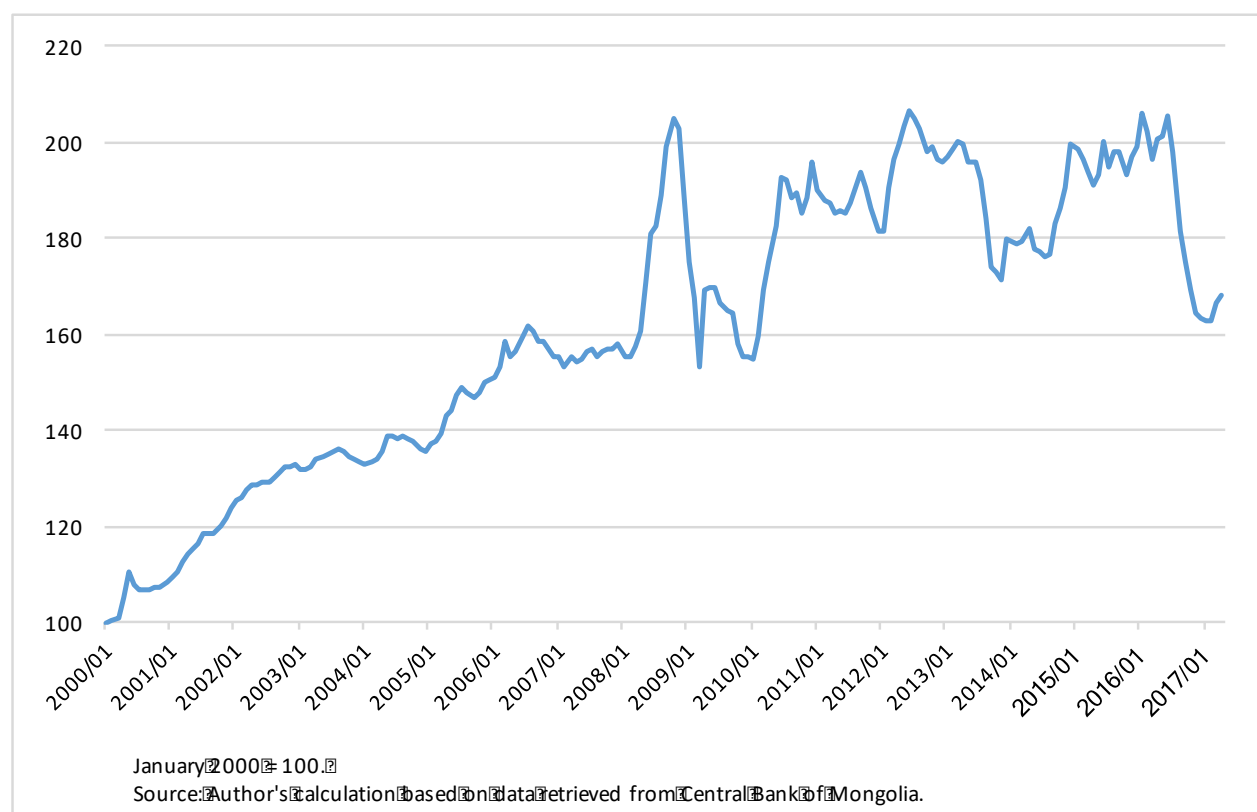
In the aftermath of the 2008-09 crisis, the government adjusted its fiscal policy through expenditure restraint with an IMF stabilization program (World Bank 2010). As a result, the budget achieved a 0.5 percent fiscal surplus in 2010 despite the economic downturn. Furthermore, with assistance from the World Bank and IMF, the authorities passed a Fiscal Stability Law (FSL) in July 2010, coming into effect in January 2013. The FLS has three key components: first, a ceiling on the structural deficit of 2 percent of GDP; second, a cap on expenditure growth; and last, net present value of public debt cannot exceed 40 percent of GDP (World Bank 2014).

However, once again the government soon started to spend without restraint as mineral prices recovered. In 2011-12, increases in fiscal expenditures outpaced that of mineral revenues, and the fiscal deficit widened from 4.8 percent of GDP in 2011 to 8.4 percent of GDP in 2012 (World Bank 2014). Furthermore, as FDI and coal exports declined sharply in 2013-15, the government resorted to expansionary fiscal policies. While the structural on-budget deficit was kept below 2 percent of the GDP in 2013-2014 (as required by the FLS), the government channeled an extra 8 percent of GDP in capital spending through the newly created Development Bank of Mongolia (IMF 2015). The Bank of Mongolia also engaged in quasi-fiscal spending, such as mortgage subsidy programs. Revenue projection during budgeting was frequently over-estimated as well. Consequently, the deficit (including these off-budget expenditures) was around 10 percent of GDP in 2013-2015. In the run-up to the 2016 election, one-off spending spiked and the deficit reached 17 percent of GDP in 2016; the large deficit and depreciation of the currency pushed up the general government debt to nearly 70 percent at end-2016 (IMF 2017).

Fiscal overspending has resulted in Dutch Disease. Persistent high inflation since early 2000s led to continuous real effective exchange rate appreciation (Figure 4.1). Although the upward trend has

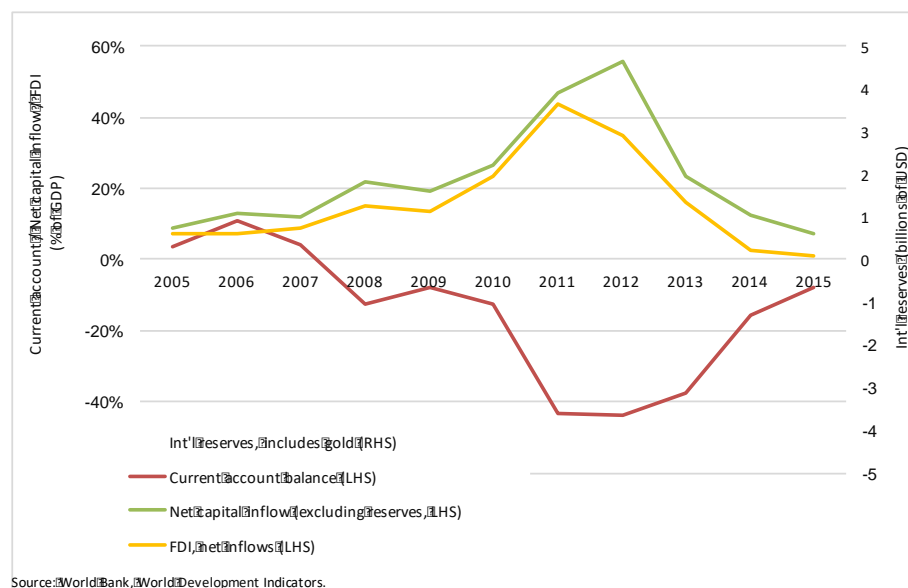
reversed since mid-2016 due to the sharp depreciation caused by recent macroeconomic instabilities, the appreciation trend is likely to resume as the economy stabilizes and the mineral rent keeps growing. This shows an urgent need for restoration of fiscal discipline and increased saving of mineral revenues. Furthermore, the macroeconomic instability caused by loose and unsustainable fiscal and monetary policies renders the country unattractive as a FDI destination; in the Global Competitiveness Index 2016-17, Mongolia ranked 121st among 138 economies in terms of macroeconomic environment (World Economic Forum 2017).

Figure 4.1. Real Effective Exchange Rate of the Togrog



Combined with large current account deficit, falling capital inflows, largely FDI, since 2011 have been putting increasing pressure on Mongolia's international reserves in recent years (Figure 4.2). This underlines the importance of liberalizing entry of foreign investment along with macroeconomic adjustment.

Figure 4.2 Mongolia's Balance of Payments: Current Account, Private Capital Flows and International Reserves



In the newly proposed Economic Recovery Program, the new government showed its determination to discipline fiscal spending, tighten monetary policy, and undertake structural reforms. A \$440 million Extended Fund Facility recently approved by the IMF, which contains conditions on fiscal consolidation as well as monetary policy and banking sector reforms, will support the reforms. The new government has already taken some important actions, such as tightening monetary policy and bringing a large part of quasi-fiscal activities undertaken by the Development Bank of Mongolia and the Bank of Mongolia on budget (IMF 2017; ERBD 2017). Nevertheless, the new government's commitment to the program is open to question given Mongolia's poor implementation record of past programs. Fiscal discipline, introduced in times of crises to receive financial assistance from IMF and other financial institutions, has always been short-lived.

The new government must commit to the reforms and follow through even after the situation stabilizes. Fiscal consolidation will require better social spending targeting; the authorities should stop providing large, untargeted subsidies, and instead focus on programs that directly reach the poor, such as food stamps (IMF 2015). In addition, public investment, especially the road sector, needs more rigorous project evaluation (such as feasibility studies to assess economic viability as well as careful screening of contractors) and prioritization (World Bank 2010). Furthermore, the Fiscal Stability Fund - the sovereign wealth fund established concurrently with the Fiscal Stability Law in 2010 but yet to come into operation

- needs to be operationalized to enhance saving of mineral wealth (World Bank 2010; IMF 2015).⁶⁵

Saving windfall profits during booms will help reduce vulnerability to various shocks, as well as contain the risk of Dutch Disease. Implementation of the sovereign wealth fund is particularly important now given that the completion of OT-2 and redevelopment of TT coalmine are expected to generate increased mineral revenues in the near future.

Summary of Policy Recommendations:

- Consolidate fiscal spending urgently.
- In particular, reduce social transfer spending through better targeting.
- Introduce more vigorous project evaluation (e.g. feasibility studies) for public investment projects.
- Maintain fiscal discipline even after the situation stabilizes.
- Operationalize the sovereign wealth fund to save windfall profits and contain Dutch Disease.

4. Private Sector Development

While mineral wealth can boost development if managed well, Mongolia also needs to diversify its economy and exports in order to shield itself from commodity price swings and achieve a stable development. The key to diversification is to attract FDI, and for this, establishing a business-friendly environment is essential. Yet, Mongolia has much to improve in terms of ease of doing business. World Bank's Doing Business 2017 (DB2017) shows that, while it is relatively easy to start a business and pay taxes in Mongolia (which results in the decent overall rank of 64th out of 190 economies), the country performed poorly with respect to "trading across borders", "getting electricity", and "enforcing contracts", ranking 103rd, 137th, and 85th for respective indicators (Figure 4.3). Additionally, the Global Competitiveness Index 2016-17 shows that Mongolia underperforms in basic areas like infrastructure and institutions, along with macroeconomic stability (World Economic Forum 2017). Among a broad range of reforms Mongolia needs to undertake, this section focuses on four areas that are of highest importance: cross-border trade, transport infrastructure, electricity, and institutions supporting the rule of law.

⁶⁵ Back in 2008, parliament established another sovereign wealth fund named Human Development Fund. However, it does not function as a sovereign wealth fund, but as a patronage tool to distribute mining revenues to the public in the form of various social benefits (e.g. pension, health insurance, mortgage support, and payments for education services). The purpose of the fund was to fulfill campaign promises to provide cash-handouts in excess of \$1,000 (U.S. Department of State 2015.).

Figure 4.3 Mongolia's Performance on the World Bank Doing Business 2017, Rank by category



4.1 Trade Facilitation: Customs Procedure and Logistics

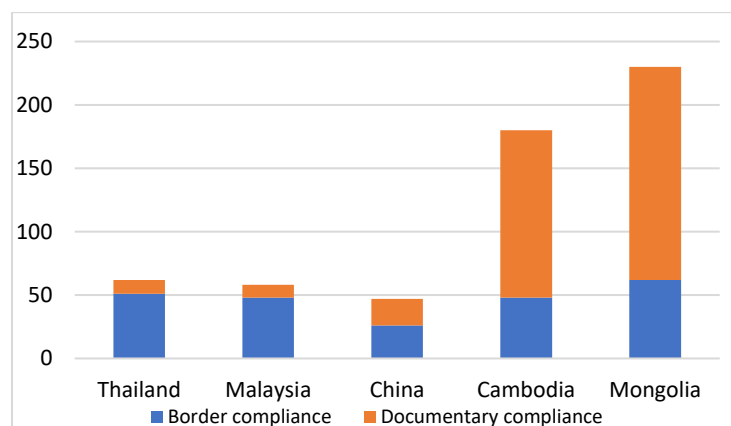
Although landlocked, Mongolia borders two important markets in the region, China and Russia, and it has potential to export consumer goods like agro-food products and light manufactured products to these two developing markets. Nevertheless, the country's rather poor performance in trade facilitation poses an obstacle to such development. Mongolia ranks 103th out of 190 economies for 'trading across borders' in DB2017 (World Bank 2017a). In order to attract FDI and boost non-mineral exports, the country needs to reduce barriers to trade by improving custom inspection procedures and infrastructure at Border Crossing Points (BCPs), as well as by encouraging private sector participation in logistics services.

Mongolia has been making some significant progress in the area of customs. In 2008, the authorities amended the Customs Law and related regulations extensively in line with the revised Kyoto Convention, incorporating almost half of 600 recommendations made by the convention. With support of the Asian Development Bank, the authorities also set up a Customs Automated Information System (CAIS) in early 2011 (UN-OHRLLS 2013; UNCTAD 2013). More recently, a joint border controls initiative taken by the customs administrations of China and Mongolia significantly reduced border-crossing time for road transport; the average border-crossing time at Erenhot-Zamyn Uud BCP (the main BCP between China and Mongolia) decreased from 24 hours to less than 8 hours (CAREC 2014; CAREC

2015).⁶⁶ The Mongolian Customs have also started to implement risk management, although it is still at the beginning stage (UN-OHRLLS 2013).

Despite this progress, there is still a need for further simplification of customs procedures. DB2017 shows that, while cost to export and import is in line with other comparable countries in Asia, time it takes to export and import is much higher in Mongolia (Figure 4.4).⁶⁷ The figure shows that time-consuming documentary compliance is the primary cause for the delay, which takes 168 hours for exporting and 115 hours for importing. Typically, eight documents are required for exporting and five for importing, according to DB2017 (World Bank 2017a). Such bothersome procedures discourage FDI and hinder development of non-extractive export sectors. The customs administration is in process of implementing the National Single Electronic Window, which should help reduce the number of documents required and generally improve the efficiency of customs (UN-OHRLLS 2013). The authorities should also increase the capacities of customs border posts by improving customs inspection equipment and anti-smuggling detection facilities at BCPs; this will help introduce risk management and post-clearance audits more widely (UNCTAD 2013). Besides simplifying customs procedures, reducing widespread corruption at BCPs will be important, as in Kazakhstan.⁶⁸

Figure 4.4. Mongolia's Time to Export, Relative to Comparator Countries



Source: Doing Business 2017.

⁶⁶ Border-crossing time for moving from China to Mongolia.

⁶⁷ There is an overlap between border compliance and documentary compliance, and therefore the sum overestimates the actual time or cost to export / import. Nonetheless, the sum offers a useful cross-country comparison.

⁶⁸ See Section 5 for more discussion on fighting corruption in public services.

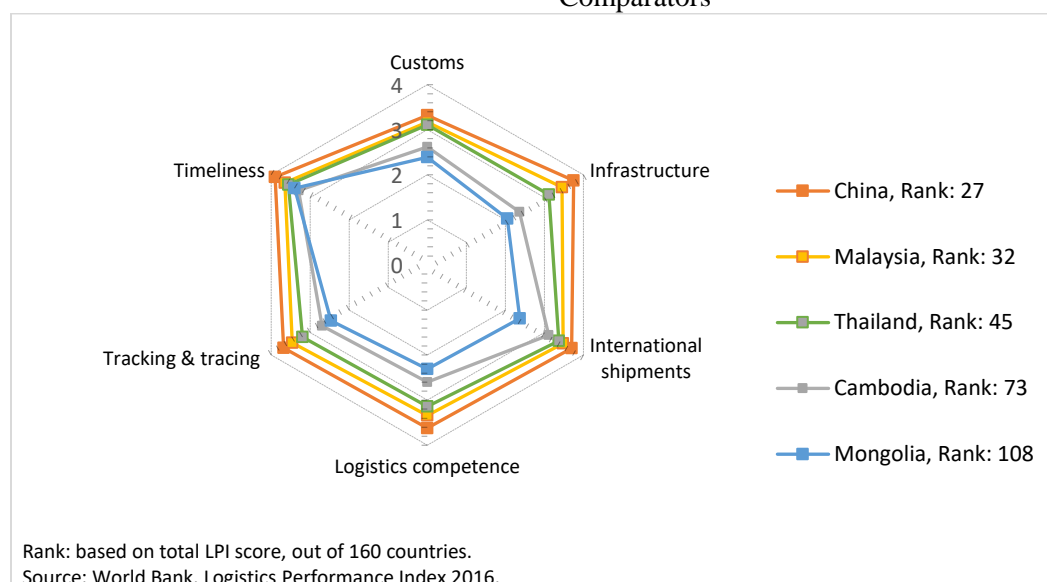
For rail transport (which is the main means of cross-border transport), inadequate trans-load facilities at BCPs create a bottleneck. Like Kazakh railways, all Mongolian railways adopt Russian gauge standards, which differ from the standard used by Chinese railways. The resulting need to trans-load at the gauge change introduces a major delay at the Erenhot-Zamyn Uud BCP, the main gateway for rail transport at the Chinese-Mongolian border (Erenhot is on the Chinese side and Zamyn Uud on the Mongolian side) (Table 4.1). According to CAREC (2015), trans-loading equipment (cranes, etc.) at the three stations in Zamyn Uud is limited; lack of wagons also constrains operation at the BCP. Improving the trans-load facilities and availability of wagons can reduce the delays. Eliminating congestion at borders can increase the railroad capacity without building new railways, and help meet the future growth of cargoes arising from new mining projects. Nonetheless, given that delays also occur at Erenhot on the Chinese side, cooperation with China is essential for addressing the issue.

Table 4.1 Delays at Mongolia-Chinese border (in hours)		
	Ernhot (China)	Zamyn Uud (Mongolia)
China to Mongolia	26.8	24.6
Mongolia to China	34.6	4.3

Source: CAREC (2015)

Mongolia performs poorly in other areas of logistics, too. In addition to customs and infrastructure, the country underperforms in areas like ‘logistics competence’ and ‘ease of arranging international shipments’ according to Logistics Performance Index 2016 (Figure 4.5). While there are multiple major freight forwarders providing integrated logistics services, both public and private, their knowledge and service levels are generally low; small local freight forwarders in particular lack experience in handling international freight. The authorities should develop a central logistic center equipped with modern facilities to increase logistics competence. They should also consider providing training for logistics and transport management, for example by offering relevant courses in tertiary public education (ADB 2009). Encouraging the use of ICT in logistics operations will improve performance in ‘tracking & tracing’, as well as overall efficiency. Entry of international third-party logistics (3PL) companies could help create competition and transfer knowledge about modern logistics handling.

Figure 4.5 Mongolia's Performance on the World Bank Logistics Performance Index, Relative to Comparators



Summary of Policy Recommendations:

- Customs
 - Streamline the customs procedure reducing the number of documents required.
 - Augment capacities at border-crossing points by increasing customs inspection equipment and anti-smuggling detection facilities.
 - Expand risk management.
 - Continue the implementation of National Single Electronic Window.
 - Further increase customs cooperation with China.
- Cross-border infrastructure
 - Upgrade trans-load facilities at rail BCPs at Chinese border.
 - Improve availability of wagons at rail BCPs.
 - Urge Chinese authorities to increase trans-loading capacities at BCPs on the Chinese side.
- Logistics
 - Develop a central logistics center equipped with modern facilities.
 - Provide training for logistics and transport management to address inadequacy of knowledge among domestic service providers (including offering relevant courses in tertiary public education).
 - Encourage the use of ICT in logistics operations.
 - Consider facilitating the entry of international third-party logistics (3PL) providers.

4.2 Transport Infrastructure

Rail and road are the two main means of transport in Mongolia. Railways play a vital role in export and import transportation, with up to 80 percent of all freight transported on rail (UN-OHRLLS 2013). Rail is important for Mongolia's access to international markets beyond China and Russia, since it connects the country to the Chinese port of Tianjin. In addition, Mongolia's strategic location between China and Russia makes Mongolia's railroad an important transit route for traffic moving between the two enormous markets; the main trunk line of Mongolia's railroad network links Russia's Trans-Siberian railroad to China's network.⁶⁹

One issue with Mongolia's international transport traffic is over-dependence on the Chinese port of Tianjin; almost all Mongolia's overseas imports and exports transit through the port. The Tianjin port however does not have adequate capacities to trans-load containers from port to trains. Consequently, the dwell time at the port is long and unpredictable, especially for inbound containers destined for Ulaanbaatar. There are no green lanes for Mongolian containers either, and Mongolian freight forwarders complain that their containers are treated as secondary priorities when the port is congested. Overall, the dwell time at the port averages 5-7 days, accounting for almost 50 percent of the total transport time from the port to Ulaanbaatar.⁷⁰ To address the problem, Mongolian authorities plan to create alternative routes and reduce reliance on the Tianjin port. One of the plans is to open a new route that allows access to the Russian ports of Vladivostok, Vostochny, and Vanino on the Pacific. While the route is more than four times longer than the route to Tianjin, the authorities are negotiating discount transit fees with Russia to make it competitive. Given the prospective increase in mineral exports, the plan is cost effective (UN-OHRLLS 2013; UNCTAD 2013). There is also another plan to develop a new road-rail transport route to the Chinese seaport of Jinzhou (CAREC 2015). These new routes will reduce congestion at the Erenhot-Zamyn Uud BCP by diverting some traffic.⁷¹

Railway covers only a small part of the vast country, and therefore road transport plays a critical role in domestic transport. However, roads in Mongolia remain in poor condition. Only about 12 percent

⁶⁹ While Mongolian railroad can serve to link China and Europe (via Russia's Trans-Siberian railway), this Trans-Siberian route faces competition with the trans-Kazakhstan route, which is being strengthened through China's New Silk Road project. At present, the transit traffic moving between China and Europe through Mongolia remains relatively small. Nevertheless, with sufficient regional cooperation (especially with Russia, whose railroad constitutes the majority of the route), the Trans-Siberian route could potentially become a good alternative to the trans-Kazakhstan route (UN-OHRLLS 2013).

⁷⁰ Moreover, dependence on the single port makes the supply chain vulnerable. For example, explosion at the Tianjin port in August 2015 resulted in significant delays in August and September (CAREC 2015).

⁷¹ The authorities are also expanding the railroad network domestically to link mines like TT and OT to existing railroads (UN-OHRLLS 2013).

of the country's road network is paved (UNCTAD 2013); Mongolia ranks 109th out of 136 economies in the Global Competitiveness Index 2016-17 in terms of 'quality of roads' (World Economic Forum 2017). The difficulty of updating the road infrastructure stems from the sheer size of the country and low population density, which raises the costs of serving rural areas (UN-OHRLLS 2013). While private-sector participation, such as Public-Private Partnerships (PPPs) is growing in the road sector and it is an important strategy to be pursued, its scope will be limited to commercially viable projects, and hence public funding will be necessary for many projects, especially in rural areas. Yet, given the need for fiscal restraint and dangers of Dutch Disease from over-spending, the authorities need to assess the economic viability of each project carefully and be selective. Currently, projects frequently lack feasibility studies, and they are mostly prioritized based on patronage and political interests (UNCTAD 2013). Tendering processes are problematic too. Many projects are awarded through direct contracting with no accompanying technical documentation and no proper screening of contractors (World Bank 2010). At least a basic feasibility study should be conducted for every project, and if the study suggest that maintenance would be too costly, then the project should not be undertaken. In order to accomplish better project evaluations and contractor screening, the authorities need to augment capacities of the agencies in charge of new infrastructure projects. Establishing a transparent and competitive tendering process is essential for reducing inefficiency and corruption, too.⁷²

Summary of Policy Recommendations:

- Rail
 - Implement plans to reduce reliance on the Tianjin port by creating alternative route to access seaports.
- Road
 - Assess the economic viability of each project carefully and be selective.
 - Undertake feasibility study for every project.
 - Do not undertake a project if future maintenance would be too costly.
 - Undertake a proper screening of contractors in tendering processes.
 - Augment the capacity of the agencies in charge of assessing new infrastructure projects.
 - Establish a transparent and competitive tendering process.

4.3 Electricity

⁷² See Section 5 for more discussion on building transparent and uncorrupt institutions

Reliable and accessible electricity supply is critical not only for the mining sector but also for developing non-extractive sectors (especially manufacturing) and for improving the standard of living. However, Mongolia performs poorly here, ranking 137th out of 190 economies for ‘getting electricity’ in DB2017 (World Bank 2017a). Mongolia’s power sector needs upgrading infrastructure and lowering obstacles to getting electricity.

With regards to physical infrastructure, both power plants and distribution system should be updated.⁷³ The main issue is that most power facilities date back to the Soviet era with little subsequent upgrading, and hence are outdated, inefficient, and unreliable. For example, two of three combined heat and power (CHP) plants in Ulaanbaatar (the capital), CHPs 2 and 3, have operated for more than 40 years, and the largest plant, CHP 4, has operated for more than 25 years. In 2012, the average outage duration in Ulaanbaatar was above 2,000 minutes, and the average frequency of outage was more than 13 interruptions per customer. The reserve margin has come close to zero, and if the operation of CHPs 2 and 3 are interrupted – which is likely given that they are 40 years old – it could result in serious power shortages (ADB 2014c; ADB 2014b). Furthermore, use of coal-based household stoves and inefficient heat-only boilers in areas lacking access to power supply has resulted in serious urban pollution in winter; Ulaanbaatar is regarded as among the most polluted cities in the Asia Pacific region.

Power transmission and distribution systems are also in urgent need of rehabilitation and upgrading. Electricity distribution losses totaled 19.6 percent in 2012, much higher than international best practice of about 5 percent (ADB 2014c). To address the issue, the government plans to build a new CHP 5 in Ulaanbaatar through PPP, and install additional capacity in the existing CHP 4 (ADB 2014c). These actions are welcome, but further investment into upgrading and maintaining the infrastructure is necessary to improve the reliability and meet demands of the growing economy. Encouraging more private sector participation (such as PPPs and FDI) would be a key for both construction of new facilities and rehabilitation of old facilities. The revised Energy Law approved in 2015, which aims at adopting a more commercially oriented approach to the energy sector, is an important step in this direction (ERDB 2017).

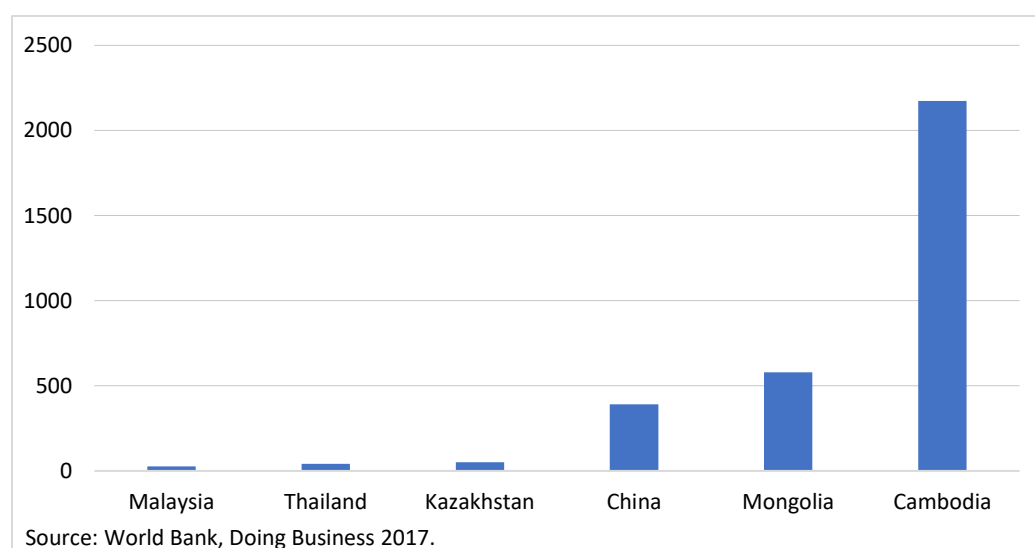
Mongolia has the potential to develop renewable energy, namely solar and wind power (UNCTAD 2013). Not only can renewable energy reduce air pollution from coal combustion, it will also address Mongolia’s unique problem regarding electrification that stems from its geography. Mongolia is large and sparsely populated outside central cities like Ulaanbaatar, and hence building transmission infrastructure to rural areas is often not cost-effective. The fact that a third of Mongolia’s population are

⁷³ In Global Competitiveness Index 2016-17, Mongolia ranked 97th out of 138 countries for ‘quality of electricity supply’ (World Economic Forum 2017).

nomadic herders also compounds the difficulty (UNCTAD 2013). Since solar and wind power production does not have to be centralized (small solar power generator can be portable and hence suits the nomadic life style), it can be an effective and economically viable way to provide electricity and heating to rural communities and nomadic herders. Renewable energy hence has an important implication for rural economic development and achieving inclusive growth. The World Bank has undertaken a project to promote solar energy in rural areas, and it continues the effort to scale up renewable energy production as a part of the Second Energy Sector Project approved in June 2017 (World Bank 2012; World Bank 2017b).

Finally, procedures for getting an electrical connection in Mongolia are costly and should be simplified. According to DB2017, eight procedures needed to be completed in order to get an electrical connection (as opposed to three procedures in best practices), and the cost associated with getting a connection is much higher in Mongolia than in other developing countries in Asia (Figure 4.6). The Enterprise Surveys 2013 shows that the process is also time-consuming; delay in obtaining an electrical connection is 78.3 days as opposed to East Asia and Pacific countries average of 25.4 days and low-income countries average of 41.5 days. Improving the ease of getting an electrical connection is essential for attracting investment in many sectors that Mongolia aims to develop, for example food processing and light manufacturing. Procedures for getting the connection must be streamlined in order to reduce cost and time required to complete the process.⁷⁴

Figure 4.6. Cost to Get Electricity (% of Income Per Capita)



⁷⁴ There is also significant corruption associated with getting electricity. See section 5 for more discussion on corruption.

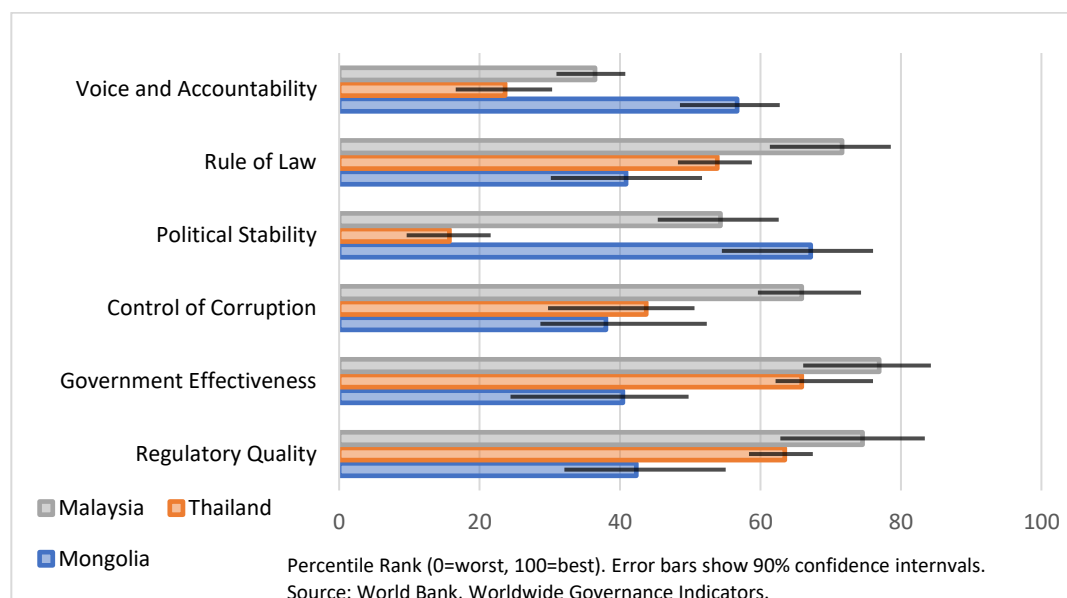
Summary of Policy Recommendations:

- Increase investment in upgrading and maintaining the electricity infrastructure (both power plans and distribution network).
- Encourage more private sector participation (such as PPPs and FDI) in both construction of new facilities and rehabilitation of old facilities.
- Promote development of renewable energy, namely solar and wind power.
- Lower cost for getting an electricity connection, and simplify the procedures.

5. Institutions and Governance

Weakness of institutions is a major deterrent to FDI and private sector development in Mongolia. World Bank's Worldwide Governance Indicators (WGI) show that the country lags behind its peers in Asia in areas like 'rule of law', 'control of corruption', 'government effectiveness', and 'regulatory quality' (Figure 4.7). This section discusses three major institutional weaknesses in Mongolia, namely widespread corruption, unclear legal and regulatory frameworks, and lack of judicial independence.

Figure 4.7. Mongolia's Performance on World Governance Indicators, 2015



Corruption is prevalent in Mongolia's public administrations. In Transparency International (2017)'s Corruption Perception Index (CPI) 2016, Mongolia ranked 87th out of 178 countries. Irregular payments are common at all levels of public administration, especially for getting license and permits (Table 4.2). In a recent survey by the Asian foundation (2016), which targeted Mongolian and foreign

businesses in Ulaanbaatar, 47.9 percent of respondents answered that there is a lot of corruption in public services, and 43.6 percent of respondents told that their business is directly affected by corruption, with large firms reporting more damage from corruption than small firms. Overall, the tax office, inspection agency, and customs are identified as the most corrupt state agencies, followed by the land utilization agency and the government independent procurement agency. Public procurement is deeply affected by corruption; in the same survey, 53.0 percent of respondents answered that political party membership or family relations influence tender awards. Corruption is deeply entrenched in the judiciary as well; in a 2013 survey by Transparency International (2013), 73 percent of respondents reported that the judiciary was corrupt or extremely corrupt.

Table 4.2 Expectation of irregular payments in various activities of public services	
Activities	Percent of firms expected to give gifts
Tax Inspection	19.5
Securing a government contract	25.9
Getting a Construction Permit	45.4
Getting an Import License	18.2
Getting an Operating License	29.7
Getting an Electric Connection	34.5
Getting a Water Connection	48.4
“Getting Things Done”	31.2

Source: World Bank, Enterprise Surveys 2013.

The authorities have made some progress in fighting corruption. In 2006, parliament passed the Anti-Corruption Law (ACL). ACL implemented an assets and income disclosure system for public servants, and established the Independent Authority against Corruption (IAAC), the principal agency responsible for investigating corruption cases. While some question the IAAC’s political impartiality (the President appoints the head), the agency has started to show some tangible results. By March 2011, the IAAD had investigated a total of 916 corruption cases and referred 186 cases for prosecution, although they resulted in only 69 convictions over four years of activity (partly due to limited capacities of the IAAC). In March 2012, the first high-profile case led to the conviction of the former President of Mongolia, followed by the conviction of four senior members of the Mongolian police force in June 2012. In May 2012, a new law came into effect, expanding the staff of IAAC from 95 to 145, regulating

conflict of interest, and requiring public officials to produce electronic private interest declarations and disclosure of assets and income (UNCTAD 2013; U.S. Department of States 2016). As a result, Mongolia's rank in the CPI improved from 120th (out of 182 countries) in 2011 to 94th (out of 176 countries) in 2012 and 87th (out of 178 countries) in 2016.

Despite these improvements, corruption remains prevalent, as indicated by the aforementioned surveys. Progress on implementation of ACL is mixed, and some officials engage in corrupt practices with apparent impunity (U.S. Department of State 2016). The limited effectiveness of anti-corruption programs is attributable largely to three factors. First, the current Criminal Code of Mongolia has a limited scope for criminalization of bribes. The authorities need to criminalize the offer and promise of a bribe, the acceptance of such an offer or promise, and the request for bribe. In addition, they should specify the definition of "bribe", and ensure that it covers non-monetary benefits (OECD 2015). Second, the scope of immunities against prosecution of corruption offences is too broad. Mongolia's Constitution immunizes virtually all high-level officials, including members of parliament and the President, and there is no clear way to lift the immunities (OECD 2015; U.S. Department of State 2016). In addition, some officials of state organizations and their staffs also enjoy immunities based on various laws. This significantly limits the IAAC's ability to investigate and prosecute high-profile cases; while the IAAC has investigated several cases involving Members of Parliament, none has so far led to conviction (UNCTAD 2013; OECD 2015). The authorities need to narrow down the scope for immunity, and establish an effective procedure for lifting immunities. Last, the activities of IAAC suffer from insufficient resources. Current IAAC's mandate is very broad, covering corruption prevention, corruption studies, public awareness raising and education, investigation of corruption offences, and reviewing assets and income declarations of public officials (OECD 2015). The authorities should provide more resources to IAAC (in terms of funding and staffing) and expand the capacity of the agency, for example through specialized training for investigators and prevention officers, as well as through establishing regional offices (UNCTAD 2013; OECD 2015).

Disconcertingly, the current political trend seems to be moving towards undermining the IAAC. In August 2015, the parliament passed an amnesty law that would have resulted in termination of 45 out of the 55 cases that the IAAC has been investigating, reportedly pushed by those under investigation and by the former President. The alleged crime involved more than \$16.2 million. While the President issued a partial veto in September 2015 so that amnesty would not apply to those accused of corruption, abuse of power, illegal enrichment, embezzlement of budget funds and appropriating others' property, this was a worrisome incident. In general, the authorities need to take more determined attitude towards fighting corruption. The previous anti-corruption strategy of Mongolia expired in 2010, and Mongolia has failed to

adopt a new national program. The Anti-Corruption Agency developed a draft of a new strategy, “the National Anti-Corruption Programme”, but the parliament rejected the draft reportedly out of its fear of any additional reinforcement of the agency; the draft has been resubmitted but it is yet to be adopted (OECD 2015; OECD 2016).

Five additional measures are recommended to reduce opportunities for corruption and foster a culture of integrity. First, promote e-governance initiatives. This will reduce opportunities for officials to demand bribes, for example in issuing licenses and permits, and increase transparency. The authorities must establish relevant legal frameworks (such as electronic signature law), and harmonize government databases (UNCTAD 2013). Second, introduce merit-based promotion system for civil servants. This will also help augment the capacity of public administration, which is currently quite limited (as reflected in poor ‘government effectiveness’ performance in WGI – see Figure 4.7). Third, enact comprehensive legislation on whistle-blower protection to encourage reporting incidences of bribery. Fourth, improve and expand the Public Procurement Law so that it covers all public contracting, including procurement funded by the Development Bank of Mongolia and other extra budgetary funds. Corruption in public procurement in Mongolia remains prevalent, in particular for large infrastructure programs (OECD 2015). Legal and regulatory mechanisms to ensure competitive, transparent, and unbiased tendering processes must be established. Overall, fighting corruption and reducing opportunities for rent seeking is an urgent task, given that the mineral revenues are expected to grow rapidly with new mining projects. Finally, the payment system for civil servants should be rationalized such that their pay is commensurate with their professional and technical expertise and experience.

Unclear legal and regulatory frameworks and lack of judicial independence are two other problems with Mongolia’s institutions. Mongolian laws and their implementing regulations lack specificity, and consequently are often interpreted and applied inconsistently. Furthermore, the regulatory vagueness invites corruption, especially where much money is at stake (U.S. Department of State 2016). Lack of judicial independence compounds uncertainty in settling disputes in court.⁷⁵ Although the Constitution states that non-judicial branches of the government should not interfere with the discharge of judicial duties, investors report government interference in the dispute resolution process, especially in cases involving disputes with government agencies, state-owned enterprises, or well-connected private parties (U.S. Department of State 2016). Constitutional changes must take place to remove the role of political entities (the President and the Parliament in particular) in the judiciary and establish judicial independence (OECD 2015). Implementation of merit-based recruitment of judges, which is at initial

⁷⁵ In the Global Competitiveness Index 2016-17, Mongolia ranked 100th out of 138 countries in terms of judicial independence.

stage, must be completed; the transparency and fairness of the procedure needs to be ensured. In addition, the Judicial General Council, which is charged with the constitutional duty to ensure the impartiality of judges, must be given express authority to investigate allegations of judicial misconduct and to impose disciplinary measures on judges (U.S. Department of State 2016).

There are two other issues with dispute settlement. First, judges are often unfamiliar with commercial practices and inexperienced in enforcing commercial laws and regulations (UNCTAD 2013). There is an urgent need for capacity building of commercial justice and of domestic arbitration. The authorities have implemented a project to train over 200 judges with assistance from the European Bank for Reconstruction and Development (EBRD) and the International Development Law Organization (IDLO) in 2012-14; they should continue offering similar programs. Establishment of a tribunal specialized in commercial disputes would also be effective. Second, implementation of court judgements related to commerce, particularly creditor claims, is reported to be problematic (U.S. Department of State). The authorities should ensure that court decisions (including foreign arbitrations) are enforced promptly to reduce uncertainty in settling disputes.

Summary of Policy Recommendations:

- Corruption
 - Criminalize the offer and promise of a bribe, the acceptance of such offer or promise, and the request for bribe.
 - Specify the definition of “bribe” in the Criminal Code of Mongolia, and ensure that it covers non-monetary benefits.
 - Narrow down the scope for immunity, and establish an effective procedure for lifting immunities.
 - Provide more resources to the Independent Authority against Corruption (IAAC).
 - Enhance the capacity of IAAC, for example through specialized training for investigators and prevention officers and establishing regional offices of IAAC.
 - Promote e-governance initiatives; establish relevant legal frameworks (such as electronic signature law), and harmonize government databases.
 - Introduce merit-based promotion system for civil servants to foster a culture of integrity.
 - Enact comprehensive legislation on whistle-blower protection to encourage reporting incidences of bribery.
 - Improve and expand the Public Procurement Law so that it would cover all public contracting, including the procurement funded by the Development Bank of Mongolia and other extra budgetary funds.

- Establish legal and regulatory mechanisms to ensure competitive, transparent, and unbiased tendering processes.
- Legal and regulatory framework
- Make laws and regulations specific and unambiguous to reduce arbitrariness in interpretation.
- Judicial independence
- Remove the role of political entities (the President and the Parliament in particular) in the judicial career.
- Complete implementation of merit-based recruitment of judges; ensure transparency and fairness in the selection procedure.
- Give the Judicial General Council express authority to investigate allegations of judicial misconduct and to impose disciplinary measures on judges.
- General issues with dispute settlement
- Promote capacity building of commercial justice and of domestic arbitration.
- Establish a tribunal specialized for commercial disputes.
- Ensure prompt enforcement of court judgements related to commerce, particularly creditor claims.

6. Diversification Strategies

Agribusiness and tourism are two sectors where Mongolia has particular potential. In both sectors, strong government actions and support are necessary to augment competitiveness and attract FDI. Developing these two sectors is important for reducing the dependency on mineral exports and make the economy less vulnerable to commodity price swings. Furthermore, both sectors have a significant implication for rural development and poverty reduction.

6.1 Agriculture and Livestock

Agriculture is a key sector for Mongolia, both in terms of economic diversification and poverty reduction. In general, the government should incentivize the private sector and take measures to attract private capital and investment targeted to agriculture. This includes building of required infrastructure and provision of social services, so as to attract private sector involvement. These measures are particularly important in light of the great attractiveness of the mining and minerals sector in the country.

Mongolia's two main agricultural subsectors are livestock (meat, dairy, leather, and notably, cashmere) and, to lesser extent, crop production (wheat, potatoes, fodder crops and other cereals). Livestock production accounts for about 75-80 percent of total agricultural production (ADB 2014a;

World Bank 2015). With its strategic location between two large economies, China and Russia, Mongolia has a significant export potential in meat and dairy products; the country has also a potential to export cashmere wool and animal skin products globally. However, agricultural productivity is currently low; the sector accounts for almost 30 percent of total employment, and yet produces less than 15 percent of GDP.⁷⁶ Despite dramatic increase in the national herd size over years,⁷⁷ the majority of herding households remain at or near subsistence level. Value addition within the country is limited; Mongolia mostly exports raw materials and processes only a small portion domestically beyond the most basic stage (ADB 2014a). The main goals for the sector would be to boost the productivity and to increase value-added within the country. In addition, there is an urgent need for ensuring sustainable livestock production through proper pasture management. Because of overstocking and poor pasture management, 70 percent of pastures are now degraded (World Bank 2015). Developing the agricultural sector has important implications for poverty reduction in rural areas, especially for nomadic herders, who consist about a third of the entire population.

Given the peril of overstocking, Mongolia's livestock sector must switch its development approach from increasing the herd size to augmenting productivity. Five actions would be effective in boosting agricultural productivity. First, address issues with animal health and hygiene. Outbreaks of transboundary animal diseases (such as foot and mouth disease) are recurrent, causing significant economic losses (ABD 2014b). In addition, ensuring food safety is also important for Mongolia's agro-food products for exporting abroad. As incomes rise, the domestic demand for safe food will rise, too. The authorities should offer more veterinary services to improve animal health, and implement better hygiene standards and food safety systems to improve the marketability of the products. Second, offer advisory services extensively to inform herders about better production methods and management, and introduce a quality-grading system so that they are incentivized to implement these methods. Lack of price differentiation based on product quality is one of the factors that discourage quality improvements in Mongolia (World Bank 2015). Also, inform producers about safety and quality standards abroad; meeting sanitary and phytosanitary requirements of importer countries is crucial. Third, introduce better risk management to reduce volatility caused by extreme weather. Extreme weather conditions known as *dzuds* pose a large risk to Mongolia's livestock sector.⁷⁸ To make the matter worse, long-term pasture

⁷⁶ World Bank, World Development Indicators.

⁷⁷ 23 million animals in 2002 to 45 million in 2013 (World Bank 2015).

⁷⁸ For more details about Dzuds and discussion on risk management, see World Bank. (2015). *Mongolia: Agricultural Sector Risk Assessment*. World Bank Group.

degradation has exacerbated the severity of livestock mortality from *dzuds*. Smaller and poorer herders tend to be more vulnerable due to limited access to capital and pastures (World Bank 2015). The authorities should promote better winter preparation (such as winter forage production) to limit the damage to livestock. The authorities should also expand the livestock insurance program for herders.⁷⁹ Fourth, establish a system of effective pasture management to ensure sustainability of production. The authorities must implement measures such as land leases and per head grazing fee to limit overgrazing. The herd size needs to be reduced; at more sustainable level, many fewer households would be supported by the livestock sector, so the authorities will need to support labor transition in rural areas (World Bank 2015). Last, promote intensification of production to improve both the quality (e.g. more fattening through feeding program) and profitability. This is essential for gaining export competitiveness.

Mongolia also needs to strengthen agricultural as well as manufacturing value chains. Five actions are recommended in this respect. First, as in Kazakhstan, organizing herders (and relevant food processors) into co-operatives would be effective for improving access to markets and access to finance (another significant obstacle for agricultural development in Mongolia), as well as augmenting efficiency through sharing equipment and facilities. Contract farming can also help link small farmers with processors, wholesalers, and retailers, especially for perishable products like milk. The authorities should establish a legal framework that encourages formation of co-operatives and contract farming. Second, improve road infrastructure and logistics to remove supply chain constraints. Better transport infrastructure and logistics will facilitate development of distribution network (both domestic and international) and better linkage of primary producers, input-suppliers, processors, and retailers. Third, promote industrial cluster development for food and other agro-processing. This is especially important for Mongolia, a vast country with underdeveloped transport networks. Clusters bring processors together, and allow them to share input-output markets and other infrastructure and systems. Fourth, develop a modern retail sector through FDI. Entry of international retailers (e.g. supermarket chains) can help establish stronger distribution networks, introduce international standards and modern logistics practices, and stimulate commercialization of domestic producers. Last, negotiate trade agreements with China and Russia to lower trade barriers and remove restrictions and generally promote regional value chains. For example, Mongolia could develop exports of leather products to China, where demand is rising. Again, Mongolian producers also need to meet the sanitary and phytosanitary requirements of the importers for stable access; Russia, for example, restricts Mongolian meat imports from time to time based on health concerns (World Bank 2015).

⁷⁹ The government should also introduce insurance for crop production to mitigate risks from extreme weathers.

6.2. Manufacturing

Development of mineral processing such as copper smelting would seem like a natural step forward in economic diversification. As UNIDO (2011) warns, however, availability of copper and other minerals does not necessarily imply that domestic processing is economically viable anywhere, and particularly in Mongolia. In fact, there are several reasons that it would be very difficult for Mongolia to develop a competitive mineral-processing sector. First, metal smelting and refining is very capital intensive and will not create much employment. Second, there is a regional over-supply of copper and steel processing capacity already, mainly in China. Third, water availability could be a serious constraint on production. Fourth, smelting is very environmentally damaging. One of Mongolia's strengths is its relatively unpolluted environment. Overall, more labor-intensive sectors such as cashmere and leather are more promising, at least in the near term.

Cashmere is particularly promising. Mongolia produces 6,000 to 7,000 metric tons of raw cashmere annually, and as such, it is the second largest producer of cashmere after China (which produces 9,000 metric tons annually). However, only about a third of Mongolia's cashmere is processed domestically, and the other two thirds are exported to China either raw or after some primary washing and dehairing. Since the largest value addition takes place in processing (in particular, knitting accounts 46 percent of the value-added in processing), Mongolia is missing potential benefits from cashmere production. To make the matter worse, bulk buying without price differentiation by Chinese traders has led to prioritization of quantity over quality, resulting in deteriorating Mongolian cashmere quality (i.e. loss of fineness from increased fiber diameter). The lowering of cashmere quality limits development potential of domestic cashmere processing. Issues with product quality constrain other fiber processing, too. For example, 94 percent of Mongolian wool is coarse, and only 1 percent is fine or semi-fine and suitable for garment production, limiting the potential of weaving and garment factories.

To raise prices received by sellers of unprocessed cashmere and to develop a competitive fiber processing industry, the authorities must take four actions. First, provide advisory services and training to herders in order to enhance raw material quality through better livestock handling, management, and breeding. Second, develop a quality-grading system and implement a mechanism to ensure price differentiation based on quality. Third, put further effort in international marketing and branding of Mongolian cashmere (UNCTAD 2013). It is imperative that Mongolia seek alternative markets to China for selling raw products, for reliance on Chinese traders is currently undermining Mongolian producers' bargaining power. Although Mongolia could potentially become competitive in fiber processing over the long-term, upgrading quality of the raw products and selling with better prices should be the priority in

the short- to medium-term. Improving the logistics as outlined in Section 5.1 is important to this end. Last, implement investment and soft loan programs to alleviate issues related with access to finance and upgrade facilities used by processors (World Bank 2015). Regarding the last action, the authorities must plan the investment programs with caution, undertaking cost-benefit analysis through feasibility studies (possibly with assistance of institutions like World Bank, Asian Bank of Development, etc.). Trying to develop garment industries without ensuring the supply of fine wool, for example, would be futile. In fact, Mongolia should start from improving the quality of basic processing and exporting semi-processed products of higher quality rather than trying to develop vertically-integrated domestic fiber processing industries. Upgrading the basic processing facilities alone can bring a large increase in domestic value-added. Overall, actions to increase the FDI into the sector is important given the need for expertise, market access and capital. Government subsidies should be eschewed given the pressures on the fiscal balance and their tendency to be politicized.

Summary of Policy Recommendation:

- Animal health, hygiene and food safety
 - Offer more veterinary services to improve animal health.
 - Implement better hygiene standards and food safety systems.
- Improving productivity of primary producers
 - Offer advisory services extensively to inform herders about better production methods and management
 - Introduce quality-grading system to incentivize herders to improve product quality.
 - Inform producers about safety and quality standards abroad.
- Risk management
 - Introduce better risk management to reduce volatility caused by extreme weathers.
 - Promote better winter preparation (such as winter forage production) to limit the damage on livestock.
 - Expand the livestock insurance program for herders.
- Pasture Management
 - Establish a system of effective pasture management to ensure sustainability of production.
 - Implement measures such as land leases and per head grazing fee to limit overgrazing; reduce the national herd size.
 - Promote labor transition in rural areas to support those displaced from herding because of reduced herd size.

- Intensification of livestock production
 - Promote intensification of production to improve both quality and profitability.
- Strengthening agricultural and manufacturing value chains
 - Organize herders (and relevant food processors) into co-operatives, and promote contract farming; establish legal framework that encourage formation of co-operatives and contract farming.
 - Improve road infrastructure and logistics to remove supply chain constraints.
 - Promote industrial cluster development for food processing.
 - Develop modern retail sector through promoting FDI.
 - Negotiate trade agreements with China and Russia to lower trade barriers and remove restrictions.
 - Assist Mongolian producers in meeting the sanitary and phytosanitary requirements of European importers.
 - Improve the raw material quality by educating and training primary producers.
 - Develop a quality-grading system and ensure price differentiation based on quality.
 - Put further effort in international marketing and branding of Mongolian cashmere.
 - Implement investment and soft loan programs to alleviate issues related with access to finance; nevertheless, undertake the investment programs only after careful cost-benefit analysis.

6.3 Tourism

Tourism is another key sector for economic diversification and inclusive growth. The country's vast landscape and nomadic lifestyle makes Mongolia an attractive destination for travelling. In particular, Mongolia has an ample potential in niche market tourism like adventure tourism and ecotourism. Despite limited government support, tourism is estimated to account for around 10 percent of GDP and 8 percent of exports; there are already many local and foreign companies operating in and with Mongolia. The major sources of tourists are China, Russia, Korea, the US, and Japan (UNCTAD 2013). There is still a large untapped potential in the sector, and stronger government support is needed for attracting more FDI, marketing Mongolian tourism abroad, and promoting industry-wide development. Development of the tourism sector can moreover support rural development through job creation and local sourcing of products.

The authorities need to recognize the importance of tourism in the country's development, and lead strong and sustainable development of the sector. In particular, five actions are effective in promoting the sector's development. First, establish a strong institutional framework for supporting tourism. Currently the government's tourism policy planning and administration is fragmented in various

ministries, and there is no central body capable of coordinating policies and actions. The Mongolian National Tourism Centre (MNTC), established in 2009 as a state-owned (partially self-financing) enterprise, is both under-financed and under-staffed. The authorities should transform MNTC into a proper national tourism organization, involving the private sector and playing a central role in marketing, sector-development planning, and training. Associating the new national tourism organization through a PPP with a foreign-owned tourist organization would be effective (UNCTAD 2013). In addition, the authorities should provide the organization with more funding and professional staff. Second, through the new national tourism organization, address constraints to high-end tourism development such as lack of sanitary facilities and low service standards. These issues are among least pleasant comments reported in a survey undertaken in 2004, and are important in building image of the country (UNCTAD 2013). Third, facilitate local sourcing. Currently, a high proportion of inputs and supplies in the tourism sector is imported, limiting the benefits of tourism for local development and poverty reduction. The new national tourism organization should promote linkage of tourism sector and local suppliers. Nevertheless, it should be noted that for increasing local sourcing, improving product quality of local supplies is crucial (UNCTAD 2013). Fourth, improve the quality of transport infrastructure. In addition to improving rail and road infrastructure, strengthening aviation is also important given the sheer size of the country. Internal travel by road involves long, uncomfortable journeys (UNCTAD 2013). The authorities must put efforts to increase the number of domestic and international travel options, possibly through PPPs, and the quality of airport infrastructure must be improved. Nonetheless, such investment should be undertaken only after careful feasibility studies. Last, protect the environment for sustainable development of tourism. Nature is the key resource for Mongolia's tourism. The government must ensure that new mining projects do not harm unduly the environment (especially national parks) and local communities in tourist attraction areas. There have been allegation of high-level corruption involving construction projects in national parks (UNCTAD 2013). Environmental standards must be strictly enforced, with emphasis on sustainable tourism development.

Overall, attracting FDI into the sector and linking foreign investors with local suppliers should be the key strategy for tourism development. The new national tourism organization should strive to create an environment favorable to such investment and to build an appealing image of the country's tourism globally to attract FDI. As the number of visitors increase and demands for local products increase, more FDI may start flowing into sectors with linkages to tourism such as cashmere and other light manufacturing.

Summary of Policy Recommendations:

- Recognize the critical role of tourism in development.
- Establish a strong institutional framework for supporting tourism.
- Transform MNCT into a proper national tourism organization, involving the private sector and playing a central role in marketing, sector-development planning, and training; associate the new national tourism organization through a PPP with a foreign-owned tourist organization.
- Provide more funding and professional staff to tourism development.
- Address constraints to high-end tourism development such as lack of sanitary facilities and low service standards.
- Facilitate local supply sourcing; promote linkage of tourism sector and local suppliers.
- Improve the quality of transport infrastructure (road, rail, and air).
- Put efforts to increase the number of domestic and international travel options (possibly through PPPs).
- Improve the quality of airport infrastructure.
- Protect the environment for sustainable development of tourism.
- Ensure that new mining projects would do not harm unduly the environment (especially national parks) and local communities in tourist attraction areas.

7. Conclusion

Although blessed with ample mineral resources, Mongolia has been struggling to convert mineral endowment into economic development. The government's resource nationalism and resulting disputes in mining project negotiations have deterred foreign mining companies and left much of the reserves unexplored and unexploited. Mongolia also indulged in fiscal profligacy, spending mineral rents for wasteful social transfer programs instead of measures to promote economic diversification and development. Lack of fiscal discipline resulted in serious macroeconomic instability and triggered Dutch Disease, making non-extractive sectors uncompetitive and unattractive to FDI. Various obstacles to doing business, such as poor transport and power infrastructures and weak institutions, add to the difficulty of diversification.

A particular problem in Mongolia is the concurrent need for restraining fiscal spending (to stabilize the macro-economy and contain Dutch Disease) and increasing public investment in infrastructure and other potential sectors (to promote development and diversification). The authorities should prioritize fiscal consolidation; stable macro-economic conditions and limiting Dutch Disease effects are essential to keeping non-extractive sector competitive and attracting FDI. Concurrently, the government should allow more foreign mining projects in order to generate more mineral revenues. Much

of these revenues should be saved in a sovereign wealth fund to shield the economy from volatility and prioritize projects that can boost economic development and diversification in the long-term. Even as mineral revenues grow, the authorities need to select public investment projects carefully based on cost-benefit analyses and feasibility studies, so that they do not over-spend.

Despite the numerous difficulties, Mongolia's near-term prospects are bright. With multiple new mining projects planned, the flow of income from minerals is expected to increase. If Mongolia can manage the increased revenues prudently and further improve the investment climate, FDI is likely to increase given the ample potential in agricultural, light manufacturing (i.e. fiber processing), and tourism sectors and the country's strategic location between China and Russia. With fiscal discipline and better institutional setting, Mongolia has the potential to become one of the fastest growing counties in the world.

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1. Introduction

Bhutan is a small, landlocked country in the eastern Himalayas, situated between India and China. The country is almost entirely mountainous; the southern border with India is at an elevation of around 300 meters, and the northern border with China is more than 7,500 meters above sea level (ADB 2013). Limited access to the global market, together with the rugged terrain that constrains infrastructure development, poses a significant challenge to development and diversification. Tense diplomatic relation with China, moreover, constrains the country's ability to overcome its reliance on India. India was the destination of 94 percent of Bhutan's exports and the origin of 79 percent of imports in 2012.⁸⁰ India also accounted for 93 percent of net capital inflows in 2014-15 fiscal year.⁸¹

Despite its challenging geographical situation, Bhutan has been experiencing strong growth. Growth in 2000-2011 averaged 8.6 percent, and though the economy slowed in 2012-2013, the rate came back to around 6 percent since 2014.⁸² Thanks to the rapid growth, Bhutan's GDP per capita reached about \$8,500 international dollars in 2016, more than tripling since 2000.⁸³ With income rising, the poverty rate decreased from 23 percent to 12 percent between 2007 and 2012.⁸⁴ While Bhutan is endowed with some mineral resources and timber, the main driver of growth has been hydropower projects largely financed by India. Bhutan currently exports about 80 percent of the power it generates to India, and multiple large hydropower plants are under construction to meet increasing electricity demand from its energy-hungry neighbor (ADB 2013). The booming capital spending associated with hydropower-related construction has driven economic growth.

However, volatility of foreign aid inflows related to hydropower projects has created macroeconomic instability. Large and cyclical aid inflows financing hydropower development have led to overheating of the economy, which translated into a large current account deficit and pressure on international reserves. The result was a balance of payments crisis in 2011-2012, known as the "rupee crisis". Now, with new projects nearing completion and hydropower revenue slated to increase, Bhutan must improve its management of fiscal and monetary policies to restore macroeconomic stability.

Despite severe geographical limitations, Bhutan enjoys an advantage over its peers from its unusually strong institution for a developing country. While the country's overall rank in the Global

⁸⁰ Author's calculation based on UN Comtrade.

⁸¹ Author's calculation based on RMA (2017).

⁸² Author's calculation based on World Bank, World Development Indicators.

⁸³ Adjusted with Purchasing Power Parity (PPP). World Bank, World Development Indicators.

⁸⁴ Poverty headcount ratio at national poverty line. World Bank, World Development Indicators.

Competitiveness Index 2016-17 is only 97th out of 138 economies, Bhutan ranks 33rd in terms of institutions, above India (42nd), China (45th), Kazakhstan (49th), South Korea (63rd) and Bangladesh (125th) (World Economic Forum 2017). Control of corruption is strong, rule of law is established, and violence is rare (See Section 4). Politically, Bhutan transitioned from an absolute monarchy to a constitutional monarchy with parliamentary democracy in 2008, and accountability is gradually increasing (ADB 2013). Strong institutions reduce the risk of doing business and encourage investment.

Famous for its pursuit of Gross National Happiness (GNH), Bhutan aims for inclusive and sustainable socioeconomic development and preservation of culture and environment. However, growth led by capital-intensive hydropower has resulted in high inequality and youth unemployment. To promote inclusive development and ensure stability, Bhutan needs to diversify into more labor-intensive sectors. Tourism is the most promising candidate for diversifying Bhutan's exports. The sector has a significant implication for reducing chronically high youth unemployment in urban areas. Tourism can also support agriculture and manufacturing if tourists purchase locally produced products like traditional handicrafts. The majority of the population is employed in agriculture and the sector has some potential for growth in niche areas such as mandarin oranges and cardamom, but cannot be a major source of diversification due to limited arable land and rugged landscapes.

This chapter proposes strategies to boost employment and inclusive growth to build on Bhutan's substantial progress to date and achieve the national goal of higher GNH. Section 2 discusses the challenges of maintaining macroeconomic stability under rapid hydropower development. Section 3 analyses obstacles to diversification, such as skill mismatch in the labor market, inadequate infrastructure and access to finance. Section 4 discusses governance and institutions. Section 5 discusses Bhutan's potential areas of diversification, namely tourism and ICT services, to promote job creation and inclusive growth. Section 6 concludes.

2. Macroeconomic Management of Hydropower

2.1 Macroeconomic Stability

The hydropower sector provides huge development opportunities for Bhutan. The potential of the sector is estimated at 30,000 megawatts, out of which 1,606 megawatts are already operational and an additional 3,153 are coming on line in 2018 (World Bank 2015b). The hydropower projects are implemented with India mainly through an inter-governmental model, under which the Government of India finances the construction in forms of loans and grants. When the power plants start operating, all the electricity generated in surplus of domestic consumption is exported to India, through which Bhutan's

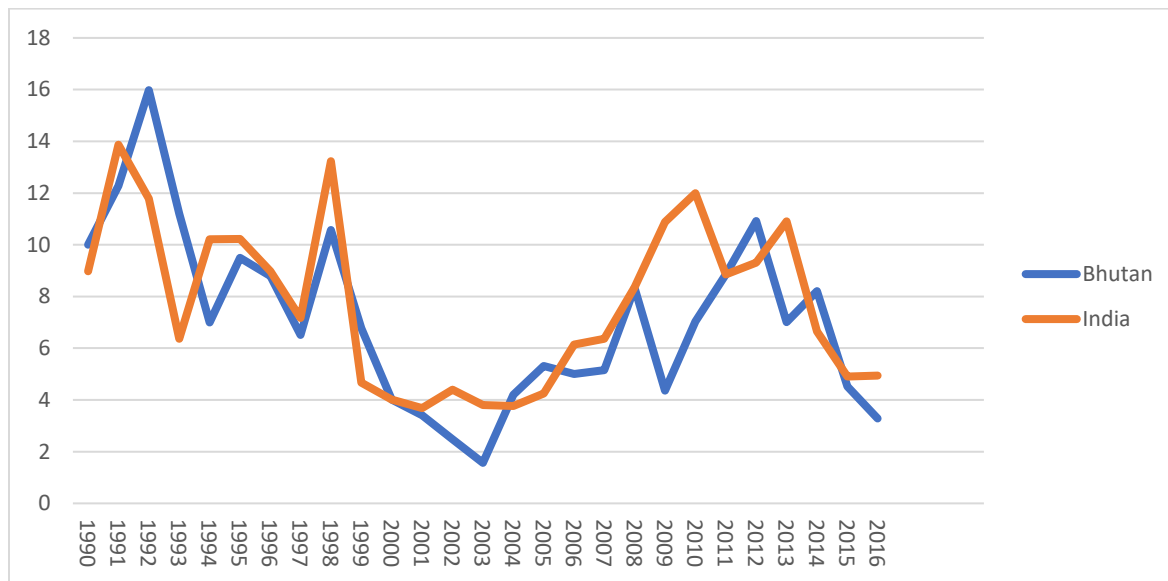
debts are serviced automatically. Nonetheless, the electricity tariff for export is determined such that it guarantees a net return of 15 percent to the Bhutanese government above debt repayment and operating cost (World Bank 2015b; Kojo 2015). Hydropower drives Bhutan's economy. In 2012, electric current accounted for 32 percent of total exports, the largest share among Bhutan's export products.⁸⁵ Yet, so far, the primary driver of Bhutan's growth has not been the export revenue from hydropower itself, but construction activities associated with hydropower projects. Because of the high capital spending associated with hydropower projects, Bhutan's gross domestic investment stood at 50 percent of GDP in 2016.⁸⁶

However, the bulky and volatile nature of hydropower-related investments poses a significant challenge to maintaining macroeconomic stability. The Government of India releases its fund on a “pay-as-you-go” basis in accordance with the progress of construction such that the size of each year's fund release is equal to the amount spent on hydropower development. Therefore, capital inflows surge during the construction phase, and decline sharply as soon as the projects are completed. Furthermore, Bhutan has no fiscal mechanism to manage the cyclicity. While Bhutan's fiscal rule requires running a balanced budget on operating expenses and income, all the financial inflows associated with hydropower development (receipt of grants and loans as well as capital expenditure towards construction) are kept off-budget, and hence are not subject to the fiscal rule. Thus, fiscal policy becomes unintendedly expansionary during construction phases. In recent years, adding quasi-fiscal spending from hydropower construction increased the public-sector deficit by up to 6 percent of GDP over the official ‘budget balance’. Monetary policy, on the other hand, is used to maintain the one-to-one peg of Bhutanese ngultrum to Indian rupee, and hence it cannot function as a stabilization tool (World Bank 2015b; Kojo 2015). Box 5.2 discusses the advantages and disadvantages of this peg. As Figure 5.1 shows, Bhutan's inflation closely follows India's, as the fixed exchange rate to the rupee implies.

⁸⁵ Ferroalloy was the second, and accounted for 24 percent. Author's calculation based on UN Comtrade.

⁸⁶ World Bank, World Development Indicators.

Figure 5.1 Inflation in Bhutan and India (Consumer Prices, Annual % Change)



Source: World Bank, World Development Indicators Online.

In the buildup to the balance of payments crisis in 2011-12, massive off-budget investments overheated the economy. Prior to and during the crisis, new hydropower plant construction led a surge in capital inflows to about 20-30 percent of GDP, with the start of new hydropower plant constructions (World Bank 2015b). The foreign-financed, quasi-fiscal spending boosted aggregate demand, pushed up domestic prices of non-tradables (including labor and land), and created a real estate bubble. Real interest rates fell as inflation rose faster than nominal interest rates, and rapid credit expansion followed; between 2001 and 2012, credits to the private sector expanded by 34 percent per year on average. The overheating placed a tremendous pressure on the external accounts. On the financial account, rapid credit expansion translated to a greater demand for rupee borrowing, offsetting surpluses from hydropower-related capital inflows. The current account deteriorated to nearly 25% of GDP in 2010-11 due to booming aggregate demand pushing up demands for consumer-goods imports and to increasing imports of construction materials and fuels for hydropower projects (World Bank 2015b; Kojo 2015).

By November 2011, Bhutan almost ran out of rupee reserves leading to the “rupee crisis” of 2011-12.⁸⁷ In response, the Royal Monetary Authority (RMA), the central bank, introduced a number of exchange controls on holdings of Indian rupees. The capital controls not only undermined the credibility

⁸⁷ As a result, the authorities had to resort to short-term liquidity financing from India to meet import needs and pay back hydro debts. The high interest rate charged on short-term rupee borrowing strained the external account further; during 2011-12 alone, debt service on the short-term facilities were equivalent to 120 percent of exports of goods and services (Kojo 2015).

of the fixed exchange regime, but also caused price hikes of imported food items. To make matters worse, the authorities mismanaged the crisis. While the RMA acted to tame credit growth, the Ministry of Finance failed to tighten the fiscal policy as it continued to focus solely on keeping the official budget deficit which, as noted previously, excludes hydropower-related expenditures, thus ignoring the root cause of the problem. Large-scale hydropower investment thus continued to fuel aggregate demand (Kojo 2015). Due to the resulting crisis, economic growth slowed from 7.9 percent in 2011 to 5.1 percent in 2012 and just 2.1 percent in 2013.⁸⁸

With many projects in progress or coming in line, Bhutan urgently needs to establish a mechanism to limit volatility of hydropower-related spending. Given that Bhutan has little scope for independent monetary policy (because of the currency peg), fiscal policy must take the role as a stabilizer. Three fiscal reforms are recommended. First, bring hydropower development expenses on budget. This will enable clearer assessments of the stance of fiscal policy. Second, introduce a new fiscal rule such that overall fiscal expenditures (including hydropower investments) are smoothed over time. Under the new fiscal rule, non-hydro public expenditures must function as a counter-cyclical tool, reducing them in periods when major hydro dams are under construction and increasing them when hydropower-related spending declines (World Bank 2015b). Third, implement a mechanism for saving excess revenues, such as a Sovereign Wealth Fund. This is especially important as hydropower revenue is expected to increase dramatically starting in 2018, as new generation power plants start operating (Kojo 2015).⁸⁹ The current fiscal rule that focuses solely on balancing the operating budget cannot handle the prospective increase in revenue.⁹⁰ In order for a Sovereign Wealth Fund (or other similar mechanisms for saving revenues) to function properly, the authorities must establish a strong governance framework to ensure strict adherence to fiscal rule and prevent the fund from being diverted to finance fiscal profligacy.

In the medium term, hydro revenue is expected to increase rapidly, and in response, there could be significant pressures to expand social spending and raise public sector wages. However, the authorities must deal with these pressures with caution and resist large increase in spending (IMF 2016). If the authorities fail to manage the increased revenue prudently, then fiscal policy will become even more expansionary than it is now and soon or later Bhutan will face another, possibly severer, macroeconomic instability.

⁸⁸ World Bank, World Development Indicators.

⁸⁹ World Bank (2015b) estimates that electricity exports will rise by more than ten folds by 2025.

⁹⁰ In addition, hydropower revenues tend to fluctuate depending on the amount of rainfall, and requires some smoothing out in general.

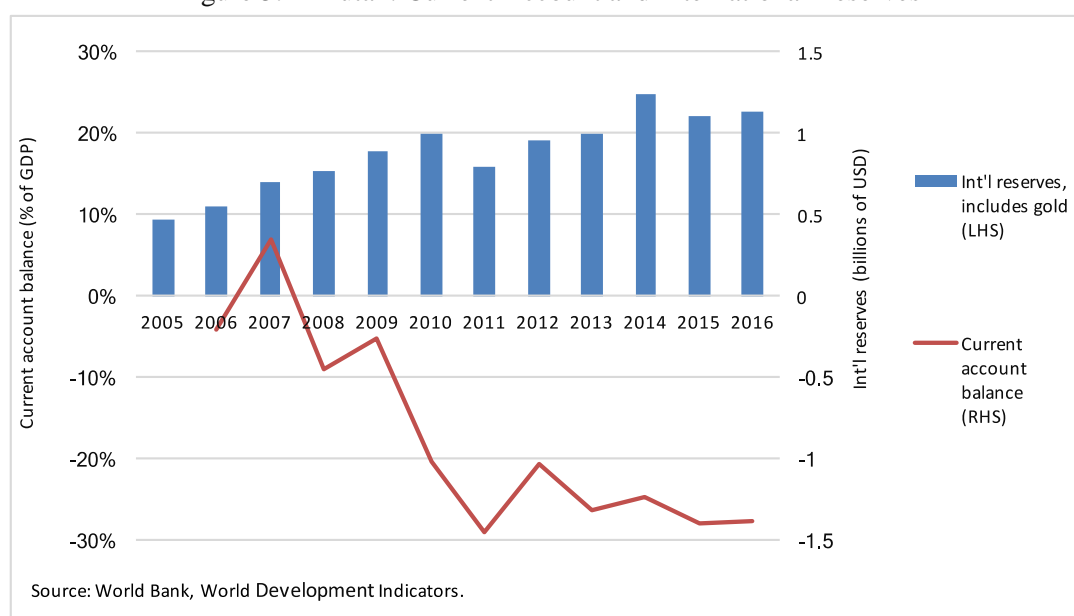
Summary of Policy Recommendations:

- Bring hydropower development expenses on budget.
- Introduce a new fiscal rule to smooth out fiscal expenditures over time.
- Let non-hydro public expenditures function as a counter-cyclical tool, i.e. reducing them in periods when hydro-related investment goes up, and increasing them in other periods.
- Establish a strong governance framework to ensure strict adherence to the new fiscal rule.
- Implement a mechanism for saving excess revenues, such as a Sovereign Wealth Fund.
- Limit expansion of social spending and increase of public sector wages within non-expansionary level.

Box 5.1 Are Bhutan's large current account deficit and external debt dangerous?

Because of the imports of construction materials for hydropower development, Bhutan's current account deficit has been at extreme levels, reaching nearly 30 percent in recent years (Figure 5.2). However, the large current account deficit is not dangerous by itself, because it is financed by large capital inflows associated with hydropower development. In fact, as an overall trend, international reserves have been increasing gradually, despite large current account deficits.

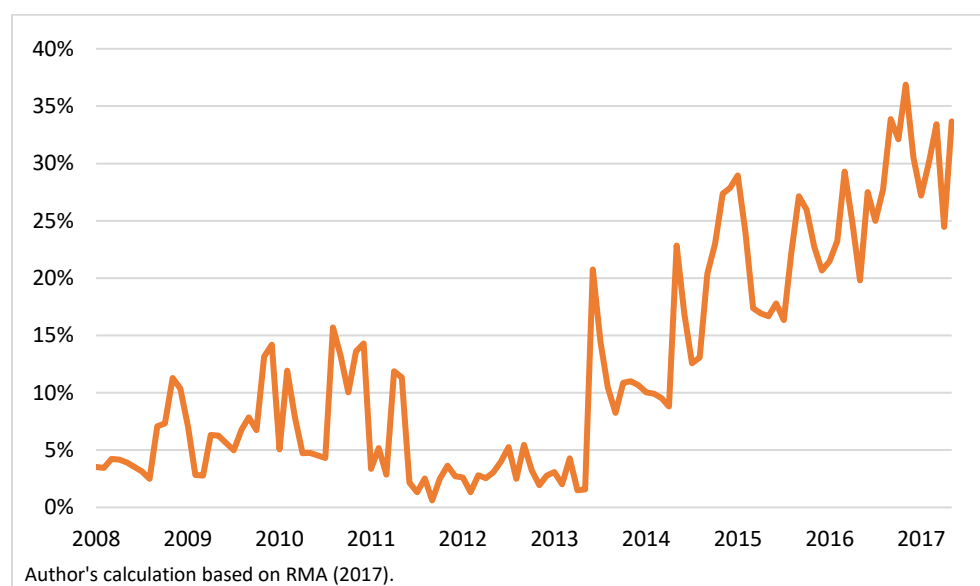
Figure 5.2 Bhutan: Current Account and International Reserves



Yet, poor reserve management and enormous dependence on India for trade and capital flows make the reserves prone to rupee shortages (as was the case with the “rupee crisis” of 2011-12). The

Indian rupee is not fully convertible, meaning that there are restrictions on converting major international reserve currency holdings like US dollars into rupees. In the rupee crisis, Bhutan's rupee reserves, which were at very low level, failed to meet immediate demands created by bulky debt servicing for hydropower projects and rising imports. While the currency denomination of imports and debt service were both about 80 percent in rupees (IMF 2014), the share of rupee-denominated assets in the reserves was merely 5-15 percent (equivalent to around 40-140 million dollars or 0.5-2 months of imports from India) in leading up to the rupee crisis (Figure 5.3).⁹¹

Figure 5.3 Share of Rupee-Denominated Assets in Total Reserves



Overall, the risk of rupee shortages increases when 1) the current account deficit reflects aggregate demand outpacing productive potential, and/or 2) domestic credit expands rapidly financed by borrowing from India. Hence, the authorities must keep fiscal policy tight and refrain from over-stimulating aggregate demand. At the same time, the RMA must strengthen its effort to maintain the share of Indian rupees in the reserves at the sufficient level, and implement other measures to improve its reserve management (e.g. making projections of rupee inflows and outflows for coming quarters).⁹² The

⁹¹ The rupee crisis brought the share even lower to around 2.5 percent (equivalent to around 20 million dollars or less than 0.3 months of imports from India) between 2011 and 2012. The share fell to a low of 0.6 percent (5.7 million USD or 0.1 months of imports from India) in September 2011. (Author's calculation based on RMA (2017)).

⁹² Recently, the RMA reached a swap agreement with the Reserve Bank of India (RBI), and is currently negotiating an arrangement with the RBI that would allow the RMA to convert US dollars into Indian rupee. Bhutan also plans to participate in the World Bank's Reserve Advisory Management Program (IMF 2016). These agreements and actions will help mitigate the risk of renewed rupee shortages.

RMA has been increasing the share of rupee reserves since mid-2013, and as of May 2017, it is about 34 percent of total reserves.⁹³ Nevertheless, IMF (2016) reports that the composition of reserves is still sub-optimal.

Bhutan's large external debt is not necessarily dangerous, either. External public and publicly guaranteed debt (PPG) has been increasing steadily mainly because of hydropower-related lending, and reached 94.5 percent of GDP in 2015 (IMF 2016).⁹⁴ However, given the commercial viability of hydropower projects and explicit guarantees from India that cover financial and construction risks for all hydropower projects, the risk of Bhutan's external debt distress remains moderate (World Bank 2015a; IMF 2016). Revenue from electricity sales will be more than enough to service all hydropower-related debts in the long-term (World Bank 2015b). Nevertheless, Bhutan must make strong efforts to increase domestic tax revenues, as non-hydro public expenditures are expected to grow in the future (as will be discussed in Section 2.2).

Box 5.2 Currency peg to the Indian rupee: implication for macroeconomic policies

Given that India is Bhutan's most important trade and development partner, the peg to the India rupee is appropriate, at least for now (IMF 2016). The peg can reduce transaction costs (such as financial risks for cross-border trades and businesses). After all, hydropower-related loans from India are denominated in the Indian rupee. Nevertheless, the peg necessitates careful management of the macro-economy and international reserves, as the previous box indicates. Loose fiscal policy can overheat aggregate demand and create another rupee shortage as consumption-related imports increase and domestic credit expands. Such a shortage will require re-implementation of capital controls, which are distortionary and harmful to the economy. Furthermore, under fixed exchange regimes, high domestic inflation translates directly into real exchange rate appreciation. So far, Bhutan's inflation mostly has been kept single-digit, and IMF (2016) assesses the ngultrum to be only mildly overvalued. Yet, if domestic inflation surges, the resulting real exchange rate appreciation can reduce the competitiveness of Bhutan's non-hydropower sectors, which are important for diversifying Bhutan's economy.

2.2 Hydropower and Fiscal Self-Reliance

⁹³ This is equivalent to 354 million US dollars or 4.7 months of imports from India. Source: RMA (2017) and author's calculation.

⁹⁴ As of March 2017, the total outstanding external debt is 2470 million US dollars (121.5 percent of GDP), out of which 74 percent was denominated in Indian rupee. Source: RMA (2017) and author's calculation.

In addition to implementing a new fiscal rule to prevent pro-cyclicality, Bhutan needs to increase the degree of fiscal self-reliance. Currently foreign aid finances a large part of Bhutan's public investments, including hydropower projects. The gap in self-reliance – the share of public investment not covered by government revenue – is currently about 15 percent of GDP (World Bank 2015b). In addition to foreign financing of hydropower projects, Bhutan relies upon grants and concessional finance from multilateral and bilateral donors for many other public investments. Hydro revenue is unlikely to eliminate the fiscal deficit. According to estimates by the World Bank (2015b), the gap in fiscal self-reliance is expected to decline for about next ten years to reach near zero; however, over the long-term, the gap will start to widen again, returning to the current level by around 2030. This is because the increase in hydro revenue is expected to decelerate after around 2027-28 (if no new projects come on stream), while the economy will keep growing and public investments will continue to increase. Nonetheless, Bhutan cannot continue to rely upon external grants from multilateral or bilateral donors (IMF 2016). As income per capita rises, Bhutan will no longer be eligible for many grants and concessional loans that it currently receives.

Thus, Bhutan must undertake tax reforms to strengthen domestic sources of government revenue. Bhutan's tax collection is low by international standards, and in recent years, it has been declining relative to GDP (World Bank 2015b; IMF 2016). The cause of the decline is the increased use of tax expenditures (such as tax holidays and exemptions) that have been eroding the tax base, weakening tax compliance and making tax administration burdensome (IMF 2016).⁹⁵ Sales tax exemptions, in particular, account for 50 percent of foregone revenue (World Bank 2015b). The authorities are currently undertaking some reforms of the sales tax, with a goal of replacing the existing inefficient system with a simple, broad-based Goods and Services Tax (GST) by 2018 (IMF 2016). The authorities must continue reforming the tax systems and reassessing tax exemptions and incentives to increase the tax base, notwithstanding the expected increase in hydro revenue. IMF (2016) recommends avoiding new tax exemptions, not renewing expiring exemptions, and phasing out existing exemptions wherever appropriate, as well as listing and costing all tax expenditures on the budget in order to increase fiscal transparency.

Overall, the authorities must undertake tax reforms with long-term fiscal sustainability in mind, not just current levels of fiscal self-reliance. The authorities should not be deceived by a period of temporary improvement of fiscal self-reliance from revenues deriving from new hydropower plants.

⁹⁵ Tax holidays and exemptions also distort incentives. For example, the current tax system discourages much-needed formal employment because it is more susceptible to taxation than (informal) self-employment (World Bank 2015b).

Implementing fiscal rules as outlined in Section 2.1 is also critical for achieving strong and sustainable fiscal self-reliance.

Summary of Policy Recommendations:

- Increase tax collection through reforming the sales tax and reassessing tax exemptions.
- Avoid new tax exemptions, do not renew expiring exemptions, and phase out existing exemptions wherever appropriate,
- Increase fiscal transparency by listing and costing all tax expenditures on the budget.

3. Obstacles to private sector development

The capital-intensive hydropower sector provides limited employment, and hence its benefit is limited only to a small part of the population. In order to achieve inclusive growth in line with the philosophy of GNH, Bhutan must develop growth drivers other than hydropower. Given that large public investment programs are not fiscally sustainable, job-creating growth must come from the private sector. In addition, fostering private enterprise will make the economy more resilient to the volatility of hydro-related capital investment, boost economic efficiency and spur diversification.

To spur private sector growth, a business-friendly environment is essential. While Bhutan's overall rating on the World Bank Doing Business indicators is decent, there are some significant weaknesses. This section discusses the most important obstacles faced by the private sector: labor market skills, infrastructure, trade facilitation, access to finance, and regulation and licensing – and offers a few policy recommendations to address the issues.

3.1 Skills mismatch and high youth unemployment

Skills mismatch is a critical constraint for development of a strong private sector and diversification beyond the hydropower sector. While the youth are increasingly educated, many firms continue to identify lack of skills as an obstacle for doing business. In the most recent Enterprise Surveys by the World Bank (2015c), 14.4 percent of firms identified an inadequately educated workforce as a major constraint. The number was particularly high in hospitality and tourism sectors (29.5 percent) - Bhutan's most promising candidate as a diversification driver - while it was relatively low for the manufacturing sector (5.8 percent). Other evidence suggests that the lack of skilled labor also extends to professions like engineering, medicine, nursing, and teaching. Because of the shortage of domestic high-skilled workers, foreign technicians, mainly from India and Nepal, often fill up the jobs requiring skills

(ADB 2013).⁹⁶ The skill mismatch is reflected by high youth unemployment. While Bhutan enjoys low overall unemployment (just 2.6 percent in 2014), youth unemployment was quite high at 9.7 percent in 2014 (IMF 2016). Youth unemployment is particularly high in urban areas, and includes many educated youths. About 25 percent of the urban unemployed have some secondary education, and a further 25 percent have tertiary education (ADB 2013).

However, the skills mismatch stems less from deficiencies in the educational system than from a deeper “motivation mismatch--most educated youth want to work in the public sector and are not interested in taking private sector jobs. In a recent survey, nearly three quarter of the unemployed responded that they want to work in the public sector (World Bank 2015b). Public sector jobs typically offer higher salaries, better job security, and more prestige than private sector jobs.⁹⁷ In addition, benefits such as old-age pensions are largely unavailable outside the public sector (World Bank 2015b; IMF 2016). Thus, many youths do not pursue skill acquisition for the private sector jobs that are available, and continue to queue for highly competitive public-sector jobs.

In order to achieve private sector-led diversification, the authorities must align public sector compensation with that of private sector. While there have been significant political pressures to raise civil servant salaries and to increase the number of public sector jobs, the authorities must keep compensation growth in the public sector in line with that of the private sector, and the public sector must be expanded only in very compelling cases. Such changes not only risk overheating the economy (through increased government expenditure) but also can distort the labor market and undermine the competitiveness of Bhutan’s private sector in two ways (World Bank 2015b). First, if the public sector offers better salaries, benefits, and job security, talented youth will choose to go into the public sector, and the private sector will be crowded out in the labor market. Second, compensation increases in the public sector (or public-sector expansion) will put upward pressure on private sector compensation, pushing up labor costs for private firms. At present, vacancies in the private sector point to the existence of such crowding out effects. Aligning the public-sector compensation (and non-monetary incentives) with the private sector will incentivize a greater number of talented youth to acquire skills demanded in the private sector, and alleviate the skills mismatch.

⁹⁶ Foreign workers also fill jobs requiring manual labor, which the locals are unwilling to take. The construction phase of hydropower projects is labor intensive, but only about 20 percent of construction workers are Bhutanese citizens (IMF 2016). Overall, foreign workers accounted for 16 percent of the total employment in 2010 (ADB 2013).

⁹⁷ World Bank (2015b) statistically analyses the difference of the pay between public and private sectors, and finds out that, even when controlling for characteristics like education and job types, the pay is higher in the public sector across most of the earnings distribution. The pay gap is as high as 20 percent for a sizeable share of the public-sector workforce.

At the same time, the authorities must promote private sector development and spur productivity growth, which will raise the private sector wages without undermining competitiveness⁹⁸ and help close the pay gap between public and private sectors. This is important because an attempt to cut the public-sector compensation will almost certainly face strong opposition. Rapid private sector growth, on the other hand, can induce faster private sector wage growth and close the compensation gap without political tensions. The authorities can actively foster private sector growth in two ways. First, support private sector growth through outsourcing, procurement, and other private-public partnerships (PPPs).⁹⁹ This would be effective for sectors such as IT services and infrastructure maintenance. Second, support the development of small- and medium-sized enterprises (SMEs). Improving the access to finance would be important for this (see Section 3.4). In addition to aiming at raising the private sector wages, the authorities should create a labor code to improve working conditions in the private sector (World Bank 2010a). Poor employment conditions (e.g. long hours, lack of paid leaves) are one reason that the educated youth prefer to work in the public sector.

In combination with reducing the compensation gap between public and private sectors, the authorities should continue to support skill acquisition by Bhutanese youth through more training opportunities. ADB (2013) identifies limited access to vocational education as a problem. Enrollment into technical training institutes has doubled from 2011 to 2013 thanks to the authorities' efforts, but it remains only about 1 percent of secondary education enrollment.¹⁰⁰ The authorities have been implementing many programs to increase enrollment into tertiary and vocational education, and they are should continue their efforts.¹⁰¹ In addition, the authorities need to revise the vocational courses and programs such that their curriculum better matches private sector needs. World Bank (2010a) reports that vocational courses on offer are often not relevant for industry, and that some areas with strong industry demand are not covered by any courses. Private sector voices need to be consulted when creating a curriculum. The authorities may also consider greater utilization of private-public partnerships (PPPs) in education to augment the quality and cost-effectiveness.¹⁰²

⁹⁸ If wages rise at the same speed as does the productivity, unit labor cost remains constant and competitiveness stays the same.

⁹⁹ Nevertheless, these policies need to be designed carefully. In a small country like Bhutan where competition is limited, outsourcing and procurement can end up cost-inefficient and expensive if poorly designed. See World Bank (2015b) for more discussion.

¹⁰⁰ Author's calculation based on NSB (2016b).

¹⁰¹ Nevertheless, it should be emphasized that providing more training opportunities alone does not solve the issue; unless the underlying motivation mismatch is addressed, the enrollment in vocational education will remain low and the problem will persist.

¹⁰² See World Bank (2015b) for more discussion.

While the above reforms need to be pursued urgently, none of them can address the shortage of skilled labor in the short term. Therefore, in order to meet the immediate needs to the private sector, the authorities must also consider relaxing restrictions on employment of foreign skilled workers. Shortages of well-educated workers can severely constrain the development of important sectors like tourism and ICT.

Summary of Policy Recommendations:

- Align public sector compensation with that of private sector.
 - Keep the compensation growth in the public sector in line with that of the private sector.
 - Continue to support skill acquisition by Bhutanese youth.
- Spur productivity growth to raise the private sector wages.
 - Utilize outsourcing, procurement, and other PPPs to support sectors such as IT services.
 - Support the development of small- and medium-sized firms (SMEs), for example by improving the access to finance.
 - In addition, improve workings condition in the private sector by creating a labor code.
- Provide more training opportunities and improve access to vocational education.
 - Revise the courses and programs such that the curriculum matches the private sector needs better; consult private sector voices when creating a curriculum.
 - Consider greater utilization of private-public partnerships (PPPs) in education to augment the quality and cost-effectiveness.

3.2 Transport Infrastructure

Bhutan's poor infrastructure poses a serious obstacle to development. An inadequate road network limits access to markets for rural people as well as cross-border trade, while lack of modernization of air transport infrastructure is a constraint to the development of Bhutan's tourism sector.¹⁰³ Bhutan's telecommunication infrastructure remains inadequate, too. Bhutan's rugged terrain makes infrastructure projects costly and difficult, while small market size limits their profitability. This section first discusses Bhutan's road network, and then moves to air infrastructure.

Bhutan's road network is limited in coverage and quality, though it is rapidly improving. In the Global Competitiveness Index 2016-17, Bhutan's road infrastructure ranked 80th out of 138 (World Economic Forum 2017). The poor road infrastructure is an impediment for both improving ease of doing business and ensuring inclusive growth. 30.1 percent of firms in hospitality and tourism sector and 21.4

¹⁰³ There is no railway transport in Bhutan, which would be expensive to build given the mountainous terrain of the country.

percent of manufacturing firms identified transportation as a major constraint to doing business (World Bank 2015c). Highways are generally narrow, steep, and curvy, since they are built along land contours with a minimum number of bridges due to difficult topography and lack of resources (ADB 2013). Transportation cost is high, and landslides and adverse climate conditions such as heavy snowfall make the road transport unreliable, undermining Bhutan's competitiveness. Low rural connectivity is a challenge for rural development and inclusive growth. Almost 25 percent of farm roads are considered to be in very poor condition (farm roads, 5,375 km in total, constitute about 50 percent of Bhutan's road network) (ADB 2014b). Nonetheless, Bhutan has been making a rapid progress in improving road infrastructure. Between 2007 and 2012, travel time to the nearest asphalt road on foot fell by about 75 percent, and travel time to market declined by more than 50 percent. In particular, in the Eastern region - the least developed part of Bhutan - average travel time to market fell from about one hour in 2007 to less than 30 minutes in 2012 (ADB 2013). New highways to increase the connectivity of various regions are under construction, too (ADB 2014b). Bhutan should continue the development of road network, as funding permits.

More important for successful development of tourism would be improving the air transport infrastructure. Currently Bhutan has only one international airport – Paro International Airport (PIA). PIA is in a deep valley near Thimphu (Bhutan's capital) in the western region, 2,200m above sea level and surrounded by peaks reaching up to about 5,500m. The airport lacks instrument landing facilities, and the approach into Paro is by visual flight rules. Hence, operations of the PIA are limited to daylight hours, and disruptions due to adverse weather conditions are frequent. Further, the capacity of PIA and related facilities is insufficient to accommodate an increase of international passengers during peak seasons (ADB 2013; ADB 2014b). The ADB estimated that, in the absence of capacity constraints, total annual air passenger traffic at PIA would increase to 491,200 passengers by 2020 and 915,100 passengers by 2030 compared to 181,659 passengers in 2012 (ADB 2014b). In order to accommodate strong tourism growth, the authorities need to expand the capacity and facilities at PIA, in particular safety and navigation equipment and structures, while ensuring optimum operation of the runways and other facilities.

In parallel with expanding PIA, the authorities should also keep augmenting the domestic air transport capacity. Due to inadequate domestic air connectivity, the tourism industry is much less developed in the central, southern, and eastern regions than in the west, where PIA and the capital are located (ADB 2013). To spread the benefits of tourism widely across the country, increasing the connectivity to these regions is essential. The authorities recognize this need, and they have inaugurated three new domestic airports: Yonphula in the east, Bumthang in the central region and Gelephu in the

south (ADB 2013; ADB 2014b). The authorities should keep developing these three airports rapidly to ensure reliable and safe operations. Besides improving physical infrastructure, ADB (2014b) points to the need for enhancing staff training and skills upgrading, as well as strengthening regulatory framework for effective oversight of flight operations and airfield regulation.

While there is a significant need to expand and improve overall transport infrastructure, the authorities should be careful not to overspend. Like Mongolia, Bhutan needs to strike a balance between developing strong infrastructure and preventing pro-cyclical fiscal policy from becoming. As with Mongolia, Bhutan should prioritize sustenance of macro-economic stability (by saving excess hydro revenue) over rapid infrastructure development. In fact, public investment in infrastructure can smooth fluctuations of hydropower-related investment; the authorities should lower infrastructure spending when hydropower expenditures are high, and increase it in other times (see Section 2). At any rate, the Bhutanese government should avoid making its fiscal policy too loose, and infrastructure development should be pursued within that limit, with careful prioritization and planning.

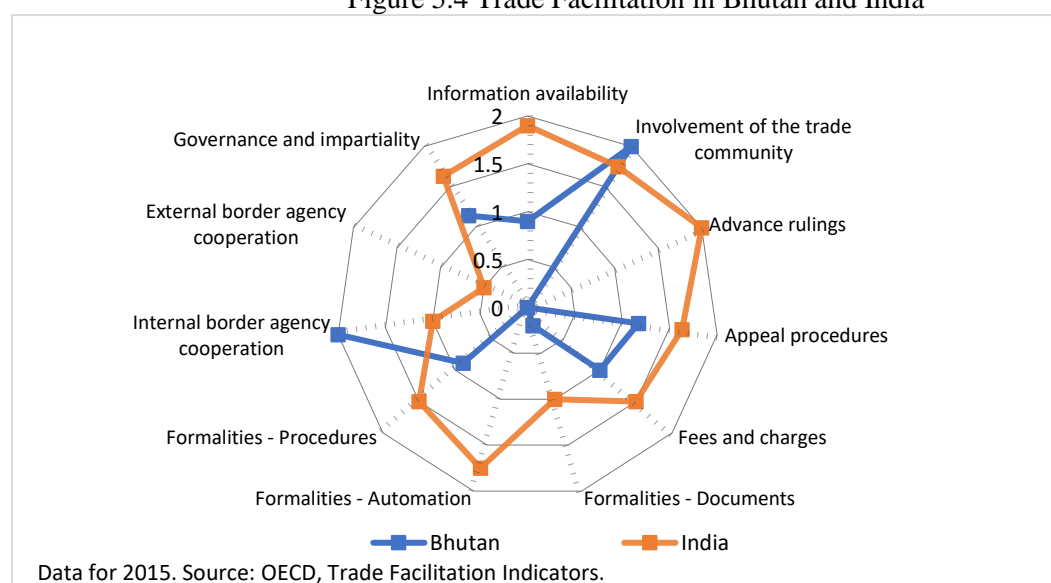
Summary of Policy Recommendations:

- Road Transport
 - Continue the development of road network, so long as it does not risk making the budget too expansionary.
- Air Transport
 - Expand the capacity and facilities at the PIA, in particular safety and navigation equipment and structures; also ensure optimum operation of the runways and other facilities.
 - Keep augmenting the domestic air transport capacity and investing in three major domestic airports.
 - Provide more staff training and enhance skills upgrading.
 - Strengthen regulatory framework for effective oversight of flight operations and airfield regulation.
- Nevertheless, prioritize macro-economic stability over infrastructure development, and refrain from overspending on it.
 - Use public investment in infrastructures to smooth out the fluctuation of hydropower-related spending.

3.3 Trade facilitation

Given its geographical isolation and small domestic market size, excellent trade facilitation is essential for Bhutan to participate in global value chain and create new trade ties beyond India. However, Bhutan's performance in trade facilitation is mixed.¹⁰⁴ While Bhutan ranks 26th in Doing Business Index by World Bank (2017) for “trading across borders”, its performance in OECD's Trade Facilitation Indicators is uneven, with particular weaknesses in areas such as custom formalities and advance rulings (Figure 5.4). Bhutan also needs to improve aspects of trade facilitation and logistics other than customs procedures. Bhutan scores poorly for every indicator in World Bank's Logistics Performance Index – infrastructure in particular but also logistics competence - and thus ranks 135th out of 160 countries.

Figure 5.4 Trade Facilitation in Bhutan and India



Four reforms are recommended in the area of customs procedures. First, streamline customs procedures by reducing the number of documents required and harmonizing them with international conventions. Second, automate customs procedures and introduce risk management. Automation will require improving the quality of telecommunications and IT systems. Third, adopt modern customs

¹⁰⁴ Different sources give different pictures about Bhutan's trade facilitation, such as the time required to prepare documents for exporting and importing. According to Doing Business Index by World Bank (2017), Bhutan's performance is quite close to the international best practice, whereas in OECD's Trade Facilitation Index, Bhutan compares rather poorly to its peers; in Enterprise Surveys, Bhutan's performance is about the same as the South Asia average (World Bank 2015c). The disparity must have stemmed from methodological differences, but it is not easy to ascertain what exactly. Still, it is clear there is room for improvement.

procedures such as pre-arrival processing of import documentation, accelerated controls for perishable goods, and advance rulings. Last, pursue introduction of a Single Window; Bhutan should seek assistance from international institutions for the development of this system. The Single Window should improve information availability, too.¹⁰⁵

Aside from improving the customs procedure, Bhutan needs to improve overall logistics competence. Expanding logistics-related facilities (e.g. logistics centers and dry ports) is essential. Also important for improving the freight movement would be to resolve traffic congestion at major border crossing points to India by constructing new roads that bypass existing routes and building dry ports that support them (ADB 2014b). Finally, promoting greater use of information and communication technology (ICT) will also help improve the logistics performance.

Summary of Policy Recommendations:

- Customs Procedures
 - Streamline the customs procedures by reducing the number of documents required and harmonizing them with international standards.
 - Automate the customs procedures and introduce risk management.
 - Adopt modern customs procedures such as pre-arrival processing of import documentation, accelerated controls for perishable goods, and advance rulings.
 - Pursue introduction of a Single Window; seek assistance from international institutions for the development of the system.
- Logistics Performance
 - Expand logistics-related facilities (e.g. logistics centers and dry ports).
 - Resolve traffic congestion at major border crossing points to India by constructing new roads that bypass existing routes and building dry ports that support them.
 - Promote greater use of information and communication technology (ICT).

3.4 Access to Finance

Improving access to finance for small- and medium-sized enterprises (SMEs) is no less important for spurring the private sector growth in Bhutan. It also presents a mixed picture. According to Enterprise Survey 2015, access to finance in Bhutan is consistently better than in other South Asian countries (Table

¹⁰⁵ OECD, Trade Facilitation Indicators: Country Note - Bhutan. Retrieved from <http://compareyourcountry.org/trade-facilitation>

5.1) but nonetheless is reported as the top constraint for doing business in Bhutan, with 16.4 percent of firms in Bhutan identifying it as a major constraint.¹⁰⁶ The difficulty is felt especially among manufacturing firms, of which 28.2 percent identified access to finance as a major obstacle (World Bank 2015c). While access to credit is relatively high – 46.5 percent of firms have a bank loan or line of credit – real interest rates are high (though gradually coming down recently), and the spread between lending and deposit rates is large, reflecting inefficiency of financial intermediation (Figures 5.5 and 5.6). While there is no ‘silver bullet’ for solving the issue, five measures could help ease SMEs’ access to finance.

First, improve credit information availability. Currently Bhutan’s financial institutions depend on collateral-based lending with high interest rates. According to the most recent Enterprise Survey, 94.5 percent of all loans required collateral in Bhutan, compared to the regional average of 81.1 percent (World Bank 2015c). Collateral-based lending does not take into account creditworthiness of borrowers in determining terms and conditions, and hence result in inefficient financial intermediation and high interest rates for borrowers. Improving the availability of credit information makes it easier for lenders to assess the credit-worthiness of borrowers, and thus encourages adoption of modern, risk-based lending (World Bank 2010a). Bhutan has been making a significant progress with respect to enhancing credit information sharing. Bhutan launched its first credit information bureau in 2009 and then a public credit registry in 2012; it also implemented additional regulations to improve access to credit information in 2014. Thanks to these reforms, Bhutan’s performance for getting credit jumped up from 176th among 183 economies in Doing Business 2011 to 109th among 189 economies in Doing Business 2014 (World Bank 2010b; World Bank 2013).¹⁰⁷ The authorities should continue their effort to enhance both coverage and accessibility of credit information system in order to improve the efficiency of financial intermediation.

¹⁰⁶ Nevertheless, this is far lower than South Asia average, which was 26.5 percent.

¹⁰⁷ The “getting credit” ranks are not comparable between years before and from 2015 due to methodological changes. That being said, Bhutan’s current “getting credit” rank is 82nd out of 190 countries (World Bank 2017).

Table 5.1 Depth of Financial Sector Outreach in Bhutan: Selected Indicators from Enterprise Surveys 2015

Indicator	Bhutan	South Asia
Percent of firms with a checking or savings account	93.3	77.6
Percent of firms with a bank loan/line of credit	46.5	27.0
Percent of firms using banks to finance investments	32.2	21.8
Proportion of investments financed by banks (%)	18.9	14.4
Percent of firms using banks to finance working capital	42.0	25.0
Percent of firms using supplier/customer credit to finance working capital	5.5	14.5
Proportion of working capital financed by banks (%)	25.9	12.4
Percent of firms identifying access to finance as a major constraint	16.4	26.5

Source: World Bank Enterprise Surveys.

Figure 5.5 Bhutan Real Lending Interest Rate

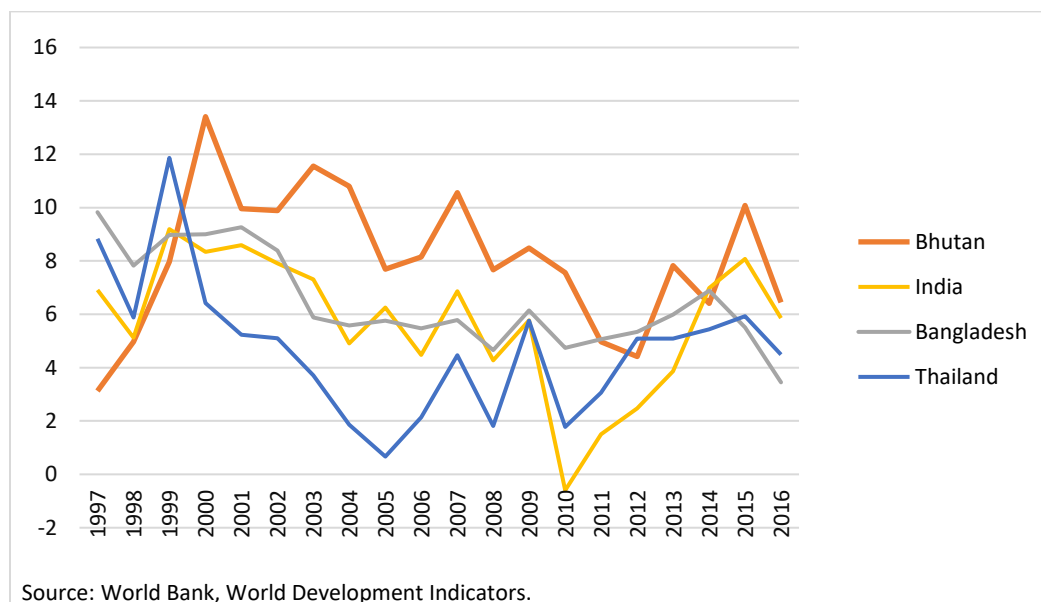
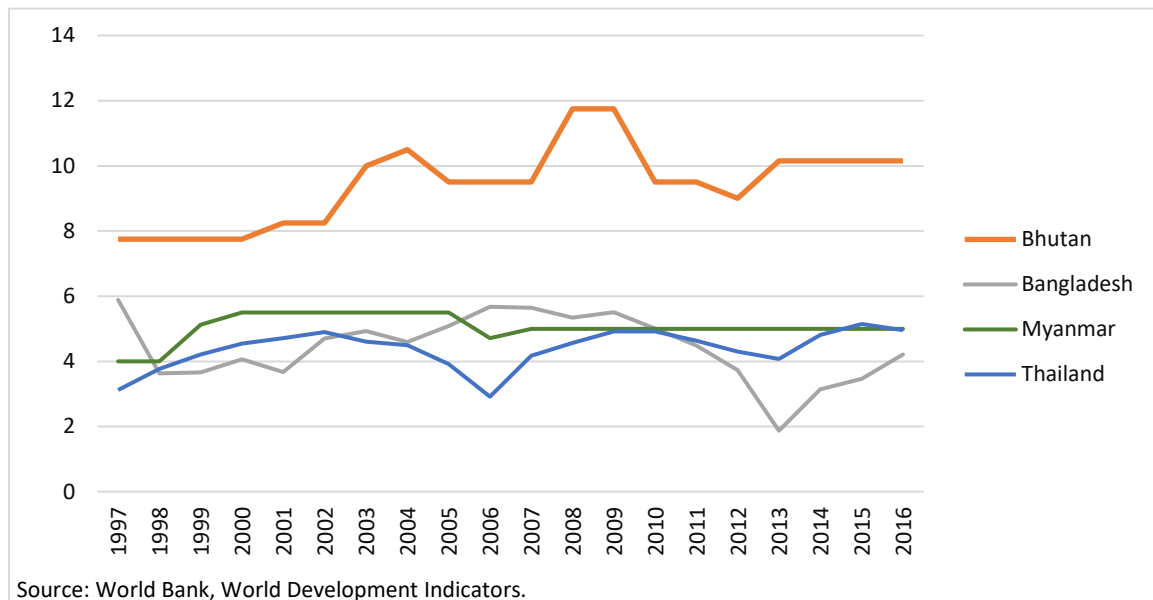


Figure 5.6 Bhutan Spread Between Loan and Deposit Interest Rates



Second, facilitate streamlining of loan application procedures. The application procedures are reported to be confusing, rigid, and lacking in transparency (World Bank 2010a). Such documentary and procedural constraints tend to affect small-scale borrowers SMEs disproportionately (ADB 2013). Also underlying the issue is limited capacity of the staff of the financial institutions (World Bank 2010a). In addition to urging banks to simplify procedures and improve customer service, the authorities should promote skill development in the financial sector, for example by promoting more training opportunities and by improving the quality of training institutes for banking and finance.

Third, promote competition by allowing foreign banks into the market. In 2010, two new domestic banks (Druk PNB and T-Bank) started operating in addition to three existing ones, and yet competition in the market remains limited and lenders continue to set high spreads (ADB 2013). Allowing entry of foreign banks (beyond the existing Indian ones) would spur competition and improve the efficiency of financial intermediation, bringing the interest rates down for borrowers and incentivizing provision of more banking products.

Fourth, establish credit-risk guarantee facilities for SMEs. Providing public-private partial loan guarantee schemes can promote lending to SMEs by sharing risks. In addition, implement any other measures to encourage longer-term lending to SMEs, for example creation of credit line facilities to financial institutions specifically for this purpose (World Bank 2010; ADB 2013).

Last, facilitate utilization of ICT in the financial sector, including development of electronic payment system infrastructure and mobile banking (World Bank 2010a; ADB 2013). These services can

spread access to finance more widely, especially in rural areas, and thus promote inclusive growth. Given the relatively high usage of ICT among firms (including SMEs), greater use of ICT in the financial sector can be an effective way to alleviate the financial constraints on SMEs.

Summary of Policy Recommendations:

- Continue to improve the credit information availability to encourage modern, risk-based lending.
- Facilitate streamlining of loan application procedures.
- Promote skill development in the financial sector, for example by providing more training opportunities and by improving the quality of training institutes for banking and finance.
- Spur competition by allowing foreign banks into the market.
- Establish credit-risk guarantee facilities for SMEs.
- Implement any other measures to encourage longer-term lending to SMEs, for example creation of credit line facilities to financial institutions specifically for this purpose.
- Facilitate utilization of ICT in the financial sector, including development of electronic payment systems and mobile banking, possibly through PPPs.

3.5 Regulations and Licensing

Excessive regulations and cumbersome procedures for obtaining licenses are significant obstacles to doing business in Bhutan. According to the latest Enterprise Surveys, 28.8 percent of senior management time is spent on dealing with government regulation. The issue is especially felt in the service and hospitality sectors, where nearly 35 percent of senior management time involves dealing with regulations; 20.6 percent of firms in tourism and hospitality sectors identify business licensing and permits as a major constraint (World Bank 2015c). The Enterprise Surveys do not break up the senior management time spent on regulations into different activities, and hence it is unknown exactly which regulations are most burdensome. A previous survey suggests that time spent on meeting environmental regulations are viewed as excessive (World Bank 2010a). UNCTAD (2013) also reports that investors often complain of complex and cumbersome environmental clearance procedures. While environmental protection is paramount (especially given its importance for the tourism sector), the authorities should streamline and simplify environmental regulations wherever possible, and clarify any confusions and ambiguities.

Among licenses and permits analyzed by Enterprise Surveys (operating license, construction-related permit, and import license), construction-related permits are the most time-consuming to obtain.¹⁰⁸ While the average for all firms surveyed is 32.9 days is above the regional average of 55.1 days, the average again masks widely differing burdens on specific sectors. The time to obtain construction-related permit is more than 50 days for non-food manufacturing firms and almost 100 days for firms in the tourism and hospitality sectors (World Bank 2015c). While there is not enough information to ascertain the cause of such sectoral disparities, the authorities must work to reduce the regulatory burden on the most adversely affected sectors.

Overall, the authorities must reduce inefficiency in procedures for obtaining licenses and meeting other regulations. World Bank (2010a) reports the licensing procedures to be unclear and overly complex with various agencies issuing numerous licenses. While many individual licenses can be obtained relatively quickly, applying for a license from one agency sometimes requires additional licenses or clearances from other agencies, making the overall burden frustrating and burdensome. The authorities must improve the coordination between different agencies and reduce the regulatory burden by streamlining licensing procedures. The authorities may also consider introducing an electronic licensing portal that 1) provides all information on licensing requirements, and 2) accepts applications and payments for obtaining licenses and permits, possibly with technical assistance by international organizations like the UN or The World Bank.

Summary of Policy Recommendations:

- Streamline and simplify environmental regulations wherever possible, and clarify any confusions and ambiguities, while maintaining strong environmental protection.
- Reduce inefficiency in procedures for obtaining licenses and meeting other requirements of regulations, for example by improving the coordination between different agencies.
- Consider introducing an electronic licensing portal that 1) provides all information on licensing requirements and 2) accepts applications and payments for obtaining licenses and permits, possibly with technical assistance by international organizations like the UN or The World Bank.

4. Institutions and Governance

Despite the constraints identified in Section 3, Bhutan has three important advantages over other South Eastern Asian countries that make the country attractive to FDI and open a prospect of strong private sector growth. First and crucially, Bhutan's institutions are strong. In the Global Competitiveness

¹⁰⁸ It is relatively easy to obtain operating and import licenses; it takes 1.2 days and 8.3 days as opposed to the regional average of 14.8 days and 15.5 days, respectively (World Bank 2015c).

Index 2016-17, Bhutan ranks 33rd out of 138 economies in terms of institutions (World Economic Forum 2017). In particular, Bhutan's control of corruption is excellent; the country ranked 27th out of 176 countries in Corruption Perception Index 2016 (Transparency International 2017). Politically, Bhutan moved from an absolute monarchy to a constitutional monarchy and parliamentary democracy in 2008, and the voice of people in political decision-making is gradually increasing (ADB 2013). In the World Bank's Worldwide Governance Indicators, Bhutan performs as well as or much better than neighboring countries (Figure 5.7). In particular, the country is politically stable, and the rule of law is strong. Second, the electricity cost in Bhutan is cheap thanks to the hydropower. The price of electricity in Bhutan is around one third of the price in China and one fifth of that in India. (Figure 5.8). Third, Bhutan's unit labor cost is lower than that of comparators (Figure 5.9). Average labor costs in Bhutan are higher than in neighboring countries – for example, they are 45 percent higher than in India but Bhutan's relatively high productivity (as a low-income country) justifies the higher wages and unit labor cost is actually low, especially in the service sector (World Bank 2010a).

Figure 5.7 Governance Indicators: Bhutan and Neighbors

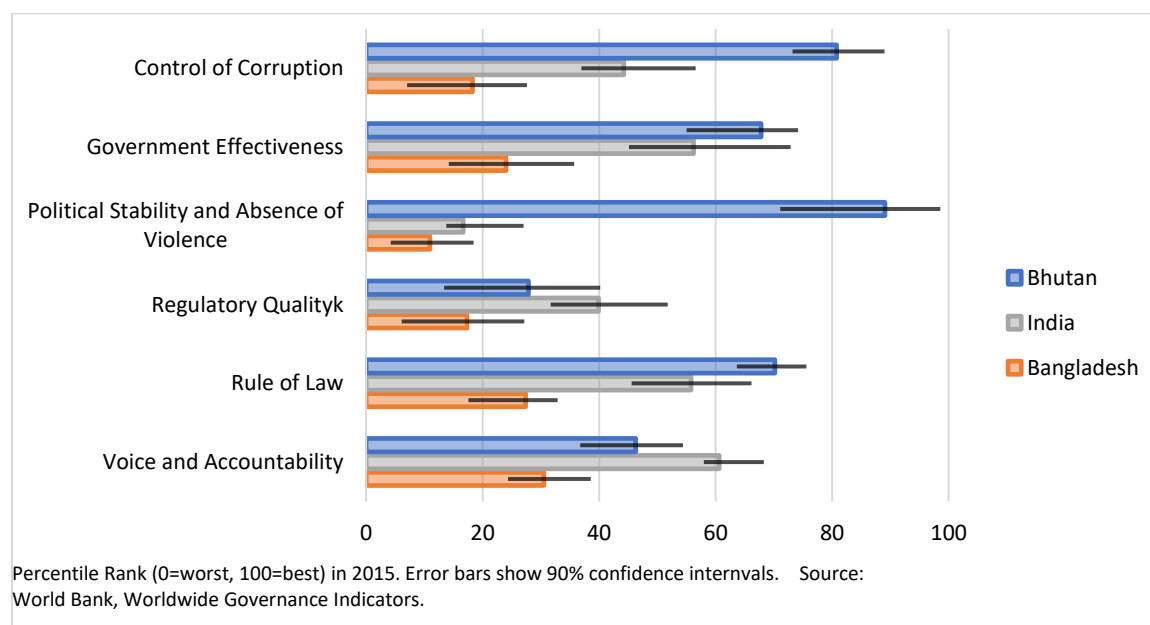


Figure 5.8 Price of Electricity: Bhutan and Neighbors

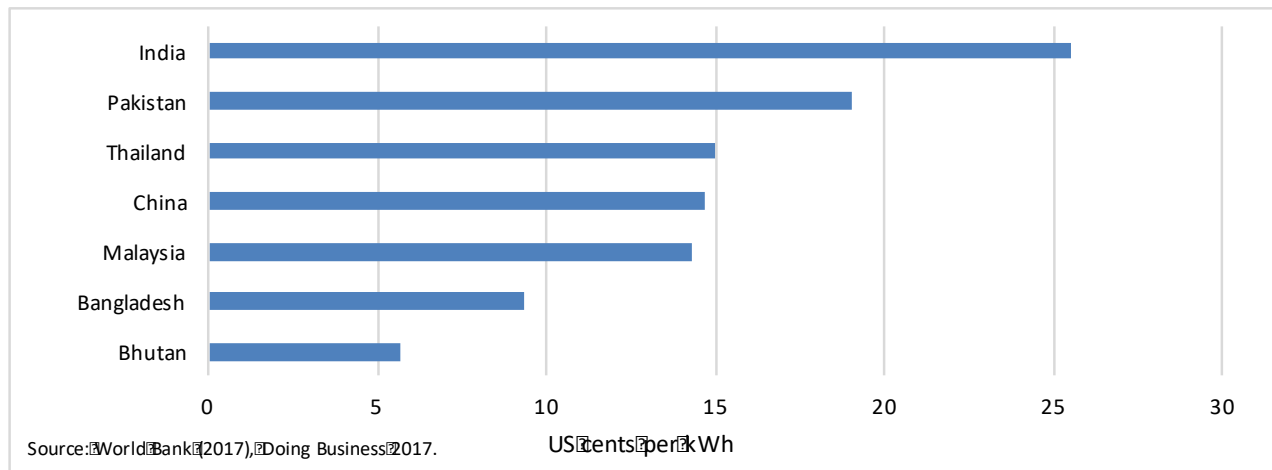
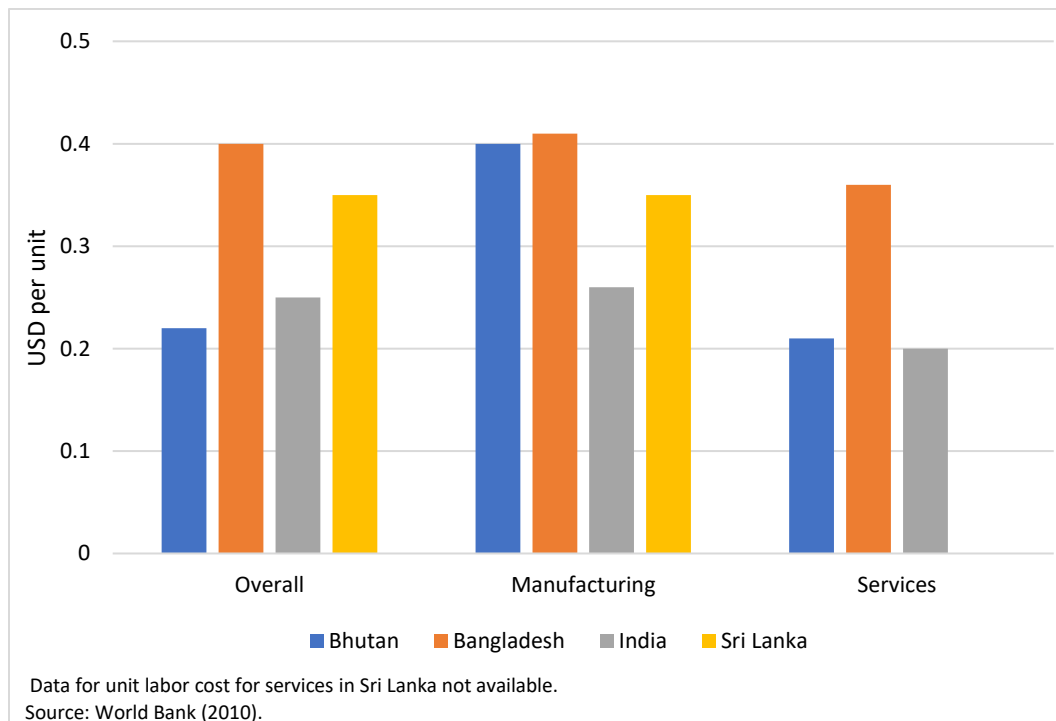


Figure 5.9 Unit Labor Cost: Bhutan and Neighbors



While the hydropower sector is likely to remain central to the economy, Bhutan also needs new, labor-intensive sources of growth and employment. New hydropower projects are labor-intensive in their construction phase, but only about 20 percent of the workers are Bhutanese citizens because many local people are unwilling to take jobs requiring manual work (IMF 2016). Bhutan needs to improve the attractiveness of private sector employment, as described previously, and develop more varied

employment opportunities across the country and for people with different education levels. The new sectors should also absorb unemployed urban educated youth. Rural employment opportunities are also important to discourage further migration to the cities. This section identifies Bhutan's tourism sector as a potential development driver, and discusses challenges it faces extensively, offering some policy recommendations. The section will also briefly touch upon Bhutan's potential in agriculture and in the information and communication technology (ICT) sector.

5. Diversification Strategies

5.1 Tourism

Bhutan's rich cultural heritage and festivals attract an increasing number of tourists. Bhutan brands its tourism as "high-value, low-impact", emphasizing preservation of the environment and culture and targeting high-end tourists. The average daily spending per visitor was estimated at \$330 in 2008, levels exceeded only by a few top tourist destinations like Switzerland and Peru; similarly, only a few countries surpass Bhutan in terms of the average length of stay, which was 7.5 days in 2011 (ADB 2013). Thanks to the authorities' efforts, the sector has been growing rapidly. Total visitor arrivals grew by 35 percent in 2016 to 209,570 visitors, almost twice the 2012 level (TCB 2016).¹⁰⁹ The sector has a large role in promoting inclusive growth. Not only do the tourism and hospitality sectors employ a large number of local people, they also create new demands for food and manufactured products, insofar as tourists consume local products. While the sector's growth has been impressive, three improvements are recommended to enable even more successful development of the sector and fully disseminate its benefits across the country.

First, diversify tourism products to reduce seasonality. Currently, most tourism products narrowly focus on cultural sites and, in particular, colorful festivals, resulting in high seasonality. High seasonality translates into a low hotel occupancy rate during lean seasons and undermines the profitability of the hotels. The peak seasons are March-May and September-November, and the industry needs to come up with new tourism products that attract tourists in other seasons. Products that focus less on festivals – for example health tourism and community-based trekking – can alleviate the seasonality. Additionally, targeting Indian tourists looking to escape the summer heat could help support the demand in off-peak summer months (ADB 2013).

¹⁰⁹ Nearly 65% of visitors in 2016 were from India. For more details on composition of tourists, refer to TCB (2016).

Second, speed up issuance of visas and liberalize the tourism tariff structure to allow price differentiation. Tourist visas are controlled and issued centrally by the Ministry of Foreign Affairs, which can lead to delays in obtaining visas. Furthermore, under the current tariff structure mandated by the government, every tourist pays \$250 per day (or \$200 per day in off-seasons) all-inclusive tariff. Out of the \$250 tariff, \$93.20 is used to pay for overseas tour agent's commission, royalty to the government, and the business tax; the remaining \$156.80 goes to the tour operator for services such as accommodation, transport, guides, and meals. The one price policy limits incentives for tour operators to compete and differentiate their products and services. Partly because of the lack of competition, the hotel prices tend to be high in Bhutan; for example, \$150-\$225 rooms in Bhutan are valued at \$80-\$100 by international standards (ADB 2013). Competition could bring hotel prices down, and incentivize tour operators to develop and offer tours to less-travelled areas.

Last, accelerate skills development and train qualified tourism professionals. For example, the authorities should consider offering training programs for interpreters and tour guides. Nearly 30 percent of firms in hospitality and tourism sectors identified an inadequately educated workforce as a major constraint in the most recent Enterprise Surveys by the World Bank (2015c). In addition to providing training and advisory services, improving the overall education level as discussed earlier can alleviate the shortages of skilled workers in the sector. Skill development is necessary in public agencies involved in tourism, too. ADB (2013) reports inefficient coordination of tourism development policies and marketing.

In addition to making the above three improvements, addressing the infrastructural issues identified in Section 3.2 is critical for further development of the sector. In particular, ensuring connectivity to rural areas is important for bringing the benefits of the sector widely across the country and adjusting the gap in tourism development between urban and rural areas.

In order to make tourism a driver of inclusive development, the authorities must actively link the sector with the agribusiness and manufacturing sectors. In particular, agriculture provides a livelihood for 58 percent of the total population (though it only accounts for 17 percent of GDP), and hence plays an essential role for reducing poverty and inequality.¹¹⁰ Yet, in order for local sourcing to be a viable option for the tourism sector, agricultural productivity must increase beyond the current subsistence level, and the quality of the products needs to improve significantly (as for Mongolia). Section 5.2 will discuss agribusiness sector and gives policy recommendations for improving productivity. The manufacturing sector – food processing and traditional handicrafts in particular – can also benefit from tourism development. For successful food processing sector development, implementing appropriate hygiene and

¹¹⁰ Data for 2015. World Bank, World Development Indicators.

food safety regulations is essential (in addition to improving the agricultural product quality). The traditional handicraft sector is no less important for inclusive growth. The sector provides 5 percent of total employment and in addition engages about 65 percent of the rural population during seasons with little cultivation activities (ADB 2013). Bhutan's traditional textile handicrafts can be nice souvenirs for tourists; the sector also has a potential to sell in the global market if export channels can be established (UNCTAD 2011). To promote expansion of the sector, the authorities should establish intellectual property protection for traditional designs, create a certification system for authentic, quality handicrafts, and pursue international branding of these products.

Summary of Policy Recommendations:

- Tourism Sector Development
 - Diversify tourism products to reduce seasonality; consider introducing products that focus less on festivals, for example health tourism and community-based trekking; also targeting Indian tourists looking to escape the summer heat to support the demand during off-peak summer months.
 - Reform the tourism tariff structure to allow price differentiation.
 - Accelerate skills development and train qualified tourism professionals, for example by offering training programs for interpreters and tour guides.
- Linking tourism development to manufacturing sector growth
 - Implementing appropriate hygiene and food safety regulations for food-processing industry.
 - Establish intellectual property protection for traditional handicrafts, create a certification system, and pursue international branding of the products.

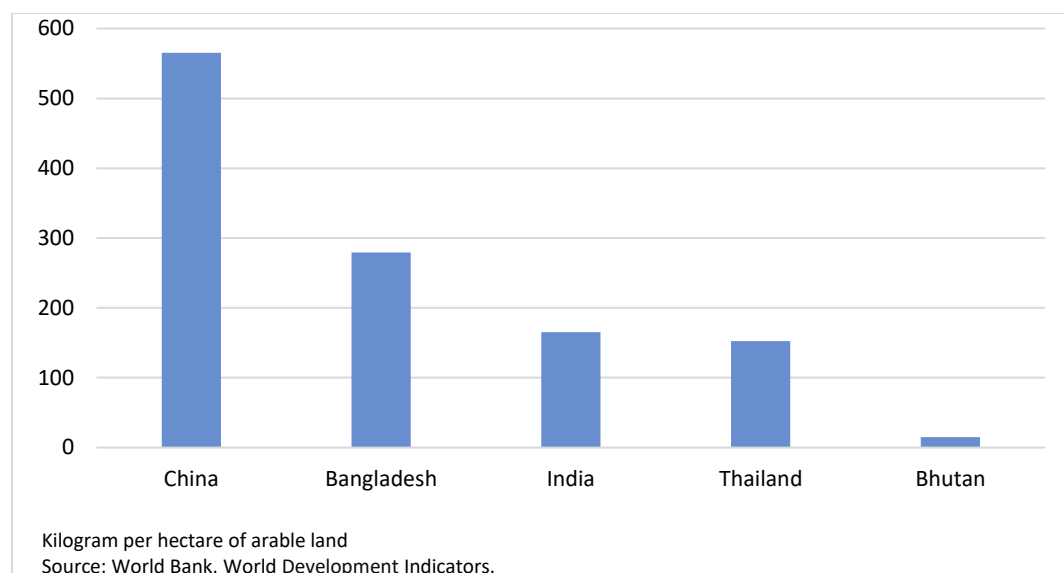
5.2 Agribusiness

Despite severe geographical limitations, Bhutan's agriculture plays a crucial role for poverty reduction and inclusive growth.¹¹¹ As mentioned earlier, even though agriculture accounts for only 17 percent of GDP, it provides a livelihood for 58 percent of the total population. Yet, the overall sector productivity is low, essentially comprised of small households farming for subsistence with little mechanization. The average size of arable landholding is only 1.2 hectare, and about 14 percent of farming landholdings have less than 0.4 hectare; merely 33 percent, 16 percent, and 10 percent of farmers use chemical fertilizer, plant protection chemicals and power tillers, respectively (ADB 2014a). Even

¹¹¹ Forest covers more than 70 percent of Bhutan's land. Only 2.6 percent is cultivated for temporary crops (crops that need to be replanted after each harvest) like rice, and 0.3 percent for permanent crops like fruits and nut. World Bank, World Development Indicators.

among those who use chemical fertilizer, the amount used is very small, as reflected in low fertilizer usage per hectare of arable land (Figure 5.10). Inadequacy of infrastructure such as irrigation and farm roads also contributes to low productivity. Out of 7,500 hectares of arable land cultivated, only 25,000 hectares is currently irrigated (ADB 2014a).

Figure 5.10 Fertilizer Use: Bhutan and Comparators (kilogram per arable acre)



Bhutan's agricultural products mainly consist of two commodity groups. The first commodity group consist of traditional cereal crops - mainly rice and maize but also wheat and barley - , which are Bhutan's food staples. Rice and maize dominate production toward southern subtropical areas. They comprise about 40 percent of Bhutan's agriculture value-added.¹¹² At the same time, Bhutan imports a large part of rice it consumes; in 2013, Bhutan domestically produced 75,229 megatons of paddy, from which it exported 118 megatons of milled rice, whereas it imported 69,885 megatons of rice.¹¹³ The second commodity group consist of fruit and vegetable crops, such as citrus, apples, and potatoes. Along with livestock, these high-value crops are important in higher altitudes where rice production is difficult (FAO 2012; ADB 2013). They are also one of Bhutan's main export products; in 2012, vegetables and fruits accounted for 3.8 percent of export, the largest share among non-mineral, non-electricity exports.¹¹⁴

Many previous studies concluded that Bhutan's comparative advantage lies in high-valued fruit production and comparative disadvantage in cereal production (where Bhutanese producers have to

¹¹² Rice and maize accounted for 24 percent and 17 percent of agricultural value-added in 2015, respectively. Author's calculation based on NSB (2016a).

¹¹³ Note the subtle unit difference; paddy is rice before threshing, so it is slightly heavier than rice. Unlike rice, import of maize is rare. Data based on NSB (2016b).

¹¹⁴ Author's calculation based on UN Comtrade.

compete with cheap Indian imports), claiming that it should shift production from the latter to the former (UNCTAD 2011; FAO 2012). They based their claim on decline of the cereal sub-sector and rapid expansion of the fruit and vegetable subsectors in 2000s. However, recent figures show reverse in the trend (Table 5.2). Over the period 2010-15, on average, the production of paddy rice and maize grew by 3.1 percent and 2.1 percent annually, while that of apple and citrus shrank by 20.6 percent and 3.6 percent annually, respectively; the growth in potatoes sub-sector also stagnated. Staggeringly, the value of gross output of apple sub-sector in 2015 was less than one third of that in 2010.¹¹⁵ There is not enough information to ascertain the cause for the reversal of the trend, and there is a need for further research in this respect.¹¹⁶ Nevertheless, it is likely that Bhutan's comparative advantage still lies in fruit and vegetable production; Bhutan continues to be an exporter of citrus, apples, and potatoes, while an importer of rice and other cereals (NSB 2016b). The authorities should continue to support new private initiatives in the subsectors where Bhutan enjoys a comparative advantage, for example through improving access to farm inputs, providing advisory services about production methods, and attracting FDI. Apart from fruits and cereals, nut and spices subsectors have been growing rapidly recently (see Table 5.2). The subsectors are deemed to have a substantial potential; ADB recently announced an investment project to boost small farmers' production of hazelnuts (ADB 2016).

¹¹⁵ Author's calculation based on NSB (2016a).

¹¹⁶ The fall in gross output for apples and citrus seems to be driven primarily by fall in production rather than fall in price. NSB (2016b) shows that a large fall in production took place in 2012 for apples (by about 60 percent) and in 2013 for mandarins (by about 30 percent). As for prices, over 2010-2014, the price of apple fell by about 25 percent, while that of citrus increased by about 20 percent; nevertheless, one may question how well the data reflect the actual prices in local markets.

Table 5.2 Bhutan's crop sector growth by commodity					
	Annual % Growth (average 2000- 2009)	Annual % Growth (average 2010- 2015)	Contribution to crop GDP growth (%) (2000-2009)	Contribution to crop GDP growth (%) (2010-2015)	Share of crop GDP (2015, %)
Arecanut	-1.6%	41.4%	-1.9%	69.7%	13.7%
Cardamom	4.7%	27.9%	4.0%	22.2%	5.1%
Other Vegetables	0.0%	16.9%	0.0%	20.1%	6.0%
Maize	-3.7%	3.1%	-38.1%	15.2%	17.3%
Paddy	-0.3%	2.1%	-3.3%	14.7%	23.6%
Other Fruits	1.1%	32.1%	0.3%	8.0%	1.7%
Ginger	9.8%	13.6%	2.0%	4.9%	1.7%
Pulses	10.2%	11.1%	5.7%	3.4%	1.4%
Millet	#N/A	-4.8%	#N/A	-0.7%	0.4%
Chili	7.1%	-0.7%	10.4%	-0.8%	3.5%
Mustard	6.3%	-12.8%	2.9%	-1.7%	0.3%
Wheat/Barley	-1.4%	-9.2%	-1.2%	-3.3%	0.9%
Buckwheat	2.3%	-14.1%	3.4%	-3.8%	0.5%
Potatoes	7.2%	-1.6%	38.6%	-5.5%	10.5%
Citrus	9.8%	-3.6%	73.6%	-13.9%	11.4%
Apple	2.3%	-20.6%	3.5%	-28.4%	2.1%
Total	2.2%	3.6%	100.0%	100.0%	100.0%

Data for 2000-09: FAO (2012). Data for 2010-2015: Author's calculation based on NSB (2016a).

Overall, Bhutan should aim at maximizing the productivity of Bhutan's agriculture, both for fruit and nut subsectors and for cereal subsectors. To this end, the authorities must promote modern production techniques and technologies (e.g. use of herbicides and fertilizers) through four measures. First, foster the growth of private input suppliers. Although public agencies currently dominate farm input distribution, their effectiveness in promoting use of modern farm inputs has been limited. Private farm input suppliers are much smaller but more dynamic, and they are evolving rapidly to fill the growing need for more sophisticated farm inputs, which the public agencies fail to provide (FAO 2012). The authorities should

support further expansion of these private suppliers. Second, shift research and development spending to areas where farmers demand the most (such as reducing losses due to wild animals and pests). Third, provide more extension and advisory services. Last, promote formation of private agricultural cooperatives; it can lower cost of purchasing modern technologies through sharing as well as improve access to finance.

In addition to upgrading farming techniques, three actions are needed for boosting agricultural productivity and growth. First, strengthen road infrastructure in order to improve access to finance, farm inputs, and markets (See Section 3.2). Second, improve irrigation infrastructure for rice production. Although Bhutan may not have comparative advantage in the subsector, there is a substantial room for augmenting productivity and increasing income for rice farmers, which constitute a large part of the agricultural population. The priority is the southern region where the climate is more suitable to rice production. Last, facilitate quality and safety upgrading of Bhutan's agricultural products to encourage local sourcing in the tourism sector. Introduction of modern sanitary and phytosanitary regulations may reassure the foreign visitors of the food safety, while it also helps reduce plant and animal diseases.

In parallel, the authorities must promote new export channels for fruit, nut, and high-value vegetable products. If farmers shift their production to these products in absence of adequate export channels, excess supply in the domestic market can drive the prices down. Thus, the authorities should help connect Bhutanese producers with retailers and wholesalers operating in India and Bangladesh by attracting FDI in the agribusiness sector. For example, organizing small producers into private cooperatives can make it easier for retailers to establish reliable supply chains. Improving logistics (in particular customs procedures) is essential for perishable products like fruits, too (See Section 3.3). While the geography poses serious infrastructural constraints, Bhutan's proximity with India and Bangladesh, the two largest markets in South Asia, gives an advantage to the agribusiness sector. Through productivity improvement and commercialization, agriculture can be a driver of export diversification and inclusive growth.

Summary of Policy Recommendations:

- Support private initiatives in subsectors where Bhutan enjoys a comparative advantage.
- Promote modern production techniques and technologies (e.g. use of herbicides and fertilizers)
 - Foster the growth of private input suppliers.
 - Shift research and development spending to areas where farmers demand the most (such as reducing losses due to wild animals and pests).
 - Expand extension and advisory services.

- Promote formation of private agricultural cooperatives.
- Strengthen road and irrigation infrastructure.
- Encourage local sourcing in tourism sector through upgrading quality and ensuring safety.
 - Introduce modern sanitary and phytosanitary regulations.
- Promote creation of new export channels for fruit, nut, and high-value vegetable products
 - Connect Bhutanese producers with retailers and wholesalers operating in India and Bangladesh.
 - Attract FDI into agribusiness sector, in particular food retailing.
 - Organize small producers into private cooperatives.
 - Improve logistics, in particular customs procedures.
 -

5.3 Information and Communication Technology (ICT)

Information and Communication Technology (ICT) is an emerging sector in Bhutan. Although the ICT sector is still nascent, a number of comparative advantages - including a disciplined English-speaking workforce, a relatively developed telecommunication network in Thimphu, cheap electricity, and proximity to India, a major offshoring destination for Information Technology Enabled Services (ITES) – give Bhutan’s ICT sector potential as a new growth driver (World Bank 2010a). ICT is a relatively clean industry, and thus it suits Bhutan’s pursuit of environmentally friendly development. Furthermore, the ICT sector can create new jobs and thus absorb the increasing number of educated youth (ADB 2013).

The government has been actively leading the development of export-oriented Information Technology (IT) services and ITES, including Business Process Outsourcing (BPO) with World Bank assistance. In 2011, the authorities launched an IT Park – the Thimphu Tech Park – to attract FDI and enhance technology transfer as well as to foster local entrepreneurs. In order to maintain the rapid pace of ICT development, the authorities should pursue (or continue to pursue) four actions. First, continue to facilitate FDI and technological transfer by improving the legal and regulatory framework for business as described in section 2. Second, continue development of the IT Park utilizing public-private partnerships (PPPs). Third, continue to improve telecommunications infrastructure and connectivity, especially for the IT Park (for example by establishing back-up fiber connectivity and power supplies to guarantee reliability). Last, support human capital and skill development in ICT, for example by creating ICT courses and programs that well-reflect private sector needs, possibly in partnership with private training companies and educational institutions (World Bank 2010a; ADB 2013).

In parallel, the authorities should promote improvement of domestic ICT infrastructure and services – for example cellular phone connectivity and mobile money servicing - in order to support inclusive growth. Utilization of ICT services helps Bhutan overcome its geographical limitations, for example by improving access to finance and knowledge in rural areas and by assisting transport and logistics services. In addition, utilizing IT services in the public sector – for example e-licensing and customs automation – can reduce the regulatory burden on businesses.

Summary of Policy Recommendations:

- Continue to facilitate FDI and technological transfer by improving the legal and regulatory framework and business.
- Keep investing in the IT Park.
- Continue to improve telecommunications infrastructure and connectivity, especially at and to the IT Park, for example by establishing back-up fiber connectivity and power supplies to guarantee reliability.
- Support human capital and skill development in ICT, for example by creating ICT courses and programs that meet private sector needs, possibly in partnership with private training companies and educational institutions.
- Continue to promote improvement of domestic ICT infrastructure and services, such as mobile money servicing.
- Utilize IT services in the public sector, for example as e-licensing and customs automation.

6. Conclusion

While hydropower will almost certainly continue to drive the GDP growth, Bhutan needs to foster other development drivers in order to diversify the economy and achieve inclusive growth. Hydropower is capital-intensive and it creates limited jobs beyond construction work (which most Bhutanese people are unwilling to do). The public sector, where many urban youths are interested in working, cannot absorb the increasing number of graduates without risking macroeconomic stability. In this context, this chapter has identified tourism and ICT services as Bhutan's most promising new potential development drivers. Endowed with beautiful nature and a rich cultural heritage, Bhutan has an immense potential in tourism, whose development can create jobs and increase income for both urban and rural people, including those employed in agriculture and manufacturing sectors. The ICT industry can take advantages of Bhutan's cheap electricity, competitive unit labor costs, and strong institutions, pursuing rapid growth through FDI and PPPs.

In order to accomplish successful private sector-led development, however, Bhutan needs to improve both macroeconomic management and the business environment. Regarding macroeconomic policies, Bhutan must implement a fiscal mechanism to shield the economy from volatility of hydropower-related expenditure, such as a new fiscal rule. The rule should require the government to save some of the future increase in hydropower revenues in order to prevent overspending; the current fiscal rule that only focuses on budget balance will soon become insufficient for containing excessive fiscal spending as hydropower revenue continues to expand. Loose fiscal policy undermines Bhutan's competitiveness as it threatens macroeconomic stability and risks real exchange rate appreciation. To create a more business-friendly environment, the authorities must address skill and motivation mismatches in the labor market to alleviate shortages of skilled labor. In parallel, Bhutan needs to continue to make improvements in a number of public services, particularly transport infrastructure, customs, logistics, access to finance, and regulatory quality. Facilitating greater use of ICT will be important for overcoming geography- and human capacity-related constraints in many of the above areas.

Spurring private sector-led growth is essential for the pursuit of Gross National Happiness (GNH). While benefits from hydropower are immense, it alone cannot bring happiness to the entire population; jobs must be created and incomes must rise for the living standard of people to increase. Tourism and ICT are key growth drivers that can help Bhutan boost job creation and income generation hand in hand with environmental and cultural preservation. As tourism and ICT expand and the share of private sector in GDP, trade, and foreign investment increases, Bhutan's macroeconomic environment will become less susceptible to volatility of hydropower-related investment, too. Nevertheless, it should be noted that development of tourism and ICT sectors does not necessarily guarantee inclusive growth; if managed poorly, they can exacerbate imbalances between urban and rural areas. The authorities must actively link the development of these sectors to others, particularly agriculture and manufacturing, while ensuring that the benefits are spread widely across the country, including rural areas. In short, the government's primary role in development would be to 1) lead and support private sector growth, and 2) make sure that development is inclusive. Overall, given the immense hydropower potential, rich nature and cultural heritage, and strong institutions, Bhutan's prospects of achieving greater national happiness are bright despite significant geographical constraints and macroeconomic challenges of hydropower management.

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