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**COUNTRY STRATEGY PAPER**

**BHUTAN AND THE EUROPEAN COMMUNITY**

**CO-OPERATION STRATEGY**

**2002-2006**

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## List of Abbreviations used in CSP and NIP Bhutan

ADB	Asian Development Bank
ALA	Asia and Latin America Committee
DAC	Development Aid Country
DoT	Department of Trade
DYT	Dzongkhag Yargye Tshogchung
EC	European Community
FTA	Free Trade Agreement
FYP	Five Years Plan
GDP	Gross Domestic Product
GYT	Gewog Yargye Tshogchung
HRD	Human Resource Development
IBRD	International Bank for Reconstruction and Development
IMF	International Monetary Fund
IPCM	Integrated Pest and Crop Management
IPM	Integrated Pest Management
LDC	Least Developed Country
MoA	Ministry of Agriculture
MoH	Ministry of Health and Education
NGO	Non-Governmental Organisation
NIP	National Indicative Programme
PIT	Personal Income Tax
PRSP	Poverty Reduction Strategy Paper
RGOB	Royal Government of Bhutan
RNR	Renewable Natural Resources
SAARC	South Asian Association for Regional Co-operation
SNV	Stichting Nederlandse Vrijwilligers Foundation of Dutch Volunteers
TBT/SPS	Tariff Trade Barriers/ Sanitary Phytosanitary
TRIPS	Trade-Related International Property Rights
UN	United Nations Organisation
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNHCR	United Nations High Commissioner for Refugees
UNICEF	United Nations Children's Fund
WB	World Bank
WFP	World Food Programme
WTO	World Trade Organisation

## EXECUTIVE SUMMARY

The Buddhist kingdom of Bhutan is nestled in the remote and mountainous eastern Himalayas, bordering China and India. Its population has been recently estimated at around 658 000 (2000), the majority living in the valleys, at an altitude of 1 000 to 3 000m. Close to 79% of the population live in rural areas.

Bhutan has embarked upon a balanced process of modernisation, while firmly preserving its environment as well as its age-old cultural and traditional values which form the basis of its national identity. Moreover, though Bhutan is still classified as a Least Developed Country (**LDC**), only very few Bhutanese suffer from the extreme poverty and destitution found in some larger South Asian countries and income distribution is relatively even. Nevertheless, the extreme isolation of many villages makes the provision of goods and basic social services difficult and costly.

The Bhutanese economy remains **subsistence**-oriented and centred around agriculture. Although the country is well-endowed with natural resources (hydropower, dense forests and mineral deposits such as limestone and dolomite), utilisation of these resources is hampered by the extreme geography and climate. While Bhutan has a history of relative isolation from the outside world, present constraints on export development, excessive dependence on India as the main trading partner and the relative vulnerability of Bhutanese economy to the steadily increasing inflows of foreign goods have underlined the need to deepen Bhutan's integration into the system of international commercial relations.

The development process in Bhutan was initiated in 1961 and has so far successfully completed four decades of planned development. The **8th Five Year Plan (FYP)** priorities (1997-2002) were characterised by hydropower development and industrialisation, institutional and human resource development, integrated rural development and improvement of social services. These objectives have guided donors' assistance to the country, which amounted to 23% of GDP in FY 98/99. The **9th FYP (2002-2007)** puts emphasis on infrastructure development and improvement in the quality of social services.

EC assistance to Bhutan started in 1982 and has amounted to about 46 million ECU between 1982-2002, of which 33 million ECU in 1991-97. The EC has gradually expanded its co-operation scope, which now includes renewable natural resources (incl. medicinal plants), rural development, health, environment and export diversification.

The EC strategy is in line with Bhutan's approach to development, as set out in various planning policy documents, most notably the **9th Five Year Plan (2002-2007)** and '**Bhutan 2020: A Vision for Peace, Prosperity and Happiness**' (May 1999). The overall objective is **poverty reduction** through the promotion of sustainable growth with special attention given to the environment. Given the country's situation, the vast majority of the funds will be allocated for Development Co-operation through the annual budget for Technical and Financial Co-operation in favour of ALA countries. The overall estimated allocation of EC aid to Bhutan in the next five years amounts to **€15 million**.

Given Bhutan's predominant **agricultural** vocation, the EC has chosen to focus its activities on:

- raising **productivity in agriculture** by introducing more efficient technologies and methods;
- improving **rural incomes** through increasing added value in agricultural outputs;

- improving the institutional **capacity** to manage sustainable development.

**Renewable Natural Resources** (incl. livestock, agricultural production and extension and Integrated Pest Management) and Health (esp. production of medicinal plants) will be the most important sectors covered by this strategy. Other areas of co-operation include trade and export diversification in order to support Bhutan in its efforts to enhance its trade and investment environment and help it participate effectively in the multilateral trading system and the global economy. Moreover, the EC will support Bhutan's effort towards Capacity Building (HRD, Decentralisation and Administrative Reforms) in all its co-operation activities. In addition, the EC will be prepared to help settlement or resettlement operations of the more than 100 000 Bhutanese refugees currently living in UNHCR camps in Nepal once a final agreement between Bhutan and Nepal is reached, and upon express request.

The main concern of the EC strategy will be to preserve the often precarious ecological balance, not only because of Bhutan's unique environment, but also to secure long-term economic sustainability of activities initiated. Hence, particular emphasis will be placed on government/community ownership and full participation of the end beneficiaries.

## 1. EC CO-OPERATION OBJECTIVES

The EC's strategic goal is to assist Bhutan in reducing poverty, whenever possible in partnership with Member States and other external development agencies. Despite recent impressive advances, poverty remains widespread in Bhutan, mainly due to the physical characteristics of the country. In pursuing the goal of **poverty reduction** the EC will assist the promotion of sustainable growth with appropriate attention to **environmental** issues.

The general objectives of the EC Country Strategy are thus fully consistent with the EU Treaty (Article 177), which sets out three broad objectives for Community development co-operation: promotion of sustainable development; campaign against poverty; and the smooth integration of developing countries into the world economy.

The communication on EC Development Policy<sup>1</sup> has provided the general framework for a co-ordinated effort with other donors (World Bank) and Member States (complementarity) designed to promote sustainable development, focusing on social and human aspects as well as on sound management of natural resources and the environment. Equally important in this context are the objectives set in the **Action Programme for Development** of Bhutan (2001-2010) at the third **LDC Conference** (May 2001) emphasising agricultural self-sufficiency, human development (social services), expansion of hydro-power generation and enhancement of revenue growth.

Moreover, the main sectoral objective of EC Co-operation takes stock of the conclusions of the **7th Round Table Meeting** (Thimphu, 7-9 November 2000), which underlined the importance of agricultural production as being intimately linked to national **food security** and national security for a landlocked country like Bhutan.

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<sup>1</sup> COM (2000) 212 Final

The EC strategy is in line with Bhutan's approach to development, as set out in various planning policy documents, most notably the **9th Five Year Plan (2002-2007)** and '**Bhutan 2020: A Vision for Peace, Prosperity and Happiness**' (May 1999). The latter remains the central unifying concept and aims to maximise **Gross National Happiness** and is the underlying rationale for any future development initiative.

The EC fully supports the concepts embodied in the development of Poverty Reduction Strategy Papers (PRSP). The EC guidelines for Country Strategy Papers have consequently placed PRSPs, and poverty indicators defined by these, at the centre of country strategies. The EC can confirm that the 9th FYP, with extremely strong national ownership and participation, sets out development objectives very much compatible with those defined by the PRSP framework.

The overarching objective of the EC's co-operation with Bhutan is **poverty alleviation**. The adopted strategy is to fully support the government's efforts in promoting sustainable economic growth. As there are clear indications that poverty in Bhutan is directly correlated with remoteness/lack of access, both the EC and the 9th FYP give particular emphasis to supporting rural development via sustainable exploitation of renewable natural resources.

## **2. BHUTAN'S POLICY AGENDA**

The overall priority of the Royal Government of Bhutan is to ensure the **independence**, sovereignty and security of the **nation state**. While most nation-states would subscribe to such an objective, in the case of Bhutan this may be more relevant, given its geo-political situation, small size and the recent history of the region.

Bhutan's development philosophy has been constantly marked by a fair balance between "the need to have and the need to be", between preserving its rich cultural heritage and natural environment and pressing forward with economic development. The central development concept is maximising '**Gross National Happiness**', i.e. broadening the development focus beyond mere economic indicators in order to include less tangible concepts such as people's 'cultural', 'spiritual' and 'emotional' needs. The perspective of 'Bhutan 2020' can be defined as an attempt to translate this concept into **five development objectives** for the next two decades. These objectives are:

**Human Development**, in order to achieve sustainable improvements in the standard of living and expanding opportunities and choices. Central to achieving this objective is reducing population growth and expanding access to basic education and health.

**Balanced and Equitable Development**, to ensure that the benefits of economic growth are widely and equitably shared among different groups and regions. Particular emphasis is accorded to controlled urbanisation through better basic infrastructure and livelihood opportunities for local communities in rural areas, with special attention given to the most vulnerable and disadvantaged groups.

**Culture and Heritage**, in order to emphasise that Bhutan has both a diversified and at the same time unique cultural heritage, which must be protected while accepting that culture

is a dynamic concept, constantly changing and therefore constantly challenged by external dynamics.

**Governance**, with a view to strengthening the process of decentralisation and developing the human resources needed for managing an increasingly complex development process. The government also seeks to increase accountability and transparency with the involvement and active participation of a broad spectrum of the population in decision-making.

**Environmentally Sustainable Development**, to ensure that Bhutan develops in a way that preserves its unique environment.

While 'Bhutan 2020' contains a long-term vision, short to medium term planning is outlined in Five Year Plans. The **8th FYP** emphasised balanced economic growth consistent with self-reliance, sustainability and the preservation of culture, traditions and the environment. The **9th FYP** will build on these objectives with particular focus on infrastructure development and improvement in the quality of social services. The overall Bhutanese strategy will be pursued by the following measures:

- (i) sound fiscal and monetary management;
- (ii) decentralisation and public participation;
- (iii) enhancing the role of the private sector through disinvestment of State assets and provision of an enabling business environment;
- (iv) promotion of sustainable development.

Various **sectoral policies** will be adopted to address such issues:

#### **a. Renewable Natural Resources (RNR)**

The **RNR** sector will continue to play a key role in the predominantly **agrarian** economy of Bhutan. The government is promoting measures aiming to:

- (i) ensure access to food for the entire population;
- (ii) protect the fragile environment of the country by focusing on sustainable exploitation of natural resources;
- (iii) create the conditions conducive to economic and sustainable production;
- (iv) counteract the tendency of rural versus urban migration.

#### **b. Social Sectors**

In the social sector, despite a number of impressive achievements, there is still a need to develop the human resources base in order to improve the quality of life.

In the field of **health**, good results have been achieved during the last decade which has seen an expansion of free basic health care services, particularly in rural areas. Emphasis is now placed on improving the institutional framework and community participation, while population planning will constitute a constant concern.

In **education**, special attention is given to the qualitative improvement of the school-system and opportunities for non-formal and technical training.

In terms of **culture**, the preservation of Bhutanese culture will be pursued through improved infrastructure and functioning in monasteries (which cover broader community

functions than just religion) , while simultaneously recognising that cultural diversity is an essential value of Bhutan's traditions.

#### **c. Infrastructure**

In the power sector, there is an immense potential for **hydropower** development where India is already heavily involved as funding agent, constructor and client. The government intends to expand **electricity** supply to rural areas, while providing policy guidelines for environmentally clean power generation.

#### **d. Trade and Industry**

In the Trade and Industry sector, the government places emphasis on **diversification** of trade (product and area-wise), on limitation of the public sector role and on provisions for an enabling environment for the private sector. Other concerns are development of industrial estates, encouragement in the creation of cottage and small enterprises and the promotion of tourism on a moderate and sustainable scale.

#### **e. Human Resource Development (HRD)**

This sector will continue to receive priority. Institutional capacity needs to be strengthened and the manpower planning process will be reinforced both in the public and in the private sector. This will include vocational training, with special emphasis on strengthening human resources in relation to the decentralisation process.

#### **f. General Public Services**

In this sector, which plays an essential role in bringing support and coherence to development programmes and projects, the government will focus on HRD in the various institutions as well as on formulating and enforcing rules and procedures.

### **3. COUNTRY ANALYSIS**

#### **3.1 Political Situation**

##### **3.1.1. Internal Situation**

Bhutan is a **hereditary monarchy** ruled by King Jigme Singye Wangchuck with the assistance of a Government and a National Assembly. Recent changes in 1998 have strengthened the role of the elected forums and further devolution has empowered the lower level administrative units (the **dzongkhags** and **geogs**). The National Assembly is now able to move a vote of confidence in the King.

The **National Assembly** has 150 members (105 representatives of the people, 10 elected by the Monks and 35 representatives of the Government) nominated by the King.

The **Royal Advisory Council** (9 Councillors) advises the King and the Ministers. The **Cabinet** consists of the 9 Councillors and 6 ministers elected by the National Assembly. The Council of Ministers handles day-to-day management and exercises governing functions. The **chairmanship** of the council **rotates** annually. The chairman is the head of government.

Since **1950** great strides have been made towards social and political modernisation (health, sanitation, education and communications), development and democratisation. For the time being, there are no political parties nor trade-unions and only a small number of national NGOs. Overall the role of civil society is relatively limited.

The decentralisation process resulted in the introduction of Dzongkhag Yargye Tshogchung (DYT) and Gewog Yargye Tshogchung (GYT), sub-national institutions meant to engage local people in political, social and economic decision-making in 1981 and 1991 respectively. Recent political initiatives incorporated in the 9th FYP should establish an even more decentralised political/administrational structure, with central authorities being mainly managers and co-ordinators of the development process while district and sub-district bodies will assume development planning and implementation powers. This decentralisation policy brought about these remarkable results: the devolution of administrative and financial powers and human resources from the capital to the Dzongkhag administration; the increased capacity of GYT and DYT to make collective decisions regarding their development plans and implementation; and the autonomy of GYT and DYT to make regulations and legislation applicable within their jurisdictions

Closely related to the **decentralisation** process is the issue of enhancing **good governance**. In some respects Bhutan is starting from a good basis, with a relatively smooth-functioning administration and very little corruption in the public sector, while the government is pursuing its programme of improving key institutions. Several ministries are expected to be split into their own specific functions and responsibilities. The government's objective of increasing **transparency** and accountability will be further enhanced by strengthening the judiciary system. An important element is the creation of the **Office of Legal Affairs** as an autonomous agency responsible for prosecution and legal services. This Office may eventually evolve into a fully fledged Ministry of Law and set up a **Human Rights Unit** in charge of promotion of human rights as well as interaction with external agencies.<sup>1</sup>

All in all, these major reforms in the areas of good governance and decentralisation have dominated the domestic political agenda recently while several donors, including Member States, are assisting the government in its efforts to democratise its institutions.

### **3.1.2. External Situation**

Bhutan has diplomatic relations with eighteen countries and with the European Union. She is a member of several major international and regional organisations such as the United Nations and its specialised agencies, the South Asian Association for Regional Co-operation, IBRD, IMF, Asian Development Bank and SAARC. Bhutan has six diplomatic missions abroad located in New Delhi, New York, Geneva, Bangkok, Dhaka and Kuwait. Bhutan maintains close and friendly relations with India, its single largest trading and development partner. Bhutan does not have diplomatic relations with China although relations are friendly and official level visits are exchanged on an annual basis to demar-

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<sup>1</sup> The government has also indicated its willingness to address human right issues by ratifying the UN Convention on the Rights of the Child in 1990 and by inviting the International Committee of the Red Cross to visit the country periodically. Moreover, in the mid-nineties the government co-operated with the UN Working Group on Arbitrary Detention (WGAD), whose initiatives have been welcomed by several independent human rights organisations (e.g. Amnesty International).

cate their border. Bhutan is party to the international agreements on Biodiversity, Climate Change, Nuclear Non-Proliferation, Rights of the Child, and the Elimination of Discrimination Against Women.. Relations with Nepal are dominated by the **refugee** issue. In 1988 Bhutan decided to conduct a population **census**, partly in order to identify illegal immigrants in south Bhutan. Most of the inhabitants in south Bhutan are of Nepalese origin. These people had for a long time been under demographic pressure in Nepal, West Bengal and Assam, and were thus attracted to Bhutan by its rich and available lands in the South. Many ethnic Nepalese were classified – according to Bhutanese law - as **illegal immigrants**. Subsequently some of them feared that the census would result in large-scale eviction even of the families who had been residing in Bhutan for generations. Matters came to a head in 1990-92 when unrest, and often violent confrontations, led to an **exodus** of a considerable number of ethnic Nepalese into seven UNHCR camps in eastern Nepal.

By now, the population of these camps has increased, mainly by natural growth, to over **100 000** people, though some of them may not come from Bhutan. Ongoing negotiations between the two Governments since July 1993 have allowed (March 2001) the beginning of the **verification process**. The international community and the EU in particular have so far covered the cost of the refugee camps' care and maintenance. The Bhutanese and Nepalese Government are expected to speed up the process to reach a viable conclusion. Donors (EU included) have repeatedly expressed their willingness to assist in the implementation of a satisfactory solution for both sides. However, in 2002 no progress has been made in solving the refugee issue.

Most recently, Southern and Eastern Bhutan have seen frequent incursions and even bases set up by insurgents opposing the Indian government in Assam. The Bhutanese government is, however, pursuing all possible means to remove the rebels from their territory and remains vigilant to any increase in terrorist attacks. National security is a highly sensitive issue that is closely monitored with great concern by Bhutanese authorities.

## **3.2 Economic and Social Situation**

### **3.2.1 Structural Performance**

Although Bhutan is well-endowed with natural resources (hydropower, dense forests and mineral deposits such as limestone and dolomite), utilisation of these resources is hampered by the extreme geography and climate.

The Bhutanese economy is still **subsistence**-oriented and centred around agriculture: which provides livelihood for about 85% of the population. Bhutan is still an **LDC** with an estimated per capita GNP of USD 590 (1999).

In conformity with the **UNDP Human Development Index** (year 2000), Bhutan is ranked 142nd out of 174 countries. Bhutan has improved its ranking in recent years and looks set to further improve its standing in the near future.

The country has made significant strides in its development in the last decade: economic growth averaged 6.5% in the period 1990-2000, led by electric power and the manufacturing industry. The rapid growth of the energy sector has lessened the relative pre-eminence of agriculture and forestry on the overall GDP, although the latter still account

for the main source of income for most Bhutanese. At the same time, Bhutan is continuing its policy of diversifying its revenue sources and focusing on the development of the agro-industry.

### ***Trade***

The main **imports** are petroleum products, vehicles, spare parts, electrical equipment, construction materials whereas the main **exports** are electricity, wood products (except raw timber), agricultural and horticultural commodities, cement and calcium carbide.

In 2000 the current account deficit stood at USD 127 million and was almost entirely covered by foreign grants. Despite the possibility of narrowing the deficit through an increase in electricity exports to India, the deficit will remain at the same level due to capital imports for power projects.

Bhutan has a history of relative isolation from the outside world, but because of present constraints on export development, its excessive dependence on India as the main trading partner and the relative vulnerability of its economy to steadily increasing inflows of foreign goods, there is a political will to deepen the country's integration into the system of international commercial relations.

In order to facilitate its integration into the global economy, Bhutan has submitted an application for full membership of the WTO and has requested EC support on this matter.

### ***Fiscal and monetary policies***

Much of the Government's capital budget is and will continue to be financed by **foreign assistance** (more often as grants), while the recurrent budget (9th FYP yearly average) of approximately USD 120 million will be almost 100% self-financed. Developing revenue to cover recurrent costs is clearly an important issue to be faced by the Government during the 9th FYP.

The **fixed parity** of the Bhutanese currency to the Indian rupee gives little scope for an independent monetary policy in Bhutan. The main objectives of Bhutanese monetary policy remain:

- (i) secure facilitation of private sector development via an adequately functioning finance and credit market;
- (ii) exercise of anti-inflationary policy.

At present, interest rates in Bhutan, which were liberalised in 1997, are close to those in India. **Inflation**, which is broadly determined by India's price changes, is likely to evolve around Indian levels, estimated in the range of **4-6%** in 2002.

Despite the favourable position concerning foreign exchange reserves (USD 293 million) and external debt (40% of GDP), the Bhutanese authorities are pursuing a rather **conservative** fiscal policy. This is partly because an expansive investment strategy would strain the country's limited human resources and increase its reliance on foreign inputs and resources.

### ***Private sector development***

Since the last FYP the Government has made great effort to implement policies to promote the private sector and privatise State-owned enterprises. Meanwhile, private sector growth has increasingly covered import and marketing functions, while the level of sub-

sidies is decreasing. Privatisation has also proved to be a rather complex issue requiring careful planning. This is mainly due to the limited market size. Environmental concerns in particular need to be addressed as privatisation of imports and marketing may lead to unsustainable and inappropriate practices (e.g. pesticides).

### 3.2.2 Social Development

In the absence of systematic household or income surveys it is difficult to provide a detailed assessment of poverty and social conditions in Bhutan. Nevertheless, extreme poverty is relatively rare and few suffer from hunger or homelessness. Due to land reforms in the early 1970s, income distribution is thought to be relatively even. Subsistence agriculture is still widespread while rural incomes and agricultural productivity remain low.

The **social indicators** available (see Annex 1) have improved steadily since the 1960s. **Life expectancy** has risen from 37 years in 1960 to 66 years in 1997, while over the same period the population with access to safe water has risen from 31% to 63% (1999). The gross **primary school enrolment** rate was estimated to be 72% in 1999, while the number of primary schools has increased from 11 in 1959 to 243 primary and community schools in 1999. The **adult literacy** rate is estimated to have risen from 23% in 1980 to 54% in 1994. Access to **basic health** has also improved considerably – whereas in 1961 Bhutan had only 4 hospitals and 11 dispensaries, by 1998 the health system consisted of 28 hospitals and 145 basic health units. However, the rural population still has only limited access to secondary social services and some extremely remote areas still lack basic facilities. Another factor that raises concern is the high **population growth** rate of 2.5%. Considering that 79% of the Bhutanese population live in rural areas, the present rate will have a considerable impact on social sector expenditure.

### 3.2.3 Gender

As regards gender issues, Bhutan is a comparatively balanced society. Women benefit from property rights and female ownership of agricultural land is relatively widespread. Girls' infant mortality rates are lower than boys' and female life expectancy is higher than male. Nevertheless, women are still underrepresented in government institutions and boys still tend to dominate in higher education. With the assistance of several donors, the government is taking action to improve the situation of women. Given the comparatively favourable position of women in Bhutan, the EC has not made gender issues a general objective per se, but it looks carefully at this matter within the context of each individual co-operation initiative.

## 3.3 Sustainability of Current Policies

The expansion of low environmental-impact **hydropower** schemes is contributing substantially to the government's revenues. At present, Bhutan is able to fund all recurrent expenditures from domestic resources including expenditures generated by development initiatives. Combined with a considerable inflow of overseas assistance, Bhutan is well positioned to achieve sustainable poverty reduction. However, additional efforts have to be made to co-ordinate external support in order to keep on track in terms of governance and management capacity.

### 3.3.1 Environment

Bhutan has given special attention to the protection of the environment because of its unique flora, fauna and general bio-diversity. The Bhutanese authorities have been very consistent in preserving the country's environment making it one of the top policy priorities. Several donors, including Member States, have contributed more than USD 20 million (1998) to the Bhutan Trust Fund for conservation activities. All major development initiatives are thoroughly assessed in relation to their environmental impact. Bhutan's restrictive **tourism** policy is also an expression of the government's concern for the environment, although cultural preservation may also play a part. The main threats to the environment could be rapid population growth, uncontrolled industrialisation and unsustainable cultivation methods in agriculture. The EC and member states are actively assisting the government in its ambitious plan to protect the environment.

### 3.4 Challenges in the Medium Term

As outlined above, the outlook for Bhutan is generally favourable and should remain so in the foreseeable future, given its small and efficient government and the projected increase in hydropower revenues. However, Bhutan could also face a number of challenges which need to be systematically addressed.

A significant **political** challenge is how to keep the necessary balance between the present philosophy of the Bhutanese political system and the achievement of economic growth, while avoiding any negative impact on the national culture and values as well as on the environment.

A major **economic** challenge for Bhutan stems from the fact of its being a least developed economy with special structural constraints and vulnerabilities. Bhutan needs to shift towards developing a more monetised and globally integrated economy. Due to the direct linkage of the Bhutanese currency to the Indian rupee and large inflows of foreign aid and hydropower revenue, wages of unskilled workers have been pushed up, making exports (except from hydropower) less competitive and hampering efforts to diversify the economy. Bhutan is heavily dependent on one main trading partner which may not be desirable in the long term. However, political and geographical factors tend to favour trade with India and no major shift is envisaged in the short term, though trade with and via Bangladesh is increasing. Finally, the government's revenue base is still too narrow, relying mainly on energy exports. From 1 January 2002 a Personal Income Tax (PIT) was introduced in the country, but in the long term Bhutan will need to broaden the revenue base still further.

As regards **development** issues, Bhutan constantly faces the challenge of being a landlocked country with a mountainous topography and scattered settlements which imply high costs for social services and development of infrastructure. This has added pressure to the national budget, diverting resources from direct investment in production.

Bhutan will need to continue its drive towards improved productivity while promoting the production of higher value products and seeking to expand in profitable market outlets.

## 4. OVERVIEW OF PAST AND ONGOING CO-OPERATION

### 4.1 Overview

The EC's role in the past has been to respond as far as possible to the needs and priorities of the Bhutanese government, as contained in the various FYPs. Bhutan has made significant strides in its development efforts over the last two decades, and the EC and the Member States have contributed to this by way of close and effective co-operation, which has been regarded as highly satisfactory by all partners.

There are two main forums where EC-Bhutan co-operation is discussed:

- the “**Annual Talks**”, which are held regularly (although not necessarily every year);
- periodic meetings at ministerial and/or services level.

The conclusions of project assessments and several independent evaluations have generally confirmed the **high quality** of EC-Bhutan co-operation. At the same time, it has been stressed that future attention should focus in particular on ongoing changes in the political and economic environment, not least the decentralisation process and efforts to promote the private sector.

### 4.2 Lessons learnt from Past and Ongoing Co-operation

EC Development Co-operation assistance to Bhutan dates back to 1982. Between 1982 and 2002 Bhutan received a total of approximately ECU 46 million in grant aid, while the corresponding figure for the 1991-1997 period was about ECU 33 million, thus indicating a substantial increase in yearly disbursements. In mid 2002 the Medical Plant “Phase II” Project was approved.<sup>1</sup>

EC efforts have focused on the following areas:

- **renewable natural resources** (livestock production, agricultural production and extension);
- **health** (traditional medicine system);
- **trade and export** diversification.

**Environmental** issues have been a major concern and have been taken fully into account in all EC-funded activities. In particular, several of the EC's development initiatives include specific environmentally sustainable objectives (e.g. the programme for the preservation of traditional Medicinal Plants, the Renewable Natural Resources extension support programme and the Wang Watershed Management Project).

**Forest management** is another focus area where the aim is to support sustainable natural resources management and conservation. The EC is actively involved in developing the government's ongoing community forest management approach and in assisting one Community Forestry Management Area in four districts in western Bhutan. Both alpine

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<sup>1</sup> This project, for a total amount of EUR 4;2 million, is an integral part of the present strategy paper.

pasture and lowland pasture on community land will be improved. Various activities in this area are included in the ongoing Wang Watershed Management Programme.

In **Civil Aviation** Bhutan also benefits from the 'EU-Asian Civil Aviation Co-operation Project', which sets out to improve practices including airworthiness, safety standards and, air traffic management.

Past EC-funded development activities have been closely and directly integrated with the RGOB's goals of reducing poverty while increasing self-reliance in food production.

This has been acknowledged for the main sectors of support, such as Agricultural/Livestock Services (extension). Participatory methods have gradually been introduced by the Ministry of Agriculture and adopted by all geogs (smallest administrative units in Bhutan) for planning new initiatives.

Extension services have been improved, strengthening their links with research and introducing new production methods and new varieties. The main stakeholders have the opportunity for the first time to learn important lessons even if results were strongly influenced by geographical remoteness and accessibility of targeted areas.

Integrated Pest Management Development (IPMD) funded activities saw the involvement of growing numbers of farmers in both areas of "problem identification/assessment" and research. Field demonstration and observation (directly linked to research) were the basis of new extension messages. Systematic impact monitoring of results so far generated by IPMD packages is still required and their replication needs to be carried out on larger geographical scale and in areas with similar characteristics.

Sectoral strategy to improve livestock production was pursued mainly for the purposes of loss reduction through Rinderpest Eradication, strengthening of veterinary services and institutional development.

EC-funded activities have reached satisfactory results in terms of both the legislative/sectoral policy framework (Livestock Master Plan) and efficient resource management performance by the beneficiaries. Areas still warranting a good deal of attention in the future are improvement of pasture coverage, expansion of backyard farming privatisation of government farms and establishing credit schemes for breeder Associations.

Finally, the consolidated experience in the health (medicinal plant) sector indicates that the main focus of future EC involvement is threefold: full utilisation of the Production Unit, adequate coverage of fixed costs (borne by the Administration) and promotion of cultivation of high value plants to improve farmer incomes and preserve bio-diversity.

### **4.3 EU Member States' & other Donors' Programmes**

In general, the EC's view is that **donor co-ordination** is primarily the responsibility of the Government. The EC's experience with Bhutan confirms that the government has comparatively strong capacity to assume such a role. Besides participating in Round Table Meetings, the EC is closely **co-ordinating** its activities and programmes with other donors, in particular the Member States.

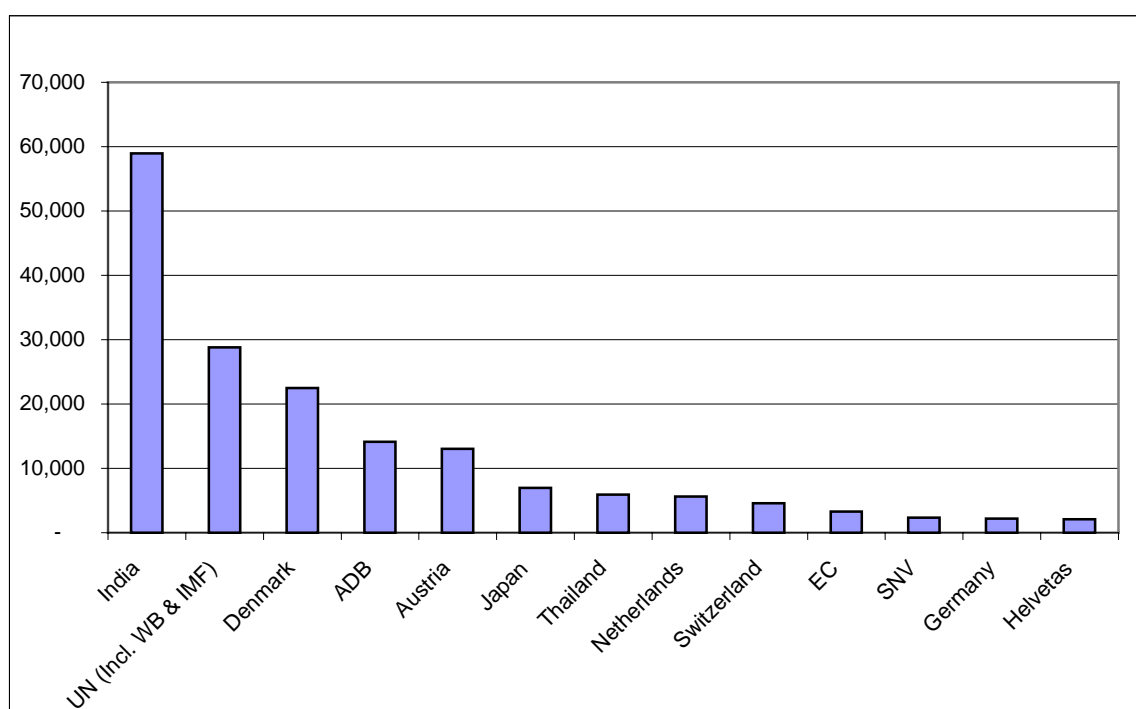
**Austria, Denmark, Finland, the Netherlands and Sweden** have established diplomatic relations with Bhutan, but no Member State has a fully fledged diplomatic representation in Bhutan. Therefore, some of the co-ordination takes place in New Delhi. The EC is however aware of the importance of strengthening day-to-day co-ordination with the donors represented in Bhutan and participates in local donor meetings when feasible. Information-sharing during project identification/review and the evaluation mission is an important aspect of the "**complementarity**" policy adopted by the EU.

Historically, **India** has been Bhutan's main development partner, concentrating mostly on the development of the **hydropower** sector, but also supporting education, health and road construction. The first two FYPs were wholly implemented with financial and technical assistance from the Government of India. From the 3rd FYP onwards, aid from India has been increasingly supplemented by assistance from other bilateral and multilateral sources. As of 1996, Bhutan received external assistance from as many as 17 multilateral organisations (mostly UN organisations), 19 individual donor countries on a bilateral basis and a number of non-governmental organisations (NGOs).

The ADB has been the single most important donor among the largest multilateral aid partners, focusing on the power sector, rural electrification, road improvement, health, urban infrastructure and vocational/technical training. The WB, as represented in Bhutan through IDA, has provided Bhutan with a soft loan scheme, which is less attractive to Bhutan than the grant aid system. Within the UN structure the UNICEF, UNDP and WFP are among the most active in Bhutan.

Four EU member states are well represented among the main donors, as shown in Figure 1. Denmark, the third largest donor in Bhutan, has been traditionally active in the sectors of health, urban development, environment/natural resource management and good governance and public administrative reforms. In the course of the 9th FYP support for the environment and natural resources is gradually being phased out, and support for the education sector will commence. Other big European donors concentrate on the power sector (Austria) and the RNR sector (the Netherlands, which has been providing mainly technical assistance, and Germany, which is contributing to vocational training).

**Figure 1: Main donors' disbursements of external assistance to Bhutan (thousands of USD, over the two years 1999-2000)**



Source: UNDP 2001 Joint Donor Database

During the 1980s Bhutan was heavily reliant on Official Development Assistance flows, which in some years amounted to more than 50% of GDP. However, rapid growth averaging 6.5% in the 1990s has reduced the dependence on aid somewhat – the country is expecting to almost entirely self-finance recurrent expenditure in the 9th FYP. Nevertheless Bhutan is still dependent on aid for funding of almost the entire capital expenditure budget of the country. In 2000 aid was recorded at a level of USD 92 million, of which USD 13 million in loans.

In 2000 the largest recipient DAC sector of external assistance was the **energy generation and supply** sector with USD 22.4 million, accounting for 24% of the total. The main donors within this sector included India and Austria.

The second largest area of donor assistance was **education** (at different levels) with USD 15.3 million (17%), which was supported by a large number of donors. Other important recipient sectors were: **health** (USD 14.7 million); **government and civil society** (USD 13.8 million); **agriculture/forestry/RNR** (USD 4.9 million); general **environmental protection** (USD 3.3 million) and social **infrastructure and services** (USD 3.0 million).<sup>1</sup>

<sup>1</sup> Source of sector aggregates: UNDP 2001 Joint Donor Database (some figures are estimates)

## 5. EC CO-OPERATION STRATEGY FOR 2002-2006

### 5.1 Principles and Objectives

The EC co-operation strategy builds on long EC experience of project implementation in Bhutan and aims to complement Bhutan's 8th and 9th FYPs in areas where the EC can contribute to **poverty reduction**.

The EC strategy formulation is based on a clear and updated assessment of needs resulting from recent bilateral/multilateral discussions between the RGOB, donors and Member States and government priorities.

In order to make this strategy a success, the EC has taken due account of the main objective of the **Bhutan 2020 document**, namely the creation of “**a society that balances development and environment, modernisation and tradition, values and technology, immediate and long term, individuals and society, realism and aspiration**”.

The overall objective of the EC-Bhutan development co-operation strategy is **poverty reduction** through the promotion of sustainable growth with special focus on the environment. Given the country's situation, the vast majority of the funds will be allocated to Development Co-operation through the annual budget for Technical and Financial Co-operation in favour of ALA countries.

On 10 November 2000, the Council and the Commission adopted a Joint Statement on the European Community's Development Policy, in which Trade and Development and Capacity Building were mentioned as two of the six priorities identified for the Community's Development Policy.

The full membership of the WTO, developed and developing countries alike, agreed in the Doha Ministerial Declaration (14 November 2001) that “international trade can play a major role in the promotion of economic development and the alleviation of poverty”, and that members “seek to place the needs and interests of developing countries at the heart of the Work Programme adopted in this declaration”. The WTO members also “confirm that technical co-operation and capacity building are core elements of the development dimension of the multilateral trading system”.

Bhutan's projected entry into the multilateral trade system and the required capacity building will be another area of EC co-operation, for which technical assistance has already been planned.

The estimated overall allocation of EC aid to Bhutan over the next five years amounts to **€15 million**.

It has to be pointed out that the absence of an EC Representative in Bhutan is a limiting factor for both development and economic co-operation activities in this country.

## 5.2 Main Areas of Concentration

Taking previous EC activities in Bhutan into account, along with various needs assessments of the main development partners, the EC assistance will continue to be concentrated on **poverty reduction**. Despite Bhutan's significant improvements in most human development indicators, poverty remains a reality in contemporary Bhutan and access to resources, services and opportunities at the most vulnerable groups in most rural areas of the country still needs to be improved considerably.

In identifying **concentration factors**, careful consideration has been given to how to maximise the impact of available resources in Bhutan. In general the EC prioritises delivery of social services such as basic health and primary education with a direct impact on poverty. The strong presence of other donor agencies in these areas, including member states, has however convinced the EC – in complete accordance with the wishes and requests of Bhutan – not to focus at this stage on these sub-sectors in order to avoid any overlap or absorption constraints.

The traditional Bhutanese agricultural system has been of a subsistence nature and for centuries people have produced enough food to meeting their family's consumption. Today rapid population growth has placed great pressure on Bhutan's limited natural resources base with significant implications and negative impact on **food security**.

Given Bhutan's predominant **agricultural** vocation, the EC has chosen to focus its activities on:

- raising **productivity in agriculture** by introducing more efficient technologies and methods;
- improving **rural incomes** through increasing added value in agricultural outputs;
- improving the institutional **capacity** to manage a sustainable development.

Throughout the EC strategy, the major concern will be to preserve the often precarious ecological balance, not only because of Bhutan's unique environment, but also to secure the long-term economic sustainability of activities initiated.

The need to enhance sustainability is also one of the main reasons why the EC emphasises government/community **ownership** in all co-operation activities. In particular, government ownership is considered to be of vital importance in ensuring the consistency of the EC-funded activities with the government's sectoral policies. So far, a frank dialogue with the Bhutanese authorities has greatly facilitated the process of designing and implementing new development activities capable of meeting the most urgent needs.

It has to be stressed that all along the planning process an important criterion systematically applied in Bhutan has been the **full participation** of end beneficiaries, in order to ensure future sustainability of co-operation activities. Bhutan's policy of enhancing the participatory process takes into account the individual's decision (or option) based on three interacting factors: perceived needs, available resources and priority or choice.

Taking into account the aforementioned considerations, the following **sectoral priorities** with the corresponding sub-sectoral options have been identified in close co-operation with the RGOB:

### 5.2.1 Renewable Natural Resources (RNR)

The **RNR** sector in Bhutan by definition includes all the agricultural sub-sectors as well as livestock. One justification for this is the very high priority the RGOB gives to the **conservation of natural resources**. All agricultural production and agricultural economic development will also have environmental consequences and must therefore be balanced with conservation requirements. Ensuring sustainable exploitation of natural resources is a key issue in all agricultural development.

In the **RNR** sector, the co-operation strategy will be aimed at improving living standards - primarily in rural areas – through better extension services, production technologies, resource management and organisational support, while special attention will be given to the promotion of environmentally sustainable production methods. The EC aims to help the government create an enabling legal and policy framework at central level while at local level efforts should be directed towards strengthening communities' capacity for improved natural resource management.

This strategy will be implemented through the following principal sub-sector:

#### ***Livestock sub-sector:***

The first EC-funded project concerning Strengthening of **Veterinary Services** for the Livestock Diseases Control was implemented from 1992-1999.

The **objective** of this project was to increase livestock production by reducing losses due to animal diseases, with the specific objectives of Rinderpest eradication, strengthening of veterinary services and institutional development. An evaluation of the project showed implementation to have been very successful and effective and the expected results to have been delivered. The project helped to effectively eradicate Rinderpest, generally reinforce veterinary services, epidemiological control and domestic vaccine production, and achieve significant institutional strengthening and development.

In view of these very positive project results, the Bhutanese government has asked the EC to pursue its support in favour of the livestock sub-sector, taking account of the following national priorities:

- encouraging peri-urban livestock production, especially dairy farming;
- improving feed and fodder capacity, e.g. by pasture development;
- exploring commercial farming and improving marketing, e.g. by mapping farmer-middleman-consumer linkages;
- continuing activities and surveillance programmes in Veterinary Health.

#### **Justification:**

The main justification for continued EC support in this sector is its potential for direct impact on most Bhutanese rural households dependent on livestock production for a significant part of their economic income. Apart from the direct link to poverty alleviation, an important objective would be environmental sustainability - relieving the ever-increasing pressure, from both people and animals, on the country's natural resources. Feed, fodder and pasture development would have a direct impact on easing some of the problems caused by the present unsustainable exploitation methods.

### ***Agricultural production***

In Bhutanese agriculture there is remarkable potential for increased yields both in agricultural and **high value** horticultural crops (improved varieties). Much needs to be done to improve productivity of labour while avoiding heavy losses (**post-harvest damages**). EC-funded initiatives will concentrate on efficient crop production methods at minimum economic and environmental cost.

This strategy will be implemented through the following principal sub-sector:

#### ***Integrated Pest Management (IPM) sub-sector:***

The first EC-funded IPM Development project was implemented from 1992-2000. The **objective** of the project was to contribute to the use of optimal IPM methods at the least economic and environmental cost to Bhutan. The evaluation showed that the project was mostly successful: IPM packages were introduced, implemented and evaluated at farm level; the pesticide management system was enhanced; the environmental impact of pesticide use was reduced; legislative support for rational pest management is now enacted; and the government institutional capacity in the sector has been strengthened.

#### **Justification:**

Nevertheless, there is still great scope for broadening the impact of the experience gained and ensuring that:

- improved IPM use and methodology reach a large majority of Bhutanese farmers, which is not yet the case at present;
- a new integrated approach, combining support for agricultural productivity with the development of commercial farming and marketing of products, is also duly considered.

Targeting agricultural production at district/local level will add to institutional strengthening of district officers and extension agents at geog level, which is in line with the ambitious decentralisation objective of the 9th FYP.

### **5.2.2 Health**

The outreach of the health system in Bhutan has improved significantly in recent decades. Nevertheless there is still scope for improving the quality of health services delivered. The RGOB continues to actively promote “So-Wa-Rigpa”, an indigenous medicinal system introduced in the 17th century from Tibet, which co-exists alongside the modern health care system in Bhutan.

A number of donor agencies lend significant support to the health sector in Bhutan, but, in the light of previous EC experience with the traditional medicinal system, the RGOB has urged the EC to continue supporting this indigenous part of the Bhutanese health system.

In the health sector the EC co-operation strategy will therefore be to increase the production of **Medicinal Plants** and integrate traditional medicine into the overall health care system. The main aim is to ensure the steady production and supply of medicinal plants, thereby improving the availability of drugs for domestic consumption. The prospects of increased export are also being studied, including sound commercial criteria for the management of the existing factory previously funded by the EC.

This strategy will be implemented through the following principal sub-sector:

***Medicinal Plants sub-sector:***

The first EC-funded Cultivation of Medicinal Plants for Traditional Medicine project was implemented from 1993-1999. The main achievement of the project was to establish an operational pharmaceutical **production** unit together with quality control and **research** capability. Progress was also made on issues such as training of plants collectors, construction of drying centres and trials on plant domestication. During the final and very positive evaluation of the first phase, a certain number of recommendations were formulated to further strengthen the medicinal plants sector from the angle of both plant production and the functioning of the pharmaceutical unit.

**Justification:**

Significant **added value** in the consolidation phase of this sector would be obtained by commercialising the activities of the existing factory and by developing a larger-scale sustainable system for conservation, collection and production of medicinal plants. Moreover, this will make for a steady supply of raw material for the production unit. In response to the request from the Bhutanese government, new EC support in this sector is justified by the importance of natural resource management in the fragile eco-system of the high altitude medicinal plants, as well as by the potential income generation for poor rural communities. A significant added value by complementing and capitalising on the results of the first project will be an increase of the current production capacity. At present, Bhutan is not able to satisfy the total demand for traditional medicines, and hence a domestic policy priority is to secure supply for the internal market.

**5.2.3 Cross-sectoral priorities**

As regards the aforementioned sectoral priorities and sub-sectors considered, four main cross-cutting issues have been identified as the common denominator for all future EC co-operation activities in Bhutan:

- a) **Management and planning:** The EC will continue to support the current policies of decentralisation as well as legal changes concerning farmers' organisations and subsidy policy. At local level any initiative supporting the districts' efforts to enhance their planning capabilities will be duly considered.
- b) **Human Resources Development (HRD):** The EC will continue to include an HRD component whereby counterpart staff, beneficiaries and/or other relevant stakeholders will receive training aimed at improving their capacity for sustainable resource management.
- c) **Farm systems development:** The EC will emphasise a decentralised approach, which calls for greater farmer participation in farm and environmental management as well as in extension supporting activities. This will be in line with present government efforts to implement a whole sector-root participatory policy.
- d) **Institutional Strengthening:** The EC will consider further support for government institutions as well as for the private sector. Planning, co-ordination, training and monitoring of field activities will be the main areas of capacity building initiatives to be undertaken, both at local and at central level.

## **5.3 Other Areas of Co-operation**

### **5.3.1 Trade**

The overall objective of the Community's assistance in the trade sector is to support Bhutan in its efforts to enhance its trade and investment environment, with a view to effectively participating in the multilateral trading system and the global economy, and to maximise the benefits for Bhutan.

Bhutan is currently negotiating its Membership to the **WTO**. To this end, the RGOB is convinced that a gradual approach and careful preparation, from the point of view of both availability of technical skills and adjustment of the national legal framework, are required. Initial assistance has been given by UNCTAD to help develop a Memorandum on Trade Regime. This is considered to be an important component of Bhutan's efforts to develop its capacity to integrate into the global trading system. All along the accession phase to the WTO, the Bhutanese authorities have reiterated the need for EC assistance in the following four areas:

- i. technical assistance and training activities for the Department of Commerce;
- ii. technical assistance in the review of legislation and, where necessary, the drafting of new legislation, in order to implement WTO regulations;
- iii. short-term learning sessions to provide better understanding of the relationship between Free Trade Agreements (FTAs) and WTO regulations;
- iv. setting up an Information Centre with website-based information in the field of international trade regulations and market access.

The EC will support Bhutan in its efforts to build up its regulatory, legislative and institutional capacities. Due consideration should be given to the ongoing WTO accession process of Bhutan, in particular to the implementation and application of its WTO commitments in fields such as TBT/SPS services, Trade-Related Intellectual Property Rights (TRIPS), and Customs Valuation.

With regard to the Doha Development Agenda, the EC will provide support to Bhutan for capacity building measures in key areas agreed at Doha, notably in areas such as trade facilitation, trade and competition and trade and investment. The EC will also support Bhutan in its efforts to increase its capacity to participate in the negotiations.

### **5.3.2 Export Diversification**

In order to further facilitate the effective participation of Bhutan in the multilateral trading system, the export sector must be diversified and new products and markets identified.

Over the past decade the economy has managed to achieve stable and export-led growth - although mainly due to the increasing export of hydropower to India. With its small domestic economy, continued growth depends crucially on export success. Moreover, the social imperatives of the country to deliver broad-based growth, improve rural incomes and create jobs for an increasing workforce demand the continued expansion of non-hydro exports.

The most recent EC-funded activity to support the development of exports is the EC-funded Trade Development Project, which started in March 1998 and ended in April 2001. During the year 2000 the Department of Trade (DoT) also managed to carry out an extensive study and produce a comprehensive **export strategy** document, with the assistance of the International Trade Centre (Geneva).

Based on this document and research carried out during the EC-funded Trade Development Project, the DoT has identified export priority sectors such as **handicrafts, wood-based products** and **export promotion** services – all included in the 9th FYP.

The RGOB has asked the EC to support the development and diversification of exports based on the following priority objectives:

- i. to design and implement a programme of export promotion, including improvement of products and design skills;
- ii. to substantially increase the export of handicraft and timber products, while creating jobs and developing income-earning opportunities for rural communities;
- iii. to increase and diversify Bhutan's exports so as to raise export revenues while contributing to sustainable employment creation and poverty alleviation;
- iv. to develop effective services for exporters in the private sector and for those seeking co-operation with companies outside Bhutan.

Subject to further detailed identification of such export diversification targets, the EC is willing to support the above-mentioned priority areas.

**Other** potential areas of future trade co-operation with Bhutan worth exploring with a view to further **diversifying** its exports and increasing its economic co-operation with third countries are:

- i. establishing a “**dry port**” (a one-point entry for rail transport in Phuentsholing at the Indian border);
- ii. financing a feasibility study on the setting-up of export **credit** schemes;
- iii. reviewing, together with the ROGB, existing or necessary legislation to attract FDI and to develop infrastructure sectors (e.g. telecommunications, transport and financial services) needed to support industries and services.

Co-operation in these areas might be considered in the longer term, but it will, however, require systematic and close dialogue with Bhutan's public and private sector representatives.

At the same time, Bhutan should also benefit from other EC initiatives and schemes under ongoing decentralised and regional programmes. The EC should facilitate access to such programmes through appropriate TA input.

### **5.3.3 Support for Refugees**

Since 1992, the EC has been the main donor (via the UNHCR) in the provision of care and maintenance assistance to people in the UNHCR camps located in south-eastern Nepal. Approximately €15 million has been committed so far by the Commission. The situation still remains unresolved. Despite the beginning of the verification/screening

process of the people in the camps in March 2001, the final selection of refugees eligible for settlement or repatriation cannot be expected soon.

The EC and the international community have reiterated their wish for a fair and acceptable solution by both parties.

In the meantime, further humanitarian assistance has been provided by the EC to supply emergency food aid to the camps via the WFP and to ensure care and maintenance contribution via the UNHCR for 2002. In the future, the EC will be prepared to help settlement or resettlement operations once a final agreement is reached, and upon express request.

#### **5.4 Complementarity within the EU and with other Development Partners**

The EC will seek to ensure that the activities supported are **complementary** to the strategies of Member States and other development partners active in Bhutan. The absence of a resident representative of the EC in Bhutan highlights the need for a careful consideration of other donors initiatives in order to achieve this objective. To a certain extent the Royal Government of Bhutan is ensuring that there is no *major* overlap and duplication of efforts.

In addition, the EC is already involved and will continue to pursue active consultations with all relevant development partners, in particular during the identification and appraisal stages of the project cycle, so as to ensure complementarity. Furthermore, consultations with Member States and other relevant development partners are usually held on a regular basis when EC representatives from Delhi visit Thimphu. The relatively small 'donor community' in Bhutan has so far ensured that there is sufficient information on the respective strategies and activities and generally the EC has so far succeeded in complementing its efforts with those of the member states and other donors.

## ANNEXES

### Annex1

#### Socio-economic Indicators<sup>1</sup>

<b>Poverty and social</b>	
GNI (former GNP) per capita ( <i>Atlas method, USD</i> )	590
GNI ( <i>Atlas method, USD billion</i> )	0.48
GDP ( <i>USD billion</i> )	0.49
GDP ( <i>average annual growth 1990-00</i> )	6.5
Consumer prices ( <i>% of change</i> )	7.0
Population ( <i>million, 1998</i> )	0.64
Population ( <i>% annual growth, 1999</i> )	2.9
Population ( <i>% of average annual growth, 1994-00</i> )	2.9
Labour force ( <i>% of average annual growth, 1994-00</i> )	2.5
Poverty ( <i>% of population below national poverty line</i> )	NA
Urban population ( <i>% of total population</i> )	15
Life expectancy at birth ( <i>years</i> )	66
Infant mortality ( <i>per 1000 live births</i> )	71
Child malnutrition ( <i>% of children under 5</i> )	18
Access to improved water source ( <i>% of population</i> )	63
Adult literacy ( <i>% of population aged 15+</i> )	54
Gross primary enrolment, male ( <i>% of school-age population</i> )	82
Gross primary enrolment, female ( <i>% of school-age population</i> )	62

<sup>1</sup> Source: World Bank (2000); Social indicators from Bhutan Human Development Report 2000 and UNDP 2001 Joint Donor Database Report for Bhutan.

<b>Government finance</b> ( <i>% of GDP, includes current grants</i> )	
Current revenue	35.9
Current budget balance	19.0
Overall surplus/deficit	-3.5
<b>Structure of economy</b> ( <i>% of GDP</i> )	
Agriculture	33.2
Industry	37.2
- of which manufacturing	10.2
Services	29.5
<b>Trade</b> ( <i>USD million</i> )	
Total exports (fob)	114
Total imports (cif)	185
<b>Balance of payments</b> ( <i>USD million</i> )	
Exports of goods and services	144
Imports of goods and services	292
Resource balance	-147
Net income	11
Net current transfers	10
Current account balance	-127
<b>External debt and resource flows</b> ( <i>USD million</i> )	
Total debt outstanding and disbursed	198
Reserves including gold	293

NA: Not available

## EC-financed projects in Bhutan

Project/Sector	Year*	EC cost (Total cost) € million
<b>Development co-operation</b>		
Plant protection	1982	<b>3.5</b>
Rural water supply and sanitation	1988	<b>4.88</b>
TA to the dept. of agriculture	1985	<b>1.1</b>
Dept. of agriculture support activities	1988	<b>3.65</b>
Livestock disease control	1990	<b>4.0</b>
HRD for Ministry of Agriculture	1991	<b>5.5</b>
Integrated pest management development	1992	<b>2.6</b>
Consolidation – health training & improving sanitation	1996	<b>0.38</b> (0.866)
Medicinal plants and traditional medicine	1997	<b>4.15</b> (5.05)
Wang watershed management project	1997	<b>9.2</b> (9.846)
Renewable natural resources extension support	1997	<b>6.285</b>
<b>Economic co-operation (only financed by EC)</b>		
Bhutan Trade Development	1995	<b>0.59</b>

\* Signature of FA or starting year



<ul style="list-style-type: none"> <li>• Power &amp; energy</li> <li>•</li> <li>• Telecom</li> <li>• Transport &amp; communication</li> <li>• Statistics</li> <li>• Private sector</li> <li>• WTO Accession</li> </ul>	X	A, NL  NL  DK DK	ADB, IN, JP, SNV  WB, IN, JP ADB, WB, IN, JP, CH ADB ADB, UN	grammes on decentralisation, human resources development, privatisation...
<b>Environment/RNR</b> <ul style="list-style-type: none"> <li>• Bio-diversity protection</li> <li>• Forestry</li> <li>• Water conservation, irrigation</li> <li>• Environmental standards and policy</li> <li>• Renewable natural resources</li> <li>• Livestock support</li> <li>• Integrated Pest Management</li> </ul>	X     X X X	NL,DK  D, NL, A, DK DK  DK  DK, NL, D	UN, CH  WB, ADB, CH,UN,WWF SNV  UN  SNV	<p>Sometimes donors do not support environmental protection directly, but they ensure the environmental compatibility of their projects.</p> <p>RNR – including livestock sub-sector and IPM – is to some degree also incorporated in specific regional/area projects.</p>
<b>Urban sector</b> <ul style="list-style-type: none"> <li>• Infrastructure</li> </ul>		DK	WB ADB	
<b>Rural development</b>	X	D	JP, CH, UN,	

<ul style="list-style-type: none"> <li>• Energy</li> <li>• Transport &amp; communication</li> <li>• Water</li> <li>• Agro-industries</li> <li>• Tourism</li> <li>• Decentralisation</li> </ul>		<b>NL</b>  <b>DK</b> <b>DK</b> <b>A, CH</b>	<b>AUS</b> <b>ADB</b> <b>ADB, WB</b>  <b>ADB</b>  <b>SNV</b>	
<b>Regional co-operation</b>			<b>ADB</b>	
<b>Support for NGOs</b>				Very few active NGOs

A: Austria

ADB: Asian Development Bank

WB: World Bank

D: Germany

DK: Denmark

NL: Netherlands

UN: United Nations (UNDP + UNICEF)

WHO: World Health Organisation

WWF: World Wildlife Foundation

IN: India

CH: Switzerland

JP: Japan

AUS: Australia

SNV: Stichting Nederlandse Vrijwilligers (Foundation of Dutch Volunteers)

**NATIONAL INDICATIVE PROGRAMME**

**2002 - 2006**

**BHUTAN**

<b>Country/Region:</b>	<b>BHUTAN</b>
<b>Budget Years:</b>	<b>2002 - 2006</b>
<b>Budget Line:</b>	<b>B7-300, B7-301</b>
<b>Legal Base:</b>	<b>ALA Regulation (Council Regulation 443/92 of 25/02/92)</b>
<b>Cost of Order:</b>	<b>EUR 15 million</b>
<b>Programming Service:</b>	<b>DG RELEX H.3</b>
<b>Head of Unit:</b>	<b>L. ARGIMON-PISTRE</b>
<b>Co-ordinator:</b>	<b>M. FERRUCCI</b>

**NB:** This National Indicative Programme does not include actions already scheduled in the 'project pipeline 2001'. Its scope is limited to budget years 2002-2006. It is part of the Country Strategy Paper, which provides the framework for co-operation for 2002 - 2006.

# NATIONAL INDICATIVE PROGRAMME

2002-2006

BHUTAN

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## **1 INDICATIVE BUDGET: GLOBAL AMOUNT AND PERCENTAGE PER PRIORITY/ SECTOR**

EUR 15 million should be earmarked for EU-Bhutan co-operation over the next 5 years, which means an approximate amount of EUR 3 million per year in terms of commitments.

The present National Indicative Programme covers a period of five years (2002-2006), for which an indicative amount of EUR 15 million would be available.

The sectors and sub-sectors indicated below take full account of the recommendation to streamline areas of EC assistance in order to enhance the impact, visibility and effectiveness of EC financial contributions.

The aggregated amount for the actions listed below comes to EUR 15 million, which should be allocated as follows:

<b>Priority 1: Renewable Natural Resources (64%)</b>	<b>EUR 9.6m</b>
Sub-Sector 1: Livestock Production and Animal Health	EUR 4.6m
Sub-Sector 2: Integrated Pest Management/Agricultural Production	EUR 5m
<b>Priority 2: Health – Traditional Medicine (28%)</b>	<b>EUR 4.2m</b>
Sub-Sector 1: Medicinal Plants Project Phase II	EUR 4.2m
<b>Priority 3: Trade Development and Export Diversification (8%)</b>	<b>EUR 1.2m</b>
Sub-Sector 1: EU-Bhutan WTO Co-operation	EUR 0.4m
Sub-Sector 2: Export Promotion/Diversification	EUR 0.8m

## 2 PRIORITY 1: SUPPORT FOR THE RENEWABLE NATURAL RESOURCES SECTOR

### 2.1 Strategic Context/Justification

Taking into account previous EC activities in Bhutan, as well as various needs assessments of main development partners, the EC's assistance will continue to be concentrated on **poverty reduction**. Despite Bhutan's significant improvement in most human development indicators, poverty remains a reality in contemporary Bhutan and access of the most vulnerable groups to resources, services and opportunities in various rural areas of the country still needs to be considerably improved.

The traditional Bhutanese agricultural system has been of a subsistence nature and for centuries farmers have struggled to meet their family's food requirements despite often harsh and difficult natural conditions. Today rapid population growth has increasingly placed great pressure on Bhutan's limited natural resources base, with significant implications and negative impact on **food security**.

Given Bhutan's predominant **agricultural** vocation, the EC has chosen to focus its activities on:

**raising productivity** in agriculture by introducing more efficient technologies and methods;

**improving rural incomes** through increasing added value in agricultural outputs;

improving the institutional capacity to manage sustainable development.

The main concern of the EC strategy, other than agricultural performance, will be to preserve the often precarious ecological balance, not only because of Bhutan's unique environment, but also to secure long-term economic sustainability of the activities initiated.

In the **RNR** sector, the co-operation strategy will aim at improving living standards - primarily in rural areas - through better **extension** services, **production** technologies, resource **management** and **organisational** support, while special attention will be given to the promotion of **environmentally sustainable** production methods. The EC aims to strengthen central government's capacity to implement an appropriate policy and legal framework while at local level efforts should be consolidated in order to strengthen communities' capacity for improved natural resource management.

This strategy will be implemented through the principal sub-sectors of Livestock and Animal Health and Agricultural Production/Integrated Pest Management.

The **National Indicative Programme (NIP)** will be periodically reviewed. This will allow for a critical review of the most recent ongoing operations and for agreement on any necessary changes of timing or priorities. In addition to this monitoring and evaluation at programme level, all future projects identified will be subject to more specific monitoring and evaluation, for which arrangements including precise performance indicators and time requirements will be included in the relevant financing proposals.

## 2.2 Sub-Sectors

### 2.2.1 Sub-Sector 1: *Livestock Production and Animal Health* (Indicative EC contribution) EUR 4.6 million

#### 1. Objectives

EC-funded activities concerning Strengthening of Veterinary Services for the Livestock Diseases Control were implemented from 1992-1999. The initial overall **objective** was to increase livestock production by reducing losses due to animal diseases with the specific objectives of eradicating Rinderpest, strengthening veterinary services and fostering institutional development. An evaluation of these activities showed implementation to have been very successful and effective and the expected results to have been delivered. EC assistance contributed to effective eradication of Rinderpest, general reinforcement of veterinary services, epidemiological control and domestic vaccine production, and to significant institutional strengthening and development.

Based on these results, the Bhutanese government has asked the EC to pursue its support in favour of the livestock sub-sector, taking account of the following national priorities: encouraging livestock production (including peri-urban areas and dairy farming);

improving feed and **fodder capacity**, e.g. by pasture development;

exploring **commercial farming** and improving marketing, e.g. by mapping farmer-middleman-consumer linkages;

consolidating activities and surveillance programmes in Veterinary Health.

The justification for EC support in the context is the potential for direct impact on most Bhutanese rural households dependent on livestock production for a significant part of the economic income of the family. Apart from the direct link to poverty alleviation and income generating targets, an important objective would be environmental sustainability - relieving the ever increasing pressure, from both people and animals, on the country's natural resources. Feed, fodder and pasture development would have a direct impact on some of the present unsustainable exploitation methods.

The national objective of having a higher degree of self-sufficiency of food products, including livestock, is of course also part of the strategic context of the project.

Targeting livestock production at **district/local** level will add to institutional strengthening of district officers and extension agents at *geog* level, which is in line with the ambitious decentralisation objective of the 9th FYP.

#### 2. Expected results

The increase in livestock production would be achieved by improving the service infrastructure and addressing production bottlenecks. Processing and marketing would be important results contributing to the ultimate objective of increased income generated from livestock production. Expected results necessary for achieving the specific objectives would be as follows:

- 1) The livestock **gene pool** will be upgraded and breeds improved.
- 2) A **network** of Village Animal Health Workers will be put in place, making for improved outreach of basic veterinary services.
- 3) A sustainable **supply of feed** and fodder will be established, via improved pastures, production infrastructure and logistics.
- 4) Processing units, particularly in peri-urban areas, will be established where feasible.
- 5) **Improved marketing** infrastructure will be established.
- 6) Farmer Co-operatives will be set up for the main purpose of marketing products. Where feasible micro-credit mechanisms will have been established.
- 7) Improved and environmentally sustainable livestock management practices will be introduced.

### **3. Activities**

- 1) Supporting supply and outreach of Artificial Insemination services.
- 2) Training and **capacity building** of village animal health workers and decentralised basic veterinary services.
- 3) Improving **pasture development**, addressing the serious constraint imposed by lack of winter fodder.
- 4) Piloting **peri-urban farming and processing**, and helping to encourage commercial farming in Bhutan.
- 5) Mapping of existing farmer-consumer linkages. Addressing constraints and bottlenecks in market access, information and logistics.
- 6) Supporting farmers' organisations/associations, especially with a view to improving marketing, sharing of transport costs, etc. The potential of establishing rural **micro-credit mechanisms** will be explored.
- 7) Introducing more efficient management of livestock, controlled grazing, culling of unproductive animals, etc.

### **4. Implementation**

An identification mission should be launched in due time to outline and formulate the project. A Financing Agreement would be signed with Bhutan, upon approval of the project and adoption of a financing decision.

### **5. Risks/Conditionality**

The request from the RGOB for the focus to be put on livestock production must be carefully balanced against the overarching objective of poverty alleviation, ensuring that the project targets the more remote, and thus poorer, areas and farmers.

The project should be approved and committed in the first half of 2003, as it will support an important priority sector of the 9th FYP of Bhutan.

Complementarity with other RNR-sector activities must be ensured, as a number of donors are involved in the sector in different geographical areas.

An important constraint to be taken into account is the ability of farmers in remoter areas to market their produce and generate income. Market access and marketing must be fully integrated in the project design.

Another constraint not to be underestimated is the widespread cultural/religious bias against killing/slaughtering animals in the Buddhist Kingdom of Bhutan.

## **6. Main indicators**

Key objective indicators are:

Poverty alleviation, as indicated by an absolute increase in household cash income from livestock production.

The proportion of overall household income in rural areas generated by livestock production.

The absolute overall livestock production of Bhutan.

Bhutan's import of livestock products.

## **7. Financial envelope**

Estimated EC contribution: EUR 4.6 million .

## **8. Indicative timeframe**

Preparation: 2002

Commitment: 2003

### **2.2.2** *Sub-Sector 2: Agricultural Production/Integrated Pest Management* (Indicative EC contribution) EUR 5 million

#### **1. Objectives**

In Bhutanese agriculture there is considerable potential for **increased yields** both in agricultural and high value horticultural crops (improved varieties).

Much needs to be done to improve productivity (both through labour and adapted technologies) while avoiding heavy losses and post-harvest damages. EC-funded initiatives will concentrate on efficient **crop production methods** at minimum economic and environmental cost.

A first set of EC-funded IPM Development activities was implemented between 1992-2000. The main **objective** was to contribute to the use of optimal IPM methods at the

least economic and environmental cost to Bhutan. Comprehensive evaluation studies showed that new IPM packages were successfully introduced, implemented and assimilated at farm level. The Bhutanese pesticide management system was also enhanced, thus reducing the environmental impact of pesticides, enacting the legislative support for a more rational pest management approach and strengthening the government's institutional capacity to deal with the most urgent issues in this sector.

The evaluation analysis, however, also showed that IPM packages had been disseminated to relatively few farms in Bhutan and that much remains to be done in terms of extended replication in order to provide appropriate IPM packages to all farmers. In addition, there is still a need to refine existing packages and to develop upgraded modules as well as fully integrating a pest management structure into the Ministry of Agriculture. Better prioritisation and co-ordination of IPM activities is required while at the same time encouraging the participation of the private sector in pesticide registration, distribution and sale. It became evident that IPM could not be treated as a separate target if the ultimate objective of impacting on farmers' incomes from agriculture was to be achieved and that it was necessary to promote IPM as part of integrated support for farmers to increase agricultural productivity, promote commercial farming and support the marketing of agricultural produce.

Summing up, the evaluation highlighted the need to address these issues, to broaden the impact of experience gained so far, and to ensure that:

improved IPM use and methodology reach the majority of the Bhutanese farmers;

integrated Pest and Crop Management (IPCM) becomes a permanent component of MoA structures capable of servicing decentralised competent administrative IPM Offices as well as downstream beneficiaries;

a new integrated approach, combining support for agricultural productivity with the development of commercial farming, marketing of products and the promotion of farmers' organisations/associations for these activities, is duly considered.

Targeting agricultural production at district/local level will add to institutional strengthening of district officers and extension agents at geog level, which ties in with the ambitious decentralisation objective of the 9th FYP.

## **2. Expected results**

Improvement of **extension services**, with delivery of updated/suitable IPM packages and methodologies reaching all farmers.

**Integration - Institutionalisation** of IPM services at all levels of MoA - into policy, strategy, research, training, extension and crop production systems - in order to modernise farm practices and improve Bhutan's overall agricultural output.

**Intensification and promotion** of farmer-consumer linkages in order to identify and remove commercial/economic bottlenecks and to make relevant information related to marketing and market access available to farmers. To this end, support should be given to farmers'

organisations/associations and the potential of micro-credit mechanisms for the promotion of commercial farming explored.

### **3. Activities**

Priority areas for EC support will be at policy and institutional level. At policy level the main priority will be to support integration/institutionalisation of IPM into the MoA. At institutional level the priority will be supporting outreach and delivery of extension services, training and support of extension agents, ensuring supply of updated/improved IPM packages, and transfer of knowledge/methodology from RNR research centres.

Increased support for farmers' organisation/associations will be provided with a view to improving marketing, sharing transport costs, etc. The potential of rural micro-credit mechanisms will also be explored to encourage commercial farming. The mapping of farmer-consumer linkages will be undertaken to improve marketing and market access, especially in remoter areas.

At the same time, the potential role of the private sector will be comprehensively assessed, particularly in relation to the registration and sustainable/responsible distribution and sale of pesticides to farmers, thereby ensuring environmentally sustainable use of pesticides.

### **4. Implementation**

An **identification** mission should be planned for 2003 to outline and formulate the project, which will build on previous experience and activities in this sub-sector while aiming especially at prioritising farmers' access to appropriate technology/methodology/information. In this context, a new integrated focus area will be the support and development of commercial farming and marketing/market access.

A Financing Agreement would be signed with Bhutan, upon approval of the project and adoption of a financing decision.

### **5. Risks/Conditionality**

An important constraint is the ability of farmers in remoter areas to market their produce and generate income; market access and marketing are issues to be analysed in depth and integrated into the project design.

Complementarity with other RNR-sector projects must be ensured, as a number of donors are active in the sector in different geographical areas.

### **6. Main indicators**

The main indicators of objective achievement to be taken into account are:

**Increase in income** from commercial farming.

**Outreach** of extension services in remoter areas, as indicated by the quantity and quality of IPM technology packages delivered and menus distributed and implemented by farmers.

**Institutional capacity** in terms of the integration of IPM into agricultural policy, as indicated by the institutionalisation of linkages and knowledge transfer from research centres, ability to update and adapt IPM packages, and the number of extension agents trained in new methodology. Also, introduction/increase of private sector involvement, as indicated by the number of entrepreneurs involved in providing services/pesticides to farmers.

**Diversification** of agriculture, as indicated by the adoption of new agricultural varieties and increased agricultural productivity.

## **7. Financial envelope**

Estimated EC contribution: EUR 5 million .

## **8. Indicative timeframe**

Preparation: 2003

Commitment: 2003/2004

## **3 PRIORITY 2: HEALTH – TRADITIONAL MEDICINE**

### **3.1 Strategic Context/Justification**

In the field of *health*, good results have been achieved during the last decade, which has seen an expansion of free basic health care services, particularly in rural areas. Emphasis is now placed on improving the institutional framework and community participation, while population planning will continue to be a constant concern.

In the health sector, the EC co-operation strategy will be to increase production of **Medicinal Plants** and fully integrate traditional medicine into the national health care system. The main aim is to ensure a steady production and supply of medicinal plants and improve the availability of drugs for domestic consumption. The prospects for increased exports are also being studied, including sound commercial criteria for the management of the existing factory previously funded by the EC. This strategy could justifiably also be classified as having a strong RNR aspect, developing, as it does, the unique natural resource of Bhutan's medicinal plants.

Despite the relative isolation of Bhutan several exclusive biodiversity resources are under stress. Many species of medicinal plants treasured for their curative potential are being depleted by unsustainable collection – both by Bhutanese and by incursions from across the long Himalayan border, which are impossible to patrol.

There is also a national security aspect to be mentioned in encouraging economic activity in the extremely remote high-altitude areas of Bhutan. As villages are being depopulated for lack of opportunities or social services, incursions, especially from across the border to China, are increasing and it is also a major security concern of the government to have large swathes of unpopulated land along the border.

Support for the Traditional Medicine system of Bhutan, which has an outreach covering every district of the country, will be an important measure in helping to sustain the rich cultural heritage of Bhutan. Although modern medicine is starting to prevail within the Bhutanese health sector, traditional medicine is still considered to be an important parallel and complementary service, perhaps with better prospects of surviving as a form of alternative medicine than the very closely related traditional medicine system in Tibet.

The National Indicative Programme will be periodically reviewed. This will allow for a critical review of recent operations and for agreement on any necessary changes of timing or priorities. In addition to this monitoring and evaluation at programme level, all future projects identified under this priority will be subject to monitoring and evaluation, for which arrangements including precise indicators and an indicative calendar will be included in the relevant financing proposals.

## **3.2 Sub-Sectors**

### *3.2.1 Sub-Sector 1: Medicinal Plants – Phase II EUR 4.2 million*

#### **1. Objectives**

A first **EC-funded Cultivation of Medicinal Plants for Traditional Medicine** project was implemented from 1993-1999. The main achievement of the project was to establish an operational pharmaceutical production unit together with quality control and research capability. Progress was also made on issues such as training of plant collectors, construction of drying centres and trials on plant domestication. During the final and very positive evaluation of this first phase a certain number of recommendations were formulated to further strengthen the medicinal plants sector, both with regard to plant/raw material production and functioning of the pharmaceutical unit.

Significant added value in the consolidation phase of this sector would be obtained by commercialising the activities of the existing factory and by developing a larger-scale sustainable system for conservation, collection and production of medicinal plants. Moreover, this will make for a steady supply of raw material for the production unit. At the request of the Bhutanese government, new EC support in this sector is justified by the importance of natural resource management in the fragile eco-system of the high altitude medicinal plants as well as by the potential income generation for the poor rural communities. Significant added value, by complementing and capitalising on the results of the first project, will be an increase in the current production capacity. At present, Bhutan is not able to satisfy the total demand for traditional medicines, and hence a domestic policy priority is to secure supply for the internal market.

The overall objective is to alleviate poverty, improve health and create economic opportunities through sustainable development of the medicinal plants sector, with due attention given to conserving natural resources.

The specific objectives are to ensure the conservation of medicinal plant resources in the high altitude areas of Bhutan; to improve the incomes, employment opportunities and livelihoods of rural communities in high altitude areas; to strengthen the organisation, management and cost-effectiveness of the medicinal plants industry; and to enhance the

availability of high quality medicinal plant products and traditional medicines for both the internal and external market.

## **2. Expected results**

Expected results from a second phase of EC support for the Medicinal Plants sub-sector will be the

**application** of technical and organisational methodologies and systems developed and implemented for the sustainable conservation, collection and cultivation of a range of high altitude medicinal plants;

**rationalisation** and organisation of sales of appropriately collected/cultivated medicinal plants from the target areas, so as to increase supply in line with market demand, while improving income generation for high altitude communities;

**development** of internal and export markets for traditional medicine products, thereby increasing output from the pharmaceutical unit in line with a rising demand;

**consolidation** of traditional medicine as part of the overall health services in Bhutan while enhancing human capacity to manage the medicinal plants industry at all levels;

**achievement** of self-sustainability by the Institute of Traditional Medicine as a viable entity run on a commercial basis (although still part of the Ministry of Health).

## **3. Activities**

There will be **two main components** of the project:

- a **Medicinal Plants Conservation and Cultivation** Component for sustainable conservation, collection, cultivation and post harvest handling of a range of high altitude medicinal plants will have a direct impact on farmers' income generation; and
- a **Traditional Medicine Product Marketing** and Commercialisation Component for enhancement of market development, marketing operations, and the commercial structure of the Traditional Medicine pharmaceutical industry. These two components are interdependent – the pharmaceutical unit being the primary outlet for medicinal plants production.

There is in both components a strong emphasis on **Human Resource Development** and capacity building.

## **4. Implementation**

Project identification was carried out in 2000/2001. A detailed financing proposal is ready for final approval. Implementation in the field should start in early 2003.

## **5. Risks/Conditionality**

Good co-operation is necessary between the two main Bhutanese line ministries responsible for implementation, the Ministry of Agriculture (MoA, implementing agency) and the Ministry of Health and Education (MoH).

In order to ensure sustainability in the longer term – financial and technical – it is considered necessary to have the full backing of the RGOB in the development of a strategic **business plan**, implying both a gradual commercialisation process and the opening of new export markets for traditional medicine products.

## **6. Main indicators**

The main indicators of achievement to be taken into account are:

**Income generation:** income increase in households in project target areas, end of project survey.

**Natural resource conservation:** no net loss in population of priority medicinal plants in the target areas.

**Strengthened management** and cost-effectiveness of medicinal plants industry: clear systems and linkages for production and marketing in place.

**Strengthening of the traditional health system** and availability of high quality traditional medicines: all Indigenous Hospitals/Units supplied on a regular basis and in good time.

**Commercial development**, internal and external market development: commercial income generation by production unit, export turnover and domestic sales to MoH, increased range of products.

**Capacity building:** key members of communities, extension staff and MoA/MoH having received appropriate training.

## **7. Financial envelope**

Estimated EC contribution: EUR 4.2 million .

## **8. Indicative timeframe**

Preparation: 2000/2001/2002

Commitment: 2002

# **4 PRIORITY 3: TRADE DEVELOPMENT AND EXPORT DIVERSIFICATION**

## **4.1 Strategic Context/Justification**

An important **economic** challenge for Bhutan stems from the fact of its being a least developed country (**LDC**) – meaning an economy with special structural constraints and vulnerabilities. Bhutan has decided to shift towards developing a more monetised and globally integrated economy. Due to the direct linkage of the Bhutanese currency to the Indian rupee and large inflows of foreign aid and hydropower revenue, wages of

unskilled workers have been pushed up, making exports (except from hydro power) less competitive and hampering efforts to diversify the economy. Bhutan is heavily dependent on one main trading partner, which may not be desirable in the long term. However, political and geographical factors tend to favour trade with India and no major shift is envisaged in the shorter term.

In 2000 the **current account deficit** stood at USD 127 million and was almost entirely covered by foreign grants. The main **exports** are electricity, wood products (except raw timber), agricultural and horticultural commodities, cement and calcium carbide.

In the last (8th) Five Year Plan the Government made a great effort to implement policies to promote the **private sector** and privatise State-owned enterprises. Meanwhile, private sector growth has increasingly covered import and marketing functions, while the level of subsidies is decreasing. Privatisation has also proved to be a rather complex issue, requiring careful planning, mainly due to the limited market size. Environmental concerns in particular need to be addressed as privatisation of imports and marketing may lead to unsustainable and inappropriate practices (e.g. use of pesticides).

Bhutan has a history of relative **isolation** from the outside world, but, because of the present constraints on export development, its excessive dependence on India as the main trading partner and the relative vulnerability of its economy to absorbing increasing inflows of foreign goods, there is a political will to deepen the country's integration into the system of international commercial relations.

In order to facilitate its integration into the global economy, Bhutan has submitted an application for full membership in WTO and has requested EC support on this matter.

In order to further facilitate Bhutan's effective participation in the multilateral trading system, the export sector must be diversified and new products and markets identified. With its small domestic economy, continued growth depends crucially on **export success**. Moreover, the social imperatives of the country to deliver broad-based growth, to improve rural incomes and to create jobs for the growing workforce also implies the continued expansion of non-hydro exports.

At the same time, Bhutan should also benefit from other EC initiatives and schemes under ongoing decentralised and regional programmes. The EC could facilitate access to such programmes through appropriate TA input.

The National Indicative Programme will be periodically reviewed. This will allow for a critical review of recent operations and for agreement on any necessary changes of timing or priorities. In addition to this monitoring and evaluation at programme level, all future projects identified under this priority will be subject to monitoring and evaluation, for which arrangements including precise indicators and an indicative calendar will be included in the relevant financing proposals.

## **4.2 Sub-Sectors**

### *4.2.1 Sub-Sector 1: EU-Bhutan WTO Co-operation EUR 0.4 million*

#### **1. Objectives**

The overall objective of the Community's assistance in the trade sector is to support Bhutan in its efforts to enhance its trade and investment environment, with a view to effective participation in the multilateral trading system and the global economy.

The EC will support Bhutan in its efforts to build up its regulatory, legislative and institutional capacities in order, eventually, - with due consideration of the presently ongoing accession process of Bhutan - to implement and apply its WTO commitments in fields such as TBT/SPS services, Trade-Related Intellectual Property Rights (TRIPS), and Customs Valuation.

Bhutan is currently negotiating its Membership to the **WTO**. To this end, the RGOB is convinced that a gradual approach and careful preparation, from the point of view of both availability of technical skills and adjustment of the national legal framework, are required. Initial assistance has been given by UNCTAD to help draft a Memorandum on Trade Regime. This is considered an important component of Bhutan's efforts to develop its capacity to integrate into the global trading system.

All along the accession phase to the WTO the Bhutanese authorities have reiterated the need for EC assistance in the following four areas:

technical assistance and training activities to the Department of Trade;

technical assistance in the review of legislation in order to adjust to WTO regulations;

short-term learning sessions to provide for a better understanding of the relationship between Free Trade Agreements (FTA) and WTO regulations;

setting up an Information Centre with website-based information in the field of international trade regulations and market access.

This assistance would ensure the necessary institutional capacity in the Department of Trade to successfully oversee the WTO accession process and the negotiations involved.

## **2. Expected results**

Expected results from EC assistance to support Bhutan's integration into a multilateral trading system will be as follows:

**Institutional capacity** of the Department of Trade with regard to WTO and Multilateral Trade will have been developed.

With the help of technical assistance, the RGOB will have reviewed all WTO-relevant legislation and identified and drafted new legislation where necessary.

The relevant staff of the Department of Trade and, to some degree, other Ministries involved in the WTO accession process will have **received specific training** in WTO regulations and Free Trade Agreements.

**An information centre and website** on trade policy/regulations and market access will have been established.

## **3. Activities**

The main activities to be considered for the implementation of EU-Bhutan WTO co-operation are:

Overall **support for the Department of Trade** in its WTO accession process and international trade policy formulation will be provided through the supply of a long-term expert and the establishment of a Multilateral Trade Support Unit in Department of Trade.

**Technical Assistance** will be provided in the form of consultancy services in two specific areas of significant importance in WTO accession: thorough a review of existing legislation and, where necessary, drafting of new legislation for the implementation of WTO rules and requirements; and analysis of the implications of WTO **membership** on existing or future Free Trade Agreements.

**Short term training** of DoT (and other key relevant staff) in import monitoring (quality controls), modern customs legislation and practices, export labelling/country of origin regulations and other WTO regulations will be carried out - funding of two fellowships for Master Degrees in recognised European universities will be provided.

1. Technical assistance and non-TA support will be provided to help set up an **Information Centre** on international trade regulations.

#### **4. Implementation**

Given the reiterated requests from the Bhutanese government since the beginning of WTO accession and to allow the country to benefit in full from immediate EC support and assistance in this area, the process should start as soon as possible.

#### **5. Risks/Conditionality**

Bhutan has a very cautious approach to too sudden an opening of its economy to the rest of the world and will probably prefer a very gradual accession to the complex system of multilateral trade.

A potential constraint that could limit the full benefit of the above-mentioned activities could be the rather low level of manpower and capacity in the RGOB/Department of Trade to absorb training and technical assistance in the absence of appropriate planning of new inputs delivery compatible with present routine activities in that administration.

#### **6. Main indicators**

Indicators are defined by and large by successful accession to the WTO **and completion of the steps** to be taken in the accession procedure. In this context, the main indicators of achievement to be taken into account are:

**Available capacity** in the Department of Trade indicated by: number of staff in RGOB/DoT trained and involved in multilateral trade issues; due progression of the WTO accession process.

Amount of **legislation reviewed** and consequent adjustments as well as any new legislation proposed by RGOB to implement WTO rules and requirements.

Number of persons having received ST and LT training in RGOB; import quality controls and export promotion functions instituted in DoT and other ministries; assistance rendered to private sector on export/import issues.

The functioning of the information centre/structure, as indicated by number of users and 'hits'

### **7. Estimated Community contribution:**

Estimated EC contribution: EUR 0.4 million.

### **8. Indicative timeframe**

Preparation: 2000/01/02

Commitment: 2002

#### *4.2.2 Sub-Sector 2: **Export Promotion/Diversification** EUR 0.8 million*

### **1. Objectives**

In order to further facilitate effective participation of Bhutan in the multilateral trading system, the export sector must be diversified and **new products and markets** identified.

The most recent project to support the development of exports is the EC-funded Trade Development Project started in March 1998 and ended in April 2001. During 2000 the Department of Trade (DoT) also managed to carry out an extensive study and produce a comprehensive **Export Strategy** document, with the assistance of the International Trade Centre (Geneva).

Based on the findings of this report and research carried out during the EC-funded Trade Development Project, the DoT has identified **export priority** sectors such as handicrafts, wood-based products and export promotion services – all included in the 9th FYP.

The RGOB has asked the EC to support the development and diversification of exports based on the following identified priorities:

design and implementation of an export promotion programme building on the relative strengths of Bhutan's production characteristics;

improvement of products and design skills in export relevant sectors;

increase in exports of handicraft and timber products, creating more jobs to develop income-earning opportunities for rural communities;

strengthening of services for private sector exporters, in particular those seeking co-operation with companies outside Bhutan.

The overall objective is to diversify and expand Bhutan's export base, the result being a higher rate of export growth, and hence growth and job creation in the economy.

With regard to export diversification, attracting Foreign Direct Investment also plays an important role, especially in providing an appropriate domestic regulatory framework. This is particularly important in relation to infrastructure and financial services.

Existing or necessary new legislation should be closely examined together with the RGOB.

## **2. Expected results**

Expected results from EC support of Bhutan's efforts to promote and diversify its exports are:

A specific export promotion programme will have been defined. The RGOB and private sector will have an improved capacity for identification of, and wider exposure to, attractive markets.

Training will have been delivered to exporters, workers and artisans leading to improved capability of designing attractive products and targeting relevant markets.

The production and export of handicrafts and wood-based products will have been increased – in quantity and quality.

A Bhutan Export Promotion Centre will have been established, guiding and supporting Bhutan's private sector exporters.

## **3. Activities**

Projected implementation activities will focus mainly on analysis, prioritisation and training:

With relevant TA support, the DoT will explore potential export niches – building on previous studies – and institute an export promotion programme defining priority products, markets and strategies for exporting.

Follow up targeted training programmes will be established focusing on private sector entrepreneurs, workers and artisans in export relevant sectors.

Specific attention and assistance will be given via focused training and support to the **handicraft** manufacturers, and the **wood-based industries**, to help increase market penetration, develop products and improve the output of the worker system in these two sectors.

Support will be provided for a **Bhutan Export Promotion Centre** to facilitate Bhutanese exposure to international markets and market fairs. It will help exporters with product and market information and research, provide support in trade fair participation and conduct training on export-related issues.

## **4. Implementation**

A project identification mission should be sent to Bhutan in 2002/2003. Some identification has already been carried out by the International Trade Centre in the form of an "Export Strategy Report". Identification may build on this, and thus also add to the overall strategy for this sector as set out in the 9th FYP.

## **5. Risks/Conditionality**

It should be clear from the outset that identifying and developing sustainable export goods/niches in Bhutan is a difficult task due to the general comparative disadvantages of this remote and land-locked country.

## **6. Main indicators**

The main indicators of achievement to be considered in this context are:

- (1) Overall (non-hydro power) export figures: national trade statistics.
- (2) Number of exporters/artisans/workers having received training.
- (3) **Export figures** for handicrafts and in wood-based products: national trade statistics.
- (4) **Job generation** in export sectors, and specifically in handicrafts/wood-based sectors: sectoral employment statistics.
- (5) Activity level of **Bhutan Export Promotion Centre**: trade fairs, trade missions, publications, etc.

## **7. Financial envelope**

Estimated EC contribution: EUR 0.8 million.

## **8. Indicative timeframe**

Preparation: 2002/2003

Commitment: 2003

## **5 CROSS-SECTORAL PRIORITIES**

As regards all the aforementioned sectoral priorities and sub-sectors considered, four main cross-cutting issues have been identified as the common denominator for all future EC co-operation activities in Bhutan:

**Management and planning:** The EC will continue to support the current policies of decentralisation as well as legal changes. At local level any initiative to support districts' efforts to enhance their planning capabilities will be duly considered.

**Human Resources Development (HRD):** The EC will continue to include a HRD component whereby counterpart staff, beneficiaries and/or other relevant stakeholders will receive training aimed at improving their capacity for sustainable resource management.

**Decentralisation:** The EC will emphasise a decentralised approach, which calls for greater participation at district and *geog* level. This will be in line with present government effort to implement a whole sector-root participatory policy.

**Institutional Strengthening:** The EC will consider further support for government institutions as well as for the private sector. Planning, co-ordination, training and monitoring of field activities will be the main areas of capacity building initiatives to be undertaken, both at local and at central level.