ECONOMIC AND FINANCIAL ANALYSIS

1. To move beyond the development paradigm, which has been dependent on natural resource endowments in hydropower, and to achieve more sustainable and stable growth that is inclusive, Bhutan must transform its economy. The economy needs to become broad-based with more diverse growth drivers so that it can generate more employment opportunities. To achieve these objectives, two critical development constraints need to be addressed.[1] First, weak institutions and systems for macroeconomic management need to be improved to effectively manage the shocks to the economy. Second, financial sector development needs to be strengthened to improve access to finance by the private sector and to stimulate investment in infrastructure. The policy actions under the outputs of the Strengthening Economic Management Program II (SEMP II) will target these development constraints.

2. From a political-economy perspective, ADB's continuous engagement with implementing agencies will strengthen the buy-in from reform-minded leaders and various other stakeholders to ensure successful implementation of the program. The sustainability of the reform momentum will be strengthened by improving the capacity of key drivers of institutional and policy changes in Bhutan such as the Ministry of Finance, the Royal Monetary Authority (RMA), and the Department of Revenue and Customs (DRC) to address the development challenges of an increasing more complex economy.

I. Output 1: Improved Macroeconomic Management

3. Under SEMP II, reforms in revenue and macroprudential management will strengthen the resilience of the economy against potential fiscal, monetary, financial, and balance of payments shocks, and thereby maintain a stable environment that is conducive for productive public and private investment.

A. Revenue Management

4. During the fiscal years (FYs) 2001-2011, Bhutan has demonstrated strong economic performance, with hydropower sector serving as the engine of growth. On the fiscal front, the Government of Bhutan has pursued a development agenda by utilizing international grants and concessional loans primarily for infrastructure development, while using domestic revenues for current spending. With the expenditures of the economy growing, the challenge for the government is to maintain a prudent fiscal balance in the medium term.[2] The government is undertaking major reforms under the Eleventh Five-Year Program (2013–2018) to (i) widen the tax base,[3] (ii) lower the dependence of the budget on external grants and loans, (iii) finance a larger share of development outlays from domestic resources, and (iv) curtail nonessential recurrent expenditures to ensure that the fiscal deficits are sustainable.

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[1] These constraints are also identified in Asian Development Bank. 2013. *Country Diagnostic Studies. Bhutan: Critical Development Constraints*. Manila.

[2] Total resources (tax and non-tax revenues, grants and other net receipts) accounted for 28.5% of gross domestic product (GDP) in FY2014 whereas outlay (current and capital expenditures, net lending and advance/suspense) corresponded to 32.5% of GDP, leaving a fiscal deficit of 4% of GDP. Tax revenues accounted for 13.2% of GDP in FY2014. Foreign grants, accounting for 9.6% of GDP, correspond to about one-third of total resources in FY2014 and were primarily used to finance capital expenditures, which stood at 17.5% of GDP. Indicative Estimate of Impact from Revenue Reforms (accessible from the list of linked documents in Appendix 2 of the main text)

[3] The tax structure, as it stands in FY2014, has a narrow base in Bhutan with revenue generation primarily reliant on corporate income tax (34.3%), of which hydropower is the main contributor, followed by sales tax at 16.5%, and excise duty at 14.8%. Royal Monetary Authority. 2015. *Annual Report 2013/14*. Thimphu. p. 63.

5. The program's revenue management reforms will make a significant contribution to achieving self-reliance in public finances. The revenue administration management information system (RAMIS) will increase the efficiency of tax administration and revenue collection by reducing tax collection costs and increasing the number of registered tax filers. Electronic and simpler tax-filing procedures are expected to improve voluntary tax compliance and thus help expand the revenue base. Furthermore, a technology-based system will facilitate the auditing and monitoring of tax collection, and help transform DRC into a modern tax administration agency.

6. The program will improve the quality of tax service delivery for the public by establishing a taxpayer information call center under DRC. The call center will (i) enable taxpayers to seek necessary clarifications on tax laws and payment processes, and (ii) minimize the cost of administration for the tax agency. These are expected to improve the tax compliance in combination with the RAMIS. The simplification of tax collection procedures will create an enabling environment for entrepreneurs and business development.

7. In addition, the program will contribute to the government's fiscal decentralization efforts for local governments. Although municipalities have been authorized to collect property taxes based on the Municipal Finance Policy, land and urban house taxes have been based on unit or area-based fixed rates and not been revised since 1992. The existing property taxation system creates significant undervaluation, leading to revenue losses for municipalities.[4] The revision of tax rates based on the objective property valuation methodology and completion of policies, systems, and processes, necessary to collect property tax using the new rates under the program will enhance the revenues in municipalities like Thimphu. This will contribute to financial self-sufficiency for local governments, and reduce dependence on transfers from the central government.

8. Revenue management reforms under SEMP II will help the government achieve a balanced and sustainable fiscal trajectory. The primary goal of the government is to contain the fiscal deficit below 3% of GDP during the Eleventh Five-Year Program. By mobilizing domestic tax revenues, the program will contribute to the ability of government to create the fiscal space for spending on infrastructure and social programs for poverty reduction, health, and education.

B. Macroprudential Management

9. The uncertain economic environment is not conducive for promoting investment. Reforms targeting critical weaknesses in public financial management and macroprudential management of the financial sector are expected to improve economic stability and create a favorable climate for private sector and infrastructure investment and thus sustainable growth.

10. To minimize volatility in flow of public funds, the Ministry of Finance will publish a calendar for issuance of government debt securities for FY2017. Reliable forecasting tools for revenues and expenditures will be developed to ensure an accurate prediction of the government's cash requirements and to avoid destabilizing spikes in debt repayments. By publicizing a schedule of Treasury bill (T-bill) issuance, including volumes and tenors, transparency of the government's funding needs will improve. Auctions for T-bills will be

[4] The land tax and urban house tax constituted only about 7.8% of the total revenue of Thimphu *municipality* in FY2011. Excluding the autonomous municipalities, the share of municipal taxes comprising urban land tax, underdevelopment land tax, and urban house tax in Bhutan's national revenues, was a minuscule amount of 0.02% in FY2012. Government of Bhutan. Ministry of Finance. *National Revenue Report 2011–2012*. Thimphu. p. 9.

conducted on a competitive basis, encouraging broader investor participation in the primary market from banks, nonbank financial institutions, and corporations, which will help minimize the debt service costs on domestic borrowing.[5] An active T-bill market will (i) improve the management of liquidity and monetary policy, (ii) create a benchmark for other interest rates, and (iii) help supply money market instruments for financial institutions to manage liquidity and asset–liability mismatches.[6]

11. Early availability of financial sector data is an important prerequisite for monitoring financial sector stability. Under SEMP II, enhanced disclosure requirements for financial institutions, which are in line with Basel III core principles, will be notified as part of the macroprudential regulations. The requirements will facilitate annual and quarterly monitoring of critical financial indicators, such as Tier 1 and Tier 2 capital; risk-weighted assets; loans classified by sectoral composition, quality, and counterparty; as well as interest and credit risks.

12. The program also targets avoidance of liquidity mismatches. To align the maturity of banking assets with the duration of their liabilities, the introduction of short-term T-bills and money market instruments is critical. RMA will introduce new money market instruments to develop the inter-financial institutions lending market to expand the range of short-term instruments for liquidity management purposes.[7]

13. As international experience shows, financial system soundness primarily depends on the strength of regulations, and regulatory and supervisory oversight of financial institutions. Reforms under SEMP II will contribute to the development of more effective and permanent systems for financial oversight in Bhutan. With the RMA's annual onsite inspections, compliance with macroprudential regulations and its effects on financial sector stability will be more rigorously evaluated.[8] These regulations primarily require banks to manage their lending, capital adequacy, and loan-loss provisioning in line with the riskiness of their asset portfolio and exposure to sectors that contribute to risk buildup in the economy.[9] With the removal of temporary credit restrictions on housing and vehicle loans—introduced during the rupee liquidity crunch—as of September 2014, these regulations are expected to moderate excessive credit growth with inflationary consequences and import-dependent consumption, resulting in potential pressure on Bhutan's international reserves in the future. Furthermore, stronger oversight of

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5 The absence of an active government securities market has deprived the government of cost-effective financing for cash shortages. As experienced during the rupee liquidity crunch, ad-hoc issuance of short-term (90 days) T-bills, and use of ways and means advances from RMA and the overdraft facility with the Bank of Bhutan Limited have proven to be costly. For the ways and means advances, RMA charges interest at a rate of 1% above the rate of the most recent auction of T-bills (roughly 3%). For the overdraft facility, the Bank of Bhutan Limited charges 5.5%.

6 One of the key structural bottlenecks in Bhutan's banking system is the asset–liability mismatch. While the liability side of the banking sector balance sheet primarily involves short-term deposits, on the asset side, capital is tied up in loans with fixed rates and longer time horizons. Demand deposits accounted for over 60% of total deposits in 2013, most of which were volatile corporate deposits.

7 Since 2012, the RMA Short Term Liquidity Adjustment Window Facility has been under implementation to provide short-term liquidity to banks that are deficient in liquidity.

8 The macroprudential regulations, which came into effect as of 1 November 2014, include (i) loan-to-value and loan-to-income restrictions, (ii) sector capital requirements, (iii) minimum ceiling on leverage ratio, (iv) restrictions on distribution of profit, and (v) the debt–equity ratio. Two regulations on countercyclical capital buffer and time-varying capital provisioning will be in effect based on RMA's discretion about the cyclical nature of the economy.

9 With RMA's strong oversight and banks' own risk management efforts, the banking system has remained largely resilient to the rupee liquidity crunch in FY2012. In September 2014, the risk-weighted capital adequacy ratio of 20% and the statutory liquidity requirement of 43.5% exceeded RMA's requirements. The non-performing loan ratio of banks stood at 11.8% compared with 12.7% in September 2013. The regulations have mitigated non-performing loan accumulation. Royal Monetary Authority. 2014. *Bhutanese Financial Sector Performance Review*. 2013–2014. September. Thimphu.

sectoral concentration and credit quality will encourage the banking system to diversify the lending portfolio away from import-dependent sectors such as construction to more productive investments that will create jobs and promote exports.[10]

14. RMA will also assess the implementation of its liquidity management and stress testing framework by the Bank of Bhutan Limited and Bhutan National Bank Limited, the two largest banks in Bhutan. For prudential monitoring, the liquidity management framework will (i) evaluate the effects of key macroeconomic indicators on banking system liquidity and (ii) building on RMA's existing maturity buckets framework, assess the prudential liquidity positions of banks, i.e., liquidity coverage ratio and a net stable funding ratio, based on the new international standards of the Basel Committee on Banking Supervision. The collection of financial data will build the macroeconomic and financial soundness indicators for conducting stress testing and scenario analysis for risk management. Finally, RMA will establish a committee tasked with forward-looking monitoring of financial sector stability, and will start publishing a financial stability report beginning with FY2015 in 2016.

II. Output 2: Strengthened Financial Sector Development

15. Limited access to finance and the high cost of financial intermediation are identified as critical developmental constraints in Bhutan.[11] Thus, financial sector development is an extremely important intervention under SEMP II (i) to enhance efficient intermediation of funds to long-term productive private sector investment and infrastructure development, particularly in transport and connectivity in rural areas;[12] and (ii) to help diversify the economy from capital-intensive hydropower to employment-generating private sector development.[13] Financial sector development will be strengthened by developing capital markets, promoting financial inclusion, and improving the Credit Information Bureau (CIB).

C. Developing Capital Markets

16. Financial intermediation in Bhutan is primarily based on the banking system (88% of total assets in 2014), while nonbank financial institutions account for only 12% of total financial assets and the capital markets have a minimal role.[14] The program will contribute to the development of institutional investors and capital market infrastructure to diversify and deepen financial intermediation.

17. To promote long-term investment, especially in infrastructure, the National Pension and Provident Fund (NPPF) will be strengthened with the approval of (i) risk-based investment

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[10] Until the credit restrictions imposed during the rupee liquidity crunch, Bhutan experienced a very rapid credit growth to the private sector, averaging over 30% during FY2010-–FY2012. As of FY2014, credit allocation of commercial banks is highly concentrated in housing (25%), personal loans (19%), and a few other sectors. Royal Monetary Authority. 2015. *Annual Report 2013/14*. Thimphu. p. 29–30.

[11] Of the micro, small, and medium-sized enterprises surveyed, 30% reported that access to finance is the major obstacle to business development. International Finance Corporation. 2009. Enterprise Survey. Washington, DC.

[12] As an indicator for assessing the cost of borrowing and efficiency of financial intermediation, the spread between lending and deposit rates was 8% in 2013 although it decreased from 11.8% in 2009. (International Monetary Fund. 2014. *International Financial Statistics*. Washington, DC.)

[13] Based on the 2013 Bhutan Labor Force Survey, urban unemployment reached 6.3% compared with the total unemployment rate of 2.9%. While 56% of employment is in agriculture, mainly for subsistence, the underdeveloped private sector, coupled with the shortage of skills and mismatches in the labor market, provides limited employment opportunities because it is dominated by micro, small, and medium-sized enterprises engaged in low-value, low-productivity activities.

[14] Royal Monetary Authority. 2015. *Annual Report 2013/14*. Thimphu.

guidelines, (ii) the National Pension Policy, and (iii) an NPPF strategic plan.[15] These will develop policies for actuarially sustainable administration of the benefits and contributions of the fund, while maintaining a financially sound investment portfolio. The institutional framework prepared under the program will promote active involvement of the NPPF in the capital markets and an increase in the membership for pension coverage.[16] The program will provide capacity building in areas such as actuarial services and asset valuation.

18. To promote the equity market, new rules and regulations will be approved for governing the public issue of shares by all the companies incorporated under the Companies Act of Bhutan. The regulations will streamline requirements for initial public offerings in the stock market and the role of institutional investors. Furthermore, a feasibility study will be conducted on requirements for establishing a separate securities and exchange commission to regulate the equity and bond market to enhance the capacity of RMA and the Ministry of Economic Affairs. The program will also provide training on the international best practices in securities law and corporate law in support of the establishment of a separate securities and exchange commission. With the early adoption and starting implementation of an additional 26 Bhutanese Accounting Standards and International Financial Reporting Standards, the standards for listed companies, financial institutions, and state-owned enterprises are harmonized with international norms with a transition period for full compliance by 2021.

19. Finally, government's capacity will be enhanced for mobilizing commercial resources for infrastructure development using international capital markets. A feasibility study will be conducted on legal and institutional requirements for international bond issuance using securitization of hydropower revenues in case preferential access to grants and concessional loans declines with rising per capita income in the future.

D. Promoting Financial Inclusion

20. With the development of the financial sector over the decade, overall availability of financial services has increased in Bhutan. However the private savings rate is still not sufficient to meet investment needs in the country.[17] In addition, a variety of financial services such as savings, insurance and pensions, payment and remittance facilities, and credit, need to be promoted particularly in remote rural areas and among low-income population and women. Owing to physical difficulties in accessing bank branches, lengthy procedures and collateral requirements, and low financial literacy, rural communities usually rely on moneylenders, friends, personal and/or family savings to invest in health, education, housing, and entrepreneurial activities.

21. Under SEMP II, the promotion of financial inclusion will improve equitable access to financial services and savings mobilization, which is critical to narrow the investment–savings

[15] The NPPF, the largest institutional investor in Bhutan, comprises a defined benefit and provident fund for civilian public servants and the armed forces, corresponding to 15% of GDP. As of June 2014, 418 employers were registered with the NPPF representing government agencies, public corporations, joint venture companies, and the armed forces. The total of 50,728 members accounts for 6.8% of the total population. Royal Monetary Authority. 2015. *Annual Report 2013/14*. Thimphu. p. 166.

[16] At least a 5% growth in NPPF membership is expected during program implementation.

[17] Savings stood at 34.1% of GDP in FY2013 in comparison with gross fixed capital formation of 57.2% of GDP. Country Economic Indicators (accessible from the list of linked documents in Appendix 2 of the main text). Most of the banking deposits are corporate, although the share of retail deposits grew from 37.4% in FY2009 to 49.9% in FY2014. The growth rate of savings deposits experienced a rebound to 24% in FY2014 from 8% in FY2012 following the rupee liquidity crunch. Royal Monetary Authority. 2015. *Annual Report 2013/14*. Thimphu. p. 32.

gap. Strengthening of the legal and regulatory framework for branchless banking and deposit-taking microfinance institutions will facilitate the outreach of diversified and affordable financial services to low-income households in remote areas. A financial literacy program with a focus on gender equity will create awareness among different socioeconomic, demographic, and gender groups on a wide array of services offered by banks and capital markets. The program will provide support to develop financial literacy materials for dissemination in media, schools, and urban and rural community information centers. Furthermore, Bhutan Development Bank Limited will implement *Gewog*[18] banking services, which will involve introducing mobile and branchless banking technology through point-of-sales devices in 205 rural community information centers across Bhutan. The branchless banking technology will allow cash deposits, loan repayments, withdrawals, balance inquiries, fund transfers and remittance, as well as mobile and utility bill payment. The mobile banking initiative will be conducted together with the Drinchen Ama Savings scheme, which will distribute 100,000 savings boxes to mothers of each family to promote a savings culture. These initiatives are expected to improve the mobilization of savings.

E. Improving the Credit Information Bureau

22. Access to finance continues to be the key obstacle to private investment, especially for micro, small, and medium-sized enterprises in Bhutan. While the shortfall between domestic savings and investment needs restrict the overall availability of credit, the distribution of existing credit is hampered by risk-averse selection of clients, excessive collateral requirements, little variety in loan products, and other financial infrastructure shortfalls. A reliable credit information system is therefore important to overcome the information asymmetries. Convenient access of financial institutions to credit profiles of borrowers would potentially lower the cost of financial intermediation and improve the quality and volume of lending, thereby improving access of entrepreneurs to finance.

23. The program will strengthen access to finance through a more effective CIB, which will improve the quality of financial intermediation in Bhutan. The new regulatory framework, to be adopted by RMA, will expand not only the financial reporting services provided by CIB such as credit history, credit scoring, fraud monitoring and alerts, but also the coverage of data providers to include financial institutions, utilities, such as electricity and telecommunication companies, and collateral registries. The expansion of data coverage will help CIB serve a wider segment of the population.[19] The regulatory oversight on the credit reporting system, consumer protection, and data security will also be strengthened through the establishment of an oversight unit under RMA. Supported under the program, CIB will implement a business plan, which will restructure its organization to merge with the central asset registry, and upgrade its information technology systems to allow for the expansion of new products and services. Public outreach will be conducted in connection with the financial literacy program to educate consumers regarding CIB functions and benefits.

III. Justification of Development Financing Amount

24. The reforms targeting revenue augmentation under Output 1 are critical for determining the government's development financing needs. The SEMP II reforms are projected to

[18] Gewog refers to group of villages.
[19] Participation in CIB was mandatory for banks and other financial institutions. Currently, records are available on 100,583 individuals and 500 companies. CIB receives an average of 4,129 enquiries per month, and estimated 35% of CIB reports are for new clients seeking their first loans.

strengthen the tax revenues operating through changes to the tax rate, the tax base and/or the efficiency of the tax administration. More specifically, the reforms would cover the following four components: (i) expanding the tax collection through efficiency improvements in tax administration; (ii) expanding the tax collection through operationalization of direct and sales tax modules of the revenue administration and management information system (RAMIS); (iii) improving compliance with better service delivery through taxpayer information call center; and (iv) expanding the tax base by mobilizing local revenues for municipalities from property taxes. The impact of (i) and (ii) above are expected to accrue starting from FY2016 onward while the impact of (iii) and (iv) are expected to accrue starting from FY2017.

25. An additional $58 million dollars of tax revenue is projected by FY2017 compared to FY2015, of which $42 million will be from direct taxes such as corporate, business, and personal income tax and $16 million will be from indirect taxes such as sales tax (Table 1).[20]

Table 1: Tax Revenue

	Item	FY2015 (Budget)	FY2016 (Projection)	FY2017 (Projection)	Total Change FY2015–FY2017
REFORM SCENARIO	**Tax Revenue (Direct +Indirect)**				
	Nu million	17,619.7	20,253.0	23,386.0	5,766.3
	$ million	271.9	298.8	329.8	57.9
	% of GDP	13.6	14.2	14.9	
	Nominal GDP				
	Nu million	129,831.4	143,039.9	156,545.4	
	Exchange rate				
	Nu/$	64.8	67.8	70.9	

FY = fiscal year, GDP = gross domestic product, Nu = ngultrum.
Sources: FY2015, nominal GDP and exchange rate projections for FY2016 and FY2017 are from Government of Bhutan. Ministry of Finance. 2014. *National Budget Financial Year 2014/15.* June. Thimphu. Tax revenue for FY2016 and FY2017 is Asian Development Bank projection from Indicative Estimate of Impact from Revenue Reforms (accessible from the list of linked documents in Appendix 2 of the main text).

26. Based on fiscal projections (Table 2), fiscal balance to GDP ratio is expected to stabilize below a deficit of 3% in FY2015. The fiscal deficit is further reduced to 0.9% in FY2016 reflecting the expected impact of the revenue reforms under SEMP II and the projected increase in grants in FY2016. The fiscal balance turns to a modest surplus of 0.1% by FY2017. The creation of a fiscal space enables the government to devote more resources for capital spending and social programs that are critical for growth.[21]

27. The total resource gap during FY2015–FY2017 is projected to be $85.5 million.[22] It is proposed that under SEMP II, ADB covers $36.2 million (42% of the gap). The ADB financing amount depends on the Asian Development Fund allocation, which allows Bhutan to have 50% of its allocation as a grant based on moderate debt risk assessment. Combined with the program, an additional World Bank development policy credit of $20 million, to be disbursed in FY2016, will finance 66% of the estimated resource gap. The remaining shortfall of $29.3 million will be funded by the government.

[20] Details of the tax revenue projections under the reform scenario are available in Indicative Estimate of Impact from Revenue Reforms (accessible from the list of linked documents in Appendix 2 of the main text).
[21] The projections for current and capital expenditures are available in Indicative Estimate of Impact from Revenue Reforms (accessible from the list of linked documents in Appendix 2 of the main text).
[22] The resource gap, which is the sum of fiscal balance and net borrowing, reflects the financing requirement of the total outlay, which could not be met from available domestic resources including grants and planned net borrowing.

Table 2: Overall Fiscal Deficit and Development Financing Needs

	Item	FY2015 (Budget)	FY2016 (Projection)	FY2017 (Projection)	Total FY2015–FY2017
REFORM SCENARIO	**Total Resources**				
	Nu million	31,959.3	42,867.6	46,436.8	121,263.6
	$ million	493.2	632.4	654.9	1,780.4
	% of GDP	24.6	30.0	29.7	
	Outlay				
	Nu million	35,406.3	44,145.8	46,301.0	125,853.1
	$ million	546.4	651.2	653.0	1,850.6
	% of GDP	27.3	30.9	29.6	
	Fiscal balance				
	Nu million	(3,447.1)	(1,278.2)	135.8	(4,589.5)
	$ million	(53.2)	(18.9)	1.9	(70.1)
	% of GDP	(2.7)	(0.9)	0.1	
	Net borrowing				
	Nu million	(1,358.1)	371.6	9.7	(976.9)
	$ million	(21.0)	5.5	0.1	(15.3)
	% of GDP	(1.0)	0.3	0.01	
	Resource gap				
	Nu million	(4,805.2)	(906.6)	145.4	(5,566.4)
	$ million	(74.2)	(13.4)	2.1	(85.5)
	% of GDP	(3.7)	(0.6)	0.1	
	Nominal GDP				
	Nu million	129,831.4	143,039.9	156,545.4	
	Exchange rate				
	Nu/$	64.8	67.8	70.9	

( ) = negative, FY = fiscal year, GDP = gross domestic product, Nu = ngultrum.
Resource gap = [domestic revenue + grants + other receipts + net borrowing – current expenditure – capital expenditure – net lending – advance/suspense].
Sources: FY2015, net borrowing, nominal GDP and exchange rate projections for FY2016 and FY2017 are from Government of Bhutan. Ministry of Finance. 2014. *National Budget Financial Year 2014/15.* June. Thimphu. Total resources, outlay, fiscal balance and resource gap for FY2016 and FY2017 are Asian Development Bank projections from Indicative Estimate of Impact from Revenue Reforms (accessible from the list of linked documents in Appendix 2 of the main text).