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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT

FOR A PROPOSED GRANT

**IN THE AMOUNT OF SDR 10.4 MILLION
(US\$ 15 MILLION EQUIVALENT)**

TO

THE KINGDOM OF BHUTAN

FOR

A FIRST DEVELOPMENT POLICY GRANT

March 30, 2006

**Poverty Reduction and Economic Management
South Asia Region**

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GOVERNMENT FISCAL YEAR
July 1 - June 30

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank	IMF	International Monetary Fund
ART	Anti-Retroviral Therapy	JSAN	Join Staff Advisory Note
BCCI	Bhutan Chamber of Commerce and Industry	MDGs	Millennium Development Goals
BLSS	Bhutan Living Standard Survey	M&E	Monitoring and Evaluation
CAS	Country Assistance Strategy	MFCC	Macroeconomic Framework Coordination Committee
CFAA	Country Financial Accountability Assessment	MFCTC	Macroeconomic Framework Coordination Technical Committee
CoM	Committee of the Council of Ministers	MTFF	Medium Term Fiscal Framework
DANIDA	Danish International Development Assistance	MYRB	Multi-Year Rolling Budgets
DPG	Development Policy Grant	NER	Net Enrollment Rate
EDP	Education Development Project	PFM	Public Financial Management
EFA	Education for All	PRSP	Poverty Reduction Strategy Paper
EOC	Emergency Obstetric Care	RAA	Royal Audit Authority
FIAS	Foreign Investment Advisory Services	RGoB	Royal Government of Bhutan
FDI	Foreign Direct Investment	RMA	Royal Monetary Authority
GDP	Gross Domestic Product		
GER	Gross Enrollment Rate	SDC	Swiss Development Corporation
GNH	Gross National Happiness	SEDF	South Asia Enterprise Development Facility
GNI	Gross National Income	SMEs	Small and Medium Enterprises
HMIS	Health Management Information System	STIs	Sexually Transmitted Infections
IDA	International Development Association	UNDP	United Nations Development Program
IDF	Institutional Development Fund	UNICEF	United Nations Children's Fund
IFC	International Finance Corporation	WHO	World Health Organization

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BHUTAN: FIRST DEVELOPMENT POLICY GRANT

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KINGDOM OF BHUTAN
FIRST DEVELOPMENT POLICY GRANT

GRANT AND PROGRAM SUMMARY

Borrower	Royal Government of Bhutan
Implementing Agency	Department of Aid & Debt Management, Ministry of Finance
Amount	Grant: SDR 10.4 million (US\$15 million equivalent)
Terms	Standard IDA Grant terms
Tranching	The grant would be disbursed in one tranche in an amount equivalent to US\$15 million upon effectiveness.
Description	The proposed first Development Policy Grant (DPG I) is in support of an ongoing reform program, which includes four components: (i) ensuring the maintenance of a sound macroeconomic framework, strengthening fiscal policy, and bolstering financial management; (ii) enhancing the investment climate for private sector growth and employment generation, (iii) augmenting the quality of and access to education; and (iv) improving health care.
Benefits	In providing support for the reform program of the Royal Government of Bhutan, this operation recognizes progress to date and will facilitate the Kingdom's next steps towards achieving better socioeconomic outcomes and reducing poverty. More specifically, the benefits expected from the development policy program include: (a) improved delivery of public services as a result of better public budget and financial management, (b) greater foreign direct investment and more job opportunities due to improvements in the investment climate and increased labor market flexibility, (c) higher school enrollment and completion, particularly in previously under served areas, as access to schooling services is expanded, and (d) better health outcomes in such critical areas as maternal mortality, as a result of an increased number of births being delivered in health facilities.
Risks	The major risks stem from: (a) low technical capacity and skill shortage which is the leading factor impeding Bhutan's overall development progress, (b) lack of economic diversification and dependency on hydropower, and (c) reform inertia due to political developments.
Operation ID Number	P078807

**PROGRAM DOCUMENT
FOR
A PROPOSED FIRST DEVELOPMENT POLICY GRANT
TO THE KINGDOM OF BHUTAN**

I. INTRODUCTION

1. The Royal Government of Bhutan's (RGoB) ongoing medium-term policy and institutional reform program is anchored in its Ninth Five-Year Plan, which is also its Poverty Reduction Strategy Paper (PRSP).¹ Reflecting the distinct vision of Gross National Happiness (GNH), the Ninth Five-Year Plan has five overall goals: (i) improving quality of life and income, especially for the poor, (ii) ensuring good governance, (iii) promoting private sector growth and employment generation, (iv) preserving and promoting cultural heritage and the environment, and (v) achieving rapid economic growth and transformation. The strategies outlined to achieve these goals include expanding infrastructure, maintaining sound macroeconomic policy, ensuring good governance, and improving access to enhanced social services. The RGoB's reform program underpins these goals and strategies, and is selectively supported by the DPG. The program is at an early stage and is still gathering pace. It is, however, moving in the right direction and is commensurate with the existing technical capacity and circumstances of the country. More importantly, the government's commitment to implementing the reform agenda is strong.

2. During the CAS consultations in early 2005, the RGoB requested policy-based assistance in order to pursue its poverty reduction strategy (PRS).² In view of the existing capacity constraints, PRS implementation in Bhutan is technically-demanding and requires long-term support from development partners. This was recently confirmed in the Ninth Round Table Meeting held in Geneva on February 15 and 16, 2006. Development policy lending is an appropriate instrument in such circumstances. Bhutan is a top performer among IDA countries, and its development progress and commitment to moving forward justify policy-based support, helping maintain the momentum of reform.

3. The proposed Development Policy Grant (DPG) would be the first in a series of programmatic budget operations, and would seek to support key components of the government's program.³ The grant would provide US\$15 million in budget support in FY06 to help the RGoB meet its development goals.⁴ Given that the proposed DPG will be the first policy-based operation in Bhutan, it will entail a deepening of the policy dialogue and a process of learning. A second operation, Development Policy Grant/Credit II, is planned for 2007-08, and would be linked to a strengthening of the reform program as well as to a

¹ The PRSP and the Joint Staff Advisory Note (*Bhutan: Joint Staff Advisory Note of the Poverty Reduction Strategy Paper*, [Report No. 30716-BT]) prepared by the staffs of the International Development Association and the International Monetary Fund, was discussed by the Board on February 8, 2005.

² The Bhutan CAS (*World Bank: Country Assistance Strategy for the Kingdom of Bhutan for the Period FY06-FY09*, Report No. 33704-BT, September 28, 2005) was discussed by the Board on November 1, 2005.

³ Bhutan is an IDA only country, and under IDA-14, it qualifies for 100 percent grants in FY06 based on: (i) the 2004 present value of external debt to GDP which is above its indicative threshold (50%), and (ii) the 2004 present value of external debt to exports ratio which is also above its indicative threshold (200%). The RGoB can frontload up to 80% of the indicative 2006-07 and 2007-08 allocations. If Bhutan continues to receive 100 percent grant assistance from IDA, the indicative allocation for the remainder of the CAS period—FY07 to FY09—would be about US\$44.0 million. Actual allocations will depend on a variety of factors including the country's own performance (absolute and relative to other IDA countries), and the amount of overall resources available to IDA.

⁴ The Bhutanese fiscal year runs from July 1 to June 30. The RGoB's 2005-06 budget projects a fiscal gap (the overall fiscal deficit including grants that is not financed by project-tied loans) of Nu. 780 million (about US\$18 million, or 2.1 percent of GDP), which would need to be financed domestically in the absence of budget support.

quickenning of the pace of implementation. These two operations are programmed in the current CAS period, FY06 to FY09. As the reform program matures and deepens, future operations could be annual and have broader coverage. They would also build on lessons learnt, including the usefulness of this instrument in facilitating development in Bhutan.

4. Under the overarching themes of enhancing economic growth, reducing poverty and achieving the Millennium Development Goals (MDGs), the following four components of the RGoB's interrelated developmental reform strategies are being supported by the DPG operation:

1. Ensuring the maintenance of a sound macroeconomic framework, strengthening fiscal policy, and bolstering financial management;
2. Enhancing the investment climate for private sector growth and employment generation;
3. Augmenting the quality of and access to education; and
4. Improving health care.

5. The Bhutan CAS emphasizes selectivity to maximize the development impact of the Bank's limited financial and staff resources. Selectivity is also a key feature of the proposed DPG operation. While there are numerous meaningful development initiatives being undertaken by the RGoB,⁵ the proposed operation will focus on the four strategic areas noted above, which are considered important to the overall success of the program. Selectivity will also help keep the operation manageable.

6. Section II of this Program Document (PD) summarizes key aspects of development progress and challenges in Bhutan. Section III reports on Bhutan's overall medium-term development reform program and the Bank's assistance strategy of support. Section IV discusses the policy and institutional reform components supported by the proposed DPG I. Section V describes implementation of the proposed operation.

II. BHUTAN'S DEVELOPMENT: PROGRESS AND CHALLENGES

7. Bhutan is a small, mountain kingdom landlocked in the eastern Himalayas between China and India. Over the past 25 years, the people of Bhutan have made rapid social and economic progress. Real GDP growth averaged more than 6 percent a year over this period, and sustained growth has increased Gross National Income (GNI) per capita to about US\$720 in 2004. The population was estimated to be 752,700 in 2004 (source? Is this the RGoB number?) and is widely dispersed, with 79 percent living in rural areas.⁶ While the cities and towns remain small, urbanization is accelerating, and Thimphu (the capital) is growing by about 10 percent a year.

8. **Structure of the economy.** The economy is undergoing profound structural change. Agriculture continues to account for about 25 percent of GDP, and over 70 percent of employment (including substantial subsistence agriculture), but the sector is lagging behind the rest of the economy, as arable land

⁵ For example, decentralization of decision-making and service delivery is a major element of the Ninth Five-Year Plan. Assistance in this area is being provided by the SNV (the Netherlands Development Organization) and the IDA-supported Decentralized Rural Development Project. Improving access to infrastructure is another major objective of the Ninth Plan. The Bank is supporting the expansion of rural access through the ongoing Rural Access Roads Project.

⁶ Source *2004 Statistical Yearbook of Bhutan (2005)*. There is substantial variation in the estimates of Bhutan's population, ranging from the official RGoB figures to much larger estimates by UN agencies. The first national census was conducted in June 2005, and the results are expected to be published in April 2006. The publication of the census will be a major step forward in underpinning national data and strengthening future survey efforts.

is limited, and land holdings are small and fragmented, constraining the potential for farm mechanization. Driven by the exploitation of vast hydropower potential—currently estimated at 30,000 megawatts—and donor support, the economy is modernizing rapidly. India is the largest donor, and hydropower resources are being developed mainly with Indian support. As a result of public investment in hydropower and other infrastructure, the construction sector is growing swiftly. Private investment in housing and hotels is also boosting the sector. Tourist arrivals have risen sharply since 2004, increasing activity in the services sector. Opportunities are expanding for the formal private sector, but with electricity revenues and donor financial support flowing through the government, the public sector remains the primary engine of growth in Bhutan.

9. **Political developments.** A process of political change is underway in Bhutan. A new constitution, aimed at creating a democratic political system consistent with the country's vision and values, has been prepared and was widely distributed in March, 2005. His Majesty the King and the Crown Prince are leading a nationwide consultation process, involving public meetings, and open comment through postings on the internet.⁷ The Constitution is to be enacted by the National Assembly in 2008. According to the draft Constitution, the Parliament of Bhutan will include a National Council and a National Assembly. The National Council will consist of 20 members directly elected by the people and representing each of the *Dzongkhags* (districts), and five members nominated by the King. The National Assembly will have a minimum of 75 members elected by each *Dzongkhag* according to its population. His Majesty the King has announced that he will step down in 2008 in favor of the Crown Prince, once a democratic, constitutional monarchy is established.

10. The draft Constitution articulates a vision of good governance based on accountability of the government, responsible management of state resources, independence of Constitutional Offices, rule of law, and legal protection of human rights. To help implement this vision, special meetings were convened at the end of 2005 in order to review the existing governance arrangements, and develop recommendations for improvements. These are described in a paper titled *Good Governance Plus: In Pursuit of Gross National Happiness*, which highlights the importance of transparency, accountability, efficiency and professionalism. The document points to a number of policy making and institutional changes, such as integrating the preparation of a Medium-Term Fiscal Framework (MTFF) into the budget process, and using the MTFF as the basis for a new planning approach (the Alternative Planning Framework) that seeks to strengthen the links between goals and resource availability. The Good Governance Plus document emphasizes the importance of the media, civil society, and the use of information technologies to underpin strong anti-corruption measures and increase the transparency and accountability of the government. Finally, the document also recommends furthering decentralization by devolving more decision making authority to lower levels of government.

11. As first key steps towards implementing governance and institutional reforms in preparation for the enactment of the Constitution in 2008, three independent constitutional bodies have been established. These are the Office of the Auditor General, the Anti-Corruption Commission, and the Election Commission. The Heads of these institutions are independent of the executive and report directly to the National Assembly.

1. **Poverty in Bhutan**

12. Efforts to measure and analyze poverty in Bhutan are relatively recent initiatives. The pilot Household Income and Expenditure Survey (HIES) of 2000 was the first attempt to quantify poverty in Bhutan at the household level.⁸ These efforts were followed by the Bhutan Living Standard Survey (BLSS)

⁷ Available at www.constitution.bt, where anyone can send comments.

⁸ In the same year, the RGoB prepared a Poverty Assessment and Analysis Report (PAAR) which presented results on poverty at the Dzongkhag (district) and Gewog (block) levels.

of 2003.⁹ While data issues make comparisons between the HIES and the BLSS difficult, these comprise the best statistics available, and suggest that poverty has declined over time in Bhutan (Table 1).

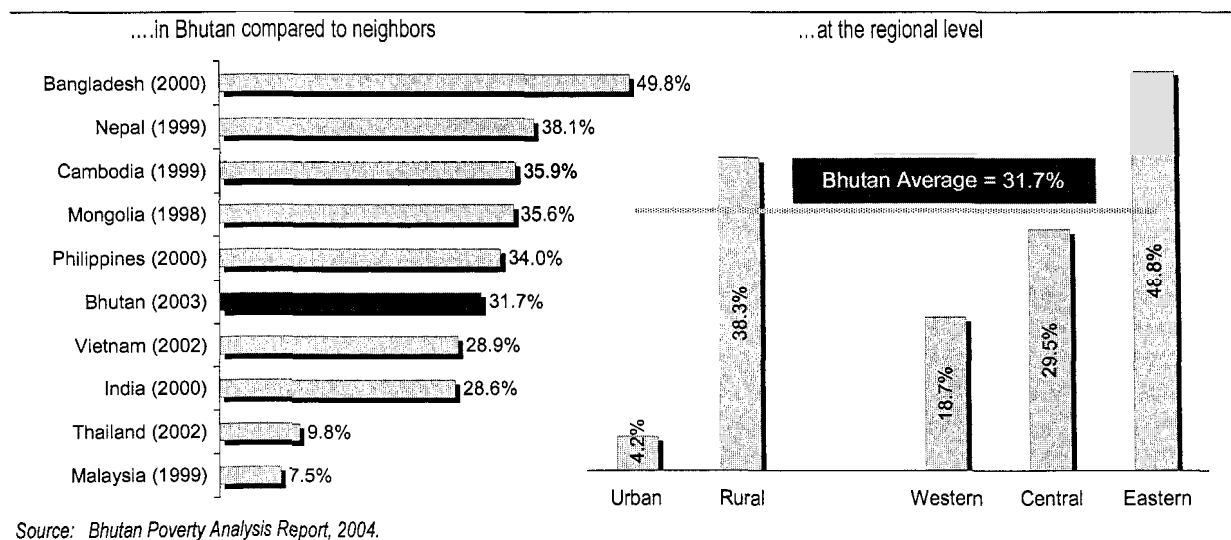
**Table 1: Poverty in Bhutan
(Head-count and Gap estimates)**

	2000 (HIES)			2003 (BLSS)		
	Urban	Rural	Total	Urban	Rural	Total
Head-count	6.4	41.3	36.3	4.2	38.3	31.7
Poverty gap		11.1			8.6	

Source: *Bhutan Poverty Analysis Report, 2004.*

13. The BLSS estimates suggest that the poverty headcount rate is 31.7 percent, and based on the official population figures for 2004, there are about 238,606 poor people in the Kingdom. The poverty rate is comparable with neighboring countries in South and Southeast Asia (Figure 1). Poverty is concentrated in rural areas, which are home to 97.4 percent of the poor in Bhutan. At the regional level, the East is the poorest part of Bhutan (Figure 1).

Figure 1: Poverty Headcount Rates, 2003



Source: *Bhutan Poverty Analysis Report, 2004.*

2. Attaining the Millennium Development Goals for Poverty Reduction and Human Development

14. Notwithstanding data limitations,¹⁰ available information suggests that Bhutan is likely to achieve most of its MDGs by 2015 (see Table 2). In fact, it has already attained two of the MDGs—reducing the

⁹ The BLSS was a nationwide survey of households undertaken by the National Statistical Bureau, using the Living Standards Measurement Study (LSMS) methodology developed by the World Bank.

¹⁰ A rigorous analysis of MDGs in Bhutan is constrained by a lack of data. In order to assess progress towards the MDGs, it is important to have time-series data on relevant indicators. The MDG analysis reported here is based on piecing together available data through linear trend analysis. Officially, the MDGs are set in terms of targets for 2015 relative to the attainment levels of 1990. In order to get the 1990 value of an indicator for Bhutan, linear extrapolation is used from actual available data. The 2015 target is then estimated from the extrapolated figure for 1990. This is compared with the predicted value of the indicator for 2015 from its actual linear trend. Thus, the actual path is compared to the MDG target path to judge whether Bhutan is on track to achieve an

number of underweight children under-five years of age and improving access to safe water. For universal primary enrollment and reducing the incidence of malaria, the Kingdom is marginally off track, but the deviation from the target path is small and achievement remains possible. Bhutan seems largely off-track only for gender equity in tertiary education enrollment and births attended by skilled personnel.

Table 2: Millennium Development Goals: Bhutan's Progress and Remaining Challenges

(In percent, unless mentioned otherwise)

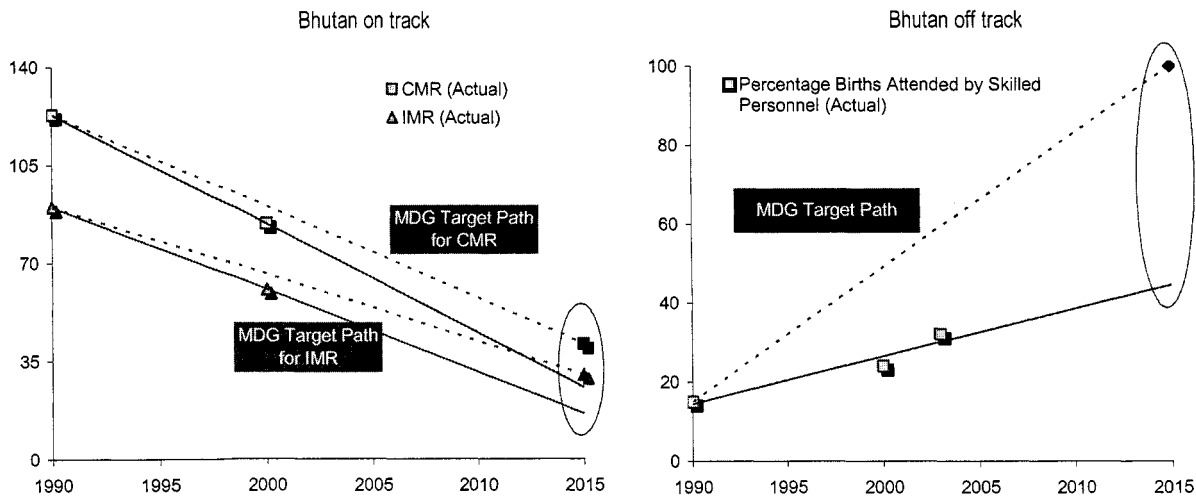
Millennium Development Goal	Indicator to measure progress	Value of indicator in 1990	Value of indicator in 2000	Value of indicator in 2003 or 2004	Year 2015 target	Likelihood of Attainment
1. Eradicate Extreme Poverty and Hunger	Population below poverty line	51.6	36.3	31.7	25.8	Likely
	Underweight children under 5 years of age	38.0	19.0	-	19.0	Achieved
	Stunted children under 5 years of age	56.0	40.0	-	28.0	Likely
2. Achieve Universal Primary Education	Gross primary enrollment	55.0	72.0	84.0	100	Possible
	Pupils starting grade 1 who reach grade 7	35.0	81.0	86.0	100	Likely
	Pupils starting grade 1 who reach grade 5	73.0	91.0	94.0	100	Likely
3. Eliminate Gender Disparity in Education	Primary Education: Girls per 100 boys	69.0	82.0	95.0	100	Likely
	Secondary Education: Girls per 100 boys	43.0	78.0	96.0	100	Likely
	Tertiary Education: Girls per 100 boys	12.0	41.0	53.0	100	Unlikely
4. Reduce Child Mortality	Under-five mortality rate (per 1,000 live births)	123.0	84.0	-	41.0	Likely
	Infant Mortality Rate (per 1,000 live births)	90.0	60.5	-	30.0	Likely
5. Improve Maternal Health	Maternal Mortality Ratio (per 100,000 live births)	560	255		140	Likely
	Births attended by skilled health personnel	15.0	24.0	32.0	100	Unlikely
6. Combat HIV/AIDS, malaria and other diseases	Reported Tuberculosis Cases	4232	1140	1002	0	Likely
	Reported Malaria Cases	22126	5935-	2760	0	Possible
7. Ensure Environmental Sustainability	Population without access to safe water	55.0	22.2	16.0	27.5	Achieved
	Population without access to improved sanitation	33.0	12.0	7.4	17.5	Achieved

Notes: The likelihood of attaining MDGs is based on linear projections from available time series data (National Health Survey for health indicators, Education MIS for the education indicators). For poverty, trends are calculated from HIES and BLSS data. 1990 data are extrapolated from linear trends. The data for 2015 are targets as related to the 1990s extrapolated values. Data are as presented on the Millennium Development Goals Progress Report 2005 prepared by the Department of Planning, RGoB.

MDG target. For more information, see "Poverty and Human Development in Bhutan: Past Achievements and Future Challenges," World Bank Note, October 2005.

15. For example, for Infant Mortality Rates (IMR) and Child Mortality Rates (CMR), the MDG target is above the predicted actual value for 2015—indicating that the Kingdom is on track to reduce the IMR and CMR by two-thirds between 1990 and 2015 (Figure 2). On the other hand, for access to reproductive health services, Bhutan appears off-track in its goal of providing skilled attendants to all births by 2015—as the predicted value for 2015 from the actual data trend is only 44.5 percent, well below the MDG target of 100 percent (Figure 2).

Figure 2: Some Millennium Development Goals for Bhutan



Source: Based on actual data from National Health Surveys. IMR and CMR presented per 1,000 live births.

16. **Some specific policy challenges are identified based on the linear trend analysis.** First, special efforts are needed to enroll and retain all children in school. Reaching out-of-school children is a major challenge, since they belong to families who need the children’s financial contribution in the form of work, and/or who live in remote, isolated communities. Second, in order to meet its Maternal Mortality Rate (MMR) reduction objectives, the RGoB needs to make major efforts to expand access to Emergency Obstetric Care (EOC) services, reduce maternal anemia (largely due to iron deficiency - which was as high as 88.2 percent in 2001), and increase the share of deliveries attended by skilled personnel. Third, even though gender disparity in the country is low in general, and there are only small differences in poverty and human development outcomes by gender, it is clearly important to have specific measures to encourage women’s participation in higher education. It should be noted that geography greatly increases the unit cost of providing adequate public services, especially in initiatives like expanding access to schooling or EOC services in very remote and sparsely populated areas.

3. Macroeconomic Developments and Outlook

17. Over the past two decades, Bhutan’s economic performance has been strong as indicated by low inflation, manageable fiscal deficits, high reserves, and solid growth. As noted above, growth averaging more than 6 percent over the past 25 years has been underpinned by sound macroeconomic management, the exploitation of hydropower resources, and strong donor support. The free trade regime with India and the policy of maintaining the Ngultrum exchange rate pegged to the Indian Rupee have been instrumental in maintaining this solid macroeconomic performance.

18. In 2004-05, growth is likely to have decelerated to around 6 percent, mainly due to a slowdown in the construction sector with the winding down of the Tala Hydropower Project (Table 3). Although agriculture continues to employ over 70 percent of the labor force, its share of GDP is in secular decline, falling from 52 percent in 1980 to about 25 percent at present. Following several years of stagnation in the number of tourist arrivals after the 9/11 terrorist attacks in the United States, tourism boomed in 2004-05, with arrivals and revenues from related activities growing by over 65 percent compared with the previous year. The sector continues to account for less than 2 percent of GDP, however, though it holds much potential. On the expenditure side, the public sector remains a key driver of growth. Large revenues from external donor assistance and hydropower sales to India flow through the government, and public investment (like in hydropower projects) and spending on the provision of public services plays a central role in ensuring the continued buoyancy of the economy. Spending by state owned enterprises also accounts for a significant portion of GDP (roughly 14 percent in 2004-05).

Table 3: Medium-Term Macroeconomic Framework (2005/06-2007/08)

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Output and prices:							
Nominal GDP at factor cost (millions of Nu)	23677	26363	29458	32814	36439	48543	52625
Nominal GDP at factor cost (millions of US dollars)	491	550	649	736	832	1086	1152
Real GDP Growth (annual percent change)	7.8	7.0	8.2	6.2	5.0	28.4	3.7
CPI (annual percent change)	2.7	1.8	3.5	3.7	3.1	3.1	3.3
Interest rate (91-day RMA bills)	4.7	3.5	3.5	3.5	3.5	3.5	3.5
Balance of payments:							
Current account balance (incl. grants) (mill. of US \$)	-48	-67	-55	-190	-150	-68	-38
(In percent of GDP)	-9.8	-12.2	-8.5	-25.8	-18.0	-6.2	-3.3
Exports (millions of US dollars)	104	113	158	186	234	349	460
Imports (c.i.f.) (millions of US dollars)	-186	-190	-245	-411	-464	-468	-468
Memorandum items:							
Total Electricity Sales (millions of Nu)	2,171	2,849	3,366	3,673	4,058	12,344	12,654
(percent change)		31.2	18.2	9.1	10.5	204.2	2.5
o/w Exports (millions of Nu)	2,027	2,363	2,815	2,631	2,868	10,482	10,628
(percent change)		16.6	19.1	-6.5	9.0	265.5	1.4
Government revenue from electricity sales (mill. of Nu)		1680	2025	1952	1808	4879	4816
Tourist arrivals	4195	6087	6872	11526	12679	13946	15341
(percent change)		45.1	12.9	67.7	10.0	10.0	10.0
Tourist receipts (\$ million)	7.9	8.5	9.2	15.3	16.8	18.5	20.4
(percent change)		7.6	8.0	66.7	10.0	10.0	10.0
Exchange rate (nu. per US\$)	48.2	47.9	45.4	44.6	43.8	44.7	45.7
Gross foreign reserves (millions of US\$)	315	373	383	420	467	504	549
(In months of GNFS imports)	17.2	19.4	16.2	10.8	10.3	10.6	11.0

Source: Macroeconomic Framework Coordination Committee, Ministry of Finance, Royal Government of Bhutan.

19. The external sector has exhibited substantial current account deficits in recent years. In 2004-05 two new Airbus passenger jets were acquired, raising the current account deficit sharply to about 25 percent of GDP. Over 90 percent of Bhutan's trade is with India. Receipts from abroad are dominated by revenues

from hydropower exports to India, grants (both project tied and program) from India, and grants from other development partners. Tourism is the largest earner of hard currency.

20. While the RGoB aims to limit the overall fiscal deficit, including grants to 4-5 percent of GDP, the small scale of Bhutan means that one or two items can have a major impact, and volatility remains a major concern. For example, a delay in the program grant caused a large deficit in 2002-03, followed by a sharp improvement in 2003-04 (Table 4). The purchase of the Airbuses led to an overall deficit of 12.5 percent of GDP in 2004-05, after significant fiscal retrenchment. In the 2005-06 budget, the RGoB has projected revenues based on Tala coming on-stream in mid 2006, and two years' of excise duty refunds from India. A delay in Tala of only a couple of months, or realizing only one year's worth of excise duty refunds, would bring a substantial change in the fiscal picture, in excess of 10-15 percent of total revenue. Hence, managing volatility continues to be an important challenge for the RGoB. Persistent deficits and the 40 percent debt portion of the massive investment in the Tala Hydropower Project have led to a sharp increase in debt stocks, from the equivalent of about 40 percent of GDP in 2000 to over 90 percent of GDP in 2004-05.

Table 4: Central Government Budget Summary and Medium-Term Fiscal Framework (2005/06-2007/08)

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
	<i>Actual</i>	<i>Actual</i>	<i>Actual</i>	<i>Budget</i>	<i>Proj.</i>	<i>Proj.</i>
	<i>(as a percentage of nominal GDP)</i>					
Total Revenue & Grants	26.8	35.4	33.8	35.3	35.4	31.0
Domestic Revenue and Program grants	21.2	23.1	23.8	25.5	23.1	21.2
Domestic Revenue	18.2	17.2	18.5	20.3	20.7	21.1
Program Grants	3.0	5.9	5.3	5.2	2.5	0.1
o/w India	3.0	5.9	5.3	4.8	2.2	0.0
Project-tied Grants	5.6	12.3	10.0	9.8	12.3	9.8
o/w India	0.5	1.8	2.7	5.4	7.7	5.7
Expenditure and net lending	37.7	33.4	46.3	40.3	35.3	34.0
Total Expenditure	37.5	33.3	47.4	40.2	37.5	36.4
(without DrukAir planes)	37.5	33.3	42.1	40.2	37.5	36.4
Current expenditure	17.4	17.5	19.8	18.9	18.0	18.0
Capital expenditure	20.1	15.8	27.6	21.3	19.5	18.4
Net lending	-0.2	0.0	0.1	0.1	-2.3	-2.4
Fiscal Balance (including all grants)	-11.0	2.0	-12.5	-5.0	0.2	-3.0
Financing, net	11.0	-2.0	12.5	5.0	-0.2	3.0
External (project-tied loans, net)	5.8	3.2	4.3	2.9	-1.4	-0.5
Domestic financing, net	5.1	-5.1	8.2	2.1	1.3	3.5
Memorandum Items:						
Total government debt (percent of GDP)	81.0	80.6	91.4	92.9	70.0	68.1
Foreign debt (percent of GDP)	72.8	78.5	81.3	81.6	60.3	55.6
Domestic debt (percent of GDP)	8.1	2.1	10.1	11.2	9.7	12.5
External debt service (percent of exports)	3.4	2.5	3.7	5.0	10.5	8.2
Nominal GDP at factor cost (mn. Ngultrum)	26363.3	29458.2	32814.1	36438.9	48542.7	52625.2

* Note: Support from the Government of India for the Tenth Plan (2007-08 to 20011-12) is still under discussion.

Source: Macroeconomic Framework Coordination Committee, Ministry of Finance, Royal Government of Bhutan.

Table 5: Revenue and Expenditure Growth

	2003/04	2004/05	2005/06	2006/07	2007/08
	<i>Actual</i>	<i>Actual</i>	<i>Budget</i>	<i>Proj.</i>	<i>Proj.</i>
	<i>(percent change)</i>				
Expenditure and Net Lending	-1.0	54.5	-3.3	16.4	4.5
Expenditure excluding Druk Air	-0.9	40.9	6.1	24.3	5.3
Current expenditure	12.4	26.3	5.9	8.3	8.2
Capital expenditure	-12.4	56.9	5.1	21.9	2.6
Total revenue and grants	47.7	6.5	15.9	33.6	-5.1
Domestic revenue	5.6	20.0	21.8	35.9	10.9
Grants	136.5	-6.2	8.8	30.6	-27.6
Nominal GDP growth	11.7	11.4	11.0	33.2	8.4

21. With continued good macroeconomic management, hydropower development, and donor support, the economic prospects in Bhutan are bright. Much will depend on the timing and net impact of Tala coming on stream. Electricity generation from Tala is expected to begin in July 2006. When the plant is fully operational, it will raise electricity generation by 230 percent and lead to a 28 percent jump in GDP in 2006/07 (similar to the rise experienced when the previous major hydroelectric power plant, Chukha, was commissioned in 1988).¹¹

22. It is worth noting that hydropower does not directly generate many jobs, and total employment in the sector, including Tala, is likely to remain below 4,000, less than 2 percent of the estimated labor force, when the sector will account for about 25 percent of GDP. Generating adequate employment opportunities for growing cohorts of school leavers, as well as those moving out of agricultural activities as part of an accelerating trend towards urbanization, is a major challenge. Manufacturing appears to be growing slowly, constrained by the absence of scale economies and other hindrances like access to suitable land. Tourism holds much potential for broad based service employment, but remains a relatively small share of the economy, and highly seasonal. Hence, public sector spending is likely to continue to drive employment and growth, through investments in infrastructure and the like, boosting construction activity, and expenditure on the provision of public services, such as education and health. Indeed, the RGoB is looking to Tala revenues to help meet its rising recurrent costs associated with the expansion in access to schooling and health care.

23. High expectations surround the commissioning of the Tala hydropower plant and domestic revenue and grants are likely to increase by over 33 percent in 2006-07 compared to the previous year (Table 5). Still, the overall resource envelope may increase by much less, as large repayments will begin with the commissioning of Tala, and the Government of India may reduce its program grants to Bhutan. In addition, other donors also plan to reduce or cease operations in Bhutan concomitantly, either for logistical reasons, or because of the high expectations associated with Tala. This was also discussed at the recently concluded Ninth Round Table Meeting in Geneva, where it was felt that further support was needed to help the RGoB meet emerging development challenges (such as political and institutional reforms). Given these circumstances, expenditure growth will need to be moderate in the coming years (especially current expenditure, which is not financed by project-tied loans) in order to limit the extent of domestic borrowing (Table 5). Part of the impetus for the DPG stemmed from the anticipated financing needs for 2005-06 and 2007-08, as described in the MTFP laid out in the Table 4.

¹¹ It is worth noting that the 28 percent increase in GDP would result if the commissioning of Tala coincides with the fiscal year. In the event of delay, even by a few months, the economic boost from Tala would be distributed more evenly across 2006/07 and 2007/08.

24. Bhutan's debt burden indicators are expected to remain high over the short term; however, they are set to decline sharply after the Tala hydroelectric project comes on stream and are likely to remain within manageable levels thereafter. The commissioning of Tala will, however, initiate the servicing of Tala-related debt. This is expected to raise Bhutan's debt servicing obligations. It should be noted that debt service obligations have been rising more slowly than debt, since much of it is highly concessional.¹²

25. Overall, the macroeconomic framework is adequate. It is worth noting that the RGoB has taken several initiatives to strengthen capacity for macroeconomic monitoring and analysis, to help underpin policy formulation and possible corrections, should they be needed. These include strengthening, refining and integrating the MTFF into the budget formulation process (as a first step towards its goal of implementing multi-year rolling budgets), and building debt management capacity with new software and training that will enable the RGoB to monitor debt more closely. Indeed, these elements are to be supported by the DPG, as described in greater detail below.

III. REFORM AGENDA OF THE ROYAL GOVERNMENT OF BHUTAN AND SUPPORT FROM THE BANK

1. Development Vision and Poverty Reduction Strategy

26. Bhutan's development has been directed by its own distinctive approach, which has attracted strong support from external donors. This approach rests on the overarching notion of Gross National Happiness, propounded by His Majesty the King in the early 1970s, and emphasizing the importance of balancing material, spiritual, emotional and cultural wellbeing as elements that together bring happiness to the individual. More recently, these aspirations were articulated in the document *Bhutan 2020: A Vision for Peace, Prosperity and Happiness*, prepared in 1999 through a highly consultative process involving representatives from the RGoB, the private sector, non-governmental organizations and communities. It seeks to translate the notion of GNH into a series of national objectives emphasizing: (a) human development, (b) cultural heritage, (c) equitable development, (d) good governance, and (e) environmental conservation. In the same vein as the MDGs, *Bhutan 2020* establishes long-term objectives, including providing electricity to 50 percent of the rural population, and ensuring that 75 percent of the rural population live within half a day's walk from the nearest "motorable" road by 2012.

27. The Ninth Five-Year Plan (2002-03 to 2006-07) outlines more detailed targets and strategies, and was prepared following a consultative process that pulled together 201 *Gewog* (block) plans, 20 *Dzongkhag* (district) plans, and numerous sectoral plans. As noted above, the Ninth Five-Year Plan has five overall goals: (i) improving quality of life and income, especially for the poor, (ii) ensuring good governance, (iii) promoting private sector growth and employment generation, (iv) preserving and promoting cultural heritage and the environment, (v) achieving rapid economic growth and transformation. The strategies for achieving these goals are:

- **Infrastructure Expansion:** The Ninth Plan gives a high priority to improving infrastructure, including roads, electricity, and telecommunications to help address the key issue of access, especially in rural areas.
- **Sound Macro-economic Policy:** With a view to providing the macroeconomic underpinnings for continued and steady economic growth, the Plan sets several targets, such as meeting recurrent expenditures with domestic revenues, limiting inflation to around 7-8 percent per annum, and maintaining an adequate level of international foreign exchange reserves.

¹² The next annual joint World Bank-IMF DSA will be prepared sometime in the first half of 2007.

- **Ensuring Good Governance:** Good governance through increased decentralization is a key part of the development strategy, and the *Dzongkhag* and *Gewog* elected councils have substantial autonomy to make plans, allocate resources, and frame rules and regulations applicable within their respective jurisdictions.
- **Improving Access and Enhancing Social Services:** Access is the defining development issue in Bhutan, and the Ninth Plan aims to improve access for rural populations to opportunities and services. Hence, rural development is being promoted with the expansion of roads, the improvement of market access, and the creation of opportunities in agro-business, horticulture, and small-scale handicraft industries. Improved access to key public services is also a high priority. In education, the government is constructing community primary schools, revising curricula, continuing adult literacy programs, and establishing the Royal University of Bhutan. Similarly, in health, the RGoB is working to increase access to doctors, control the spread of STD/HIV/AIDS, and ensure the financial sustainability of health services.

28. In addition to the overall development program outlined above, the RGoB has embarked on a series of related reform initiatives over the past few years. For example, the RGoB seeks to implement Multi-Year Rolling Budgets (MYRB) to strengthen links between annual budgets and the Five-Year Plans. There is an effort to foster private sector development through new legislation on labor and foreign direct investment. As described in greater detail below, the DPG supports these elements of the Government's reform program, and helps draw them together in an integrated manner.

2. World Bank Group Assistance Strategy (FY06 - 09)

29. The FY06-09 CAS is closely aligned with the Ninth Five-Year Plan/PRSP. It was prepared in consultation with various levels of government, the private sector, development partners, and other stakeholders. As described above, the CAS emphasizes selectivity, and envisages Bank Group support for development in Bhutan based on three pillars: (i) expanding access to better infrastructure and quality social services, as well as connecting communities to markets; (ii) promoting private sector development and employment; and (iii) strengthening the management of public resources, as well as the monitoring and evaluation of development outcomes. The CAS also aims to help underpin several of the cross-cutting elements of the RGoB's development program, including promoting effective decentralization, good governance, and sound environmental management.

30. Following from these CAS pillars in support of the RGoB's Ninth Five-Year Plan/PRSP, the FY06-09 CAS proposes financial assistance in the form of two development policy operations. As noted above, with a deepening of the reform initiative, future operations could be annual and be designed on the basis of lessons learnt. These budget operations will be a central part of the Bank's strategy to help the RGoB in implementing its poverty reduction strategy and in achieving other development goals.

Bank Activities and Collaboration with Other Development Partners

31. The Bank's support to the various proposed sectors/themes through the CAS builds on the ongoing engagement both in terms of projects, as well as analytical and advisory services. There has been a deepening engagement on macroeconomic, fiscal and financial management issues, which is to be further assisted through CAS pillar 3 and DPG item 1. The Bank and other development partners (including the UNDP) have been providing technical assistance to help the RGoB develop capacity for monitoring macroeconomic indicators, preparing an MTEF, and moving forward with their goal of implementing MYRB. To support these important public expenditure management initiatives, an IDF grant was approved at the end of 2004-05. Similarly, in the financial management area, an existing IDF is supporting (i) the drafting of the Public Finance Act; (ii) the establishment of a training and certification program to build capacity for finance, accounting, internal audit, and management staff in the National Finance Service; and

(iii) building capacity in the Department of Budget and Accounts to implement budget reforms, as well as in the Royal Institute of Management to improve training. This technical assistance program was designed on the basis of the Country Financial Accountability Assessment (CFAA) that was done in February 2002. Bhutan's development partners, including the Bank, are working together to help promote harmonization around the country's national fiduciary and safeguard systems. The Bank's ongoing fiduciary work is seeking to compare national and international public sector accounting and auditing standards.

32. The Bank has sought to help the RGoB foster the nascent formal private sector, which is to be further supported under CAS pillar 2 and DPG component 2. Technical assistance has been provided in key areas such as the development of legislation for foreign direct investment (FDI), promotion of small and medium enterprises (SMEs), and capacity building in the Bhutan Chamber of Commerce and Industry (BCCI). Analytical support has been provided through the *Private Sector Survey* (2002) mentioned above, and the *Doing Business Report* (2005). Building on the private sector survey work, the Bank Group, in collaboration with the Foreign Investment Advisory Service (FIAS), is providing crosscutting support to help improve the country's overall business environment. The IFC approved a \$10 million investment in the tourism sector in 2004.

33. Improving access to public services, especially education and more recently health, has been a central plank of Bank financial assistance. The ongoing Education Development Project (EDP)—a \$31 million IDA credit—supports Bhutan's five-year education development program to expand access to primary and secondary education, and improve education quality at all levels. The RGoB has coordinated the EDP's inputs with those of other donors, including Canada's support for curriculum reform for English at all levels of schooling, UNICEF's assistance with the establishment of resource centers, and DANIDA's budget support to the Ministry of Education. The HIV/AIDS and Sexually Transmitted Infections (STI) Prevention and Control Project (IDA Grant H1030) was approved in June 2004 to help the RGoB make progress in this vital area. While the project's main focus is on prevention, it also provides support for treatment and activities designed to strengthen Bhutan's ability to control HIV and STI. DANIDA, UNICEF and WHO are other development partners who are providing technical support on a number of related activities. Improving access to education and health are to be supported under CAS pillar 1 and through DPG components 3 and 4.

34. Several background notes/papers have been prepared by the Bank's team in developing this operation. The papers are on (a) poverty and MDGs; (b) private sector development and employment generation; (c) medium-term macro/fiscal issues; (d) financial management; (e) education; and (f) health issues.

IV. THE PROPOSED FIRST DEVELOPMENT POLICY GRANT

35. The proposed DPG I is the first in a series of two planned budget operations over the current CAS period FY06-FY09, and supports four components of the RGoB's interrelated developmental reform strategies. The associated policy program matrix, which outlines specific actions and benchmarks for these components, is appended to this Program Document. The reform components supported by the DPG are:

1. Ensuring the maintenance of a sound macroeconomic framework, strengthening fiscal policy, and bolstering financial management and accountability;
2. Enhancing the investment climate for private sector growth and employment generation;
3. Augmenting the quality of and access to education; and
4. Improving health care.

36. Specific government actions supported by the proposed DPG are described in Box 1 (see below) and are also reported at the end of each-sub-section. The Bank's program has two types of actions: (i) *up-front or prior actions* that are to be completed before the proposed DPG will be presented to the Bank's Executive Board; and (ii) *triggers* which are indicative for a second DPG/DPC and would need to be largely met before it could go forward. The RGoB has met all of the up-front actions.

Box 1: Up-Front Actions & Triggers and Associated Medium-Term Outcomes & Indicators	
Up-front Actions/Triggers	Medium-Term Outcomes & Indicators
Theme 1: Macroeconomic, Fiscal and Financial Management. <i>Ensuring the maintenance of a sound macroeconomic framework, strengthening fiscal policy, and bolstering financial management.</i>	
<p>Up-front Action 1. The RGoB's MTFF will specify target ranges for key fiscal indicators, including overall balance, the resource gap and debt, based on and consistent with a sound macroeconomic framework. It will be submitted to the Committee of the Council of Ministers (CoM) in January 2006 and the CoM's endorsement of the MTFF will be sought as a basis for the preparation of the 2006-07 budget.</p> <p>Trigger 1. The MTFF is circulated as a part of the annual budget preparation process starting in 2007-08, and annual budget numbers (expenditure, revenue, deficits and debt) are developed in accordance with MTFF targets. This will also involve implementing the strengthened debt management system.</p>	<p>Outcome. Fiscal policy is strengthened through the development and adoption of a multi-year budget process, which emphasizes systematic projections of resource availability, closer links between sectoral goals and budgets, and transparency.</p> <p>Indicators. (i) Annual budget numbers are increasingly in accordance with the MTFF; and (ii) Greater fiscal marksmanship with a reduction in the variance between the budgeted expenditures and subsequent spending.</p>
<p>Up-front Action 2. The RGoB will submit the draft Public Finance Act to the CoM.</p> <p>Trigger 2. In-year budget reports and annual financial statements are prepared on a timely basis.</p>	<p>Outcomes. Improved management of public finances through (i) Satisfactory legal and institutional framework for PFM; (ii) Improved transparency, reliability and timeliness of RGoB finances; (iii) Improved quality of financial information for decision making for each fiscal year; and (iv) Improved accountability on public financial management issues.</p> <p>Indicators. (i) Reconciliation and clearance of suspense accounts and advances take place at least quarterly within a month from end of period and with few balances brought forward; (ii) Improved timeliness and reliability in availability of funds to the spending departments; and (iii) Timely and regular in-year budget reports prepared quarterly and issued within 6 weeks of end of quarter consolidated annual financial statements prepared annually and submitted for external audit within 6 months from the end of the fiscal year.</p>
2. Private Sector Development. <i>Enhancing the investment climate for private sector growth and employment generation.</i>	
<p>Up-front Action 3. The draft Labor and Employment Act is submitted to the CoM by December 2005 and the process for recruiting foreign workers is streamlined.</p> <p>Trigger 3. The draft Labor and Employment Act is submitted to the National Assembly by July 2006.</p> <p>Up-front Action 4. Foreign Direct Investment (FDI) rules and regulations are approved by December 2005.</p> <p>Trigger 4. The business registration process is simplified, including the number of procedures, time taken and costs involved, by March 2007.</p>	<p>Outcome. More flexible labor markets, leading to an improved business environment for potential investors and better job opportunities.</p> <p>Indicators. (i) Time taken to issue approval for foreign workers' recruitment is reduced from 3 months to 3 weeks; and (ii) Number of foreign workers hired in foreign direct investment activities is flexible, governed by business needs.</p> <p>Outcome. Improved FDI environment in the country.</p> <p>Indicator. A 5% increase in FDI from 2002-03.</p> <p>Outcome. The cost of setting up a business is reduced and private sector growth is encouraged.</p> <p>Indicator. Time to register a firm is reduced from 62 days in 2004-05 to 47 days.</p>

3. Education Reform. <i>Augmenting the quality of and access to education.</i>	
<p>Up-front Action 5. As part of the implementation of its policy to expand education coverage through the establishment of new CPSs in underserved areas, the RGoB will establish 23 new CPSs in remote and/or underserved areas to increase enrollment and completion at the primary level, helping make progress toward the achievement of the education-related MDG target.</p> <p>Trigger 5. In continuing to implement its improved access to schooling policy, the RGoB plans to establish an additional 20 CPS schools by December 2007.</p> <p>Up-front Action 6. A curriculum framework is to be developed for English from classes pre-primary (PP) to 12, by December 2005.</p> <p>Trigger 6. The reformed EMIS system is to be piloted, with a first version of the EMIS available for use, learning and capacity building by December 2007.</p>	<p>Outcome. Wider access to schooling services, helping raise enrollment and completion.</p> <p>Indicator. Increase in Net Enrollment Rate (NER) as evidenced by annual MOE statistical summaries.</p> <p>Outcome. Increased quality and relevance of English curriculum leading to long-term goal of improved English proficiency among school leavers.</p> <p>Indicators. (i) All teachers of English familiarized with content of newly-developed grade-wise program of studies; (ii) Number of resource center- and dzongkhag-based workshops for English teachers to provide initial familiarization for using the new curriculum; and (iii) Inclusion of special supplement in the quarterly CAPSD Newsletter on the content of the new grade-wise program of studies for English.</p> <p>Outcome. Enhanced capacity to plan and monitor education system progress based on availability of more accurate, user-friendly, and automated data.</p> <p>Indicator. Better targeted planning, particularly for preparation of the 10th Five-Year Plan at the dzongkhag and central levels.</p>
4: Health Sector Reform. <i>Improving Health Care.</i>	
<p>Up-front Action 7. A draft strategy to increase institutional deliveries (child birth) is developed and two districts, where the strategy is to be piloted, are selected.</p> <p>Trigger 7. Prepare guidelines for the establishment of improved patient referral networks (for institutional deliveries), quality of care and measures to increase demand at the community level on the basis of lessons from the pilots. June 2007.</p>	<p>Outcome. Reduced maternal mortality.</p> <p>Indicator. Increased proportion of births delivered in Essential Obstetric Care (EOC) facilities from 26.2 percent in 2004 to 36.0 percent in June 2008. The indicator is based on 26 EOC facilities, and the denominator is the estimated number of births for 2004 derived from annual household surveys of 10 percent of households.</p>

37. Several of these up-front actions and triggers are process oriented, but this is appropriate in the context of Bhutan because: (i) some of these processes relate to specific policy or institutional changes that are desirable, and (ii) these actions and triggers are both meaningful and feasible, given the capacity constraints. For example, while the successful *implementation* of a new law is a desirable outcome, the interim process could be long, technically-demanding and politically-sensitive, requiring strong support for the process. In addition, low technical capacity and skill shortage is a significant factor impeding Bhutan's overall development progress, and the design of the proposed actions is mindful of these limitations.

1. Ensuring the Maintenance of a Sound Macroeconomic Framework, Strengthening Fiscal Policy, and Bolstering Financial Management and Accountability

(i) Institutional Changes in Macroeconomic and Fiscal Management

38. As described earlier, Bhutan's strong economic performance over the past two decades is in good measure attributable to the RGoB's sound macroeconomic and fiscal management. Still, the RGoB aims to improve its monitoring of macroeconomic indicators, including debt, and has undertaken specific initiatives to strengthen the budget preparation process. Building on a deepening dialogue between the RGoB and the Bank, along with other development partners, these areas are to be supported under the proposed DPG:

- (a) **Strengthening the macroeconomic framework.** A Macroeconomic Framework Coordination Committee (MFCC) and a Macroeconomic Framework Coordination Technical Committee were established by the RGoB at the end of 2005, to facilitate the regular preparation of reliable and systematically compiled macroeconomic and fiscal projections. This initiative arises from the RGoB's efforts to monitor macroeconomic and fiscal developments more closely, and will play an important role in helping the RGoB implement MYRB. Careful monitoring and possible policy changes to address emerging issues is especially important in the Bhutanese context, where a small number of factors can have a dramatic effect on the overall macroeconomic and fiscal situation. An important part of the MFCC's work will lie in disseminating its findings.
- (b) **Improving debt management systems.** The RGoB has acquired new debt management software and is currently training staff in the use of this tool to improve debt monitoring and to carry-out its own debt sustainability analyses in future (covering both external and domestic debt). Given the rapid buildup of debt in recent years (due to the Tala hydropower project as well as other deficit spending), careful monitoring and management of debt is a high priority.
- (c) **Bolstering the budget preparation and implementation process.** As a part of its effort to strengthen public expenditure management, the RGoB revised the Budget Manual in 2001, calling for the preparation of MYRBs. Among other goals, the MYRB initiative aims to link the five-year plans more closely to the annual budget process. However, the RGoB has yet to implement MYRBs, mainly due to capacity constraints and uncertainty surrounding the extent to which the existing budget system would need to be altered. As a first step toward instituting MYRBs, the MFCC prepared an MTFF (see Table 4 above), and used it as the basis for the 2006-07 budget calls that were issued at the end of 2005. The MTFF was endorsed by the Committee of the Council of Ministers (CoM) in January 2006 (thereby meeting an up-front action of the DPG), and is to underpin the 'Alternative Planning Framework' (APF) that was proposed by the Good Governance Plus taskforce. Following some further refinements, the RGoB plans to share the MTFF more widely and integrate it into the budget preparation process to help set the overall resource envelope. A workshop was held by the Department of Budget and Accounts of the Ministry of Finance in January 2006 to review how the MTFF envelope could be best used to develop sectoral expenditure envelopes and move to MYRB through: (i) the existing budget system, (ii) the APF, (iii) the revised framework being developed by the Planning Commission, and (iv) the structure described by the Ministry of Health. The approaches were congruent, but some effort is needed to resolve coordination issues, and develop a template for the line ministries. The MTFF will be instrumental in implementing MYRB, which is to be piloted in at least one sector in advance of the second planned DPG operation and following the preparation of guidelines.

Prior action for the DPG:

- (1 of 7) *The RGoB's MTFF will specify target ranges for key fiscal indicators, including overall balance, the resource gap and debt, based on and consistent with a sound macroeconomic framework. It will be submitted to the CoM in January 2006 and the CoM's endorsement of the MTFF will be sought as a basis for the preparation of the 2006-07 budget.*

Trigger for a future DPG/DPC:

- (1 of 7) *The MTFF is circulated as a part of the annual budget preparation process starting in 2007-08, and annual budget numbers (expenditure, revenue, deficits and debt) are developed in accordance with MTFF targets. This will also involve implementing the strengthened debt management system.*

39. As noted above, the prior action relating to the preparation of a sound and credible MTF, and its endorsement by the CoM was completed in January 2006, and is an essential part of the RGoB's effort to strengthen fiscal policy, build closer links between sectoral goals and budgets, and foster transparency. The endorsement of the MTF from the CoM signals that the MTF process enjoys sufficient support from across the government, beyond the Ministry of Finance. The trigger for a possible second operation, hinges on the actual integration of the MTF and the budget preparation process, and will provide a clear indication that the RGoB is making good progress towards its goal of implementing multi-year rolling budgets. Progress in this area will assist the RGoB in managing spending expectations for improved budget discipline, as well as anticipate variations in budget outcomes and take early corrective measures as needed. It will thereby also improve fiscal marksmanship, and be useful in helping the RGoB to manage volatility, a continuing challenge for the authorities.

(ii) Financial Management and Accountability

40. While the RGoB's existing public financial management and accountability system lacks legal underpinnings, it has been functioning satisfactorily. Following the Country Financial Accountability Assessment in 2003, a series of technical assistance activities have been undertaken, supported by several Institutional Development Fund (IDF) grants. Ongoing work notes the following strengths of the existing financial management system in Bhutan:

- The existence of detailed guidelines for the budgeting and monitoring of public funds, especially at the individual transaction level. The system provides good procedural transaction control over individual items of expenditure and receipts. All donor funds for development activities (except Tala) are included in the budget.
- The independence from the Executive of the external auditor, the Royal Audit Authority, is well established and recognized. Audits are regularly carried out and the Annual Audit Report of the RGoB is issued on a consistent basis (usually about 13 to 15 months after the end of the year). Annual reports are submitted to His Majesty the King and the National Assembly, and made publicly available.
- The ongoing computerization of all major payment, accounting and payroll-related functions, when fully integrated and networked, will help to significantly improve the quality, timeliness and reliability of accounting and financial information.

41. The RGoB recognizes that more needs to be done to strengthen and modernize its public financial management and accountability (PFMA) system. The following key components of the RGoB's on-going PFMA reform initiative have been included in the DPG program:

- (a) Establishing the legal underpinnings of the PFMA system.** The RGoB has drafted a Public Finance Act which will: (a) establish lines of responsibility for the use of public financial resources and provide a legal basis for the RGoB's financial rules; (b) provide a framework for scrutiny by the National Assembly of the RGoB's management of public assets and liabilities, including expenditure and revenue proposals; (c) encourage sound fiscal policy by specifying rules for fiscal sustainability and transparency; (d) establish financial management incentives to encourage the effective and efficient use of financial resources in the ministries and agencies; (e) specify the minimal financial reporting obligations of the RGoB's budgetary bodies and public enterprises; and (f) safeguard public assets by providing statutory authority and control for raising loans, issuing securities, giving guarantees, operating bank accounts, and investing funds. Submitting the draft to the CoM is an up-front action for DPG-I and was met in early 2006.
- (b) Separating the functions of the Department of Budget and Accounts.** The existing joint budget and accounting functions carried out by the Department of Budget and Accounts (DBA) are

overwhelming. At present, the DBA's budget functions (including notification, review of proposals, and eventual preparation) crowd out its accounting and treasury functions. As a result, insufficient attention is being paid to accounting work, which leads to major delays in the preparation of financial statements. The RGoB has segregated these key functions into two separate departments by Government Order. The next steps will be to re-assign staff and ensure that the roles and responsibilities of key staff are clarified. This change will assist in bringing efficiency and timeliness to the accounting and reporting functions.

- (c) ***Improving the Management Information System:*** The adoption of the budgeting and accounting system (BAS) in the line ministries/agencies and the central budgeting and accounting system in the DBA has brought about significant improvements in the financial management system over the past several years. Still, in the absence of adequate networking facilities, the process of compiling and preparing consolidated financial statements is time consuming. Another important responsibility of the DBA is to release funds to spending agencies on a timely basis. At present, funds are released through a manual Letter of Credit system with intimation to the respective bank. In order to expedite the release of funds, the DBA is proposing to develop a system using electronic transfers. Planned institutional changes include: (a) making the electronic transfer of fund releases operational in all spending agencies in Thimphu by January 2006, and (b) piloting the networking of the BAS between the DBA and three selected spending agencies in Thimphu by June 2006.
- (d) ***Strengthening legislative oversight of public finances.*** Deriving its mandate from a Royal Decree, the Royal Audit Authority (RAA) ascertains and evaluates whether government resources are handled in accordance with the established rules and regulations, and assesses whether public agencies within its audit jurisdiction, achieve the purposes for which they were established and for which resources have been made available. The Royal Decree provides a broad scope and a wide coverage for the audit function, and ensures that the RAA is fully independent. The institutional change proposed by the RGoB is to bring this within the legal framework of an Audit Act. A draft act has been prepared and is to be submitted to the National Assembly in the upcoming spring session. In addition, the RAA has set up a separate division to actively track and monitor responses by public spending units of audit observations until settlement/adjustment.

The role of the Legislature in scrutinizing the external audit reports is still emerging. The draft Constitution provides for the setting up of a five member Public Accounts Committee to review and report on the Annual Audit Report to the Parliament. In the interim, in accordance with the National Assembly Committees Act, 2004, a Public Accounts Committee has been set up and Rules of Procedures of the Public Accounts Committee drafted.

Prior actions for the DPG:

(2 of 7) *The draft Public Finance Act is submitted to the CoM.*

Triggers for a future DPG/DPC:

(2 of 7) *In-year budget reports and annual financial statements prepared on a timely basis.*

42. Overall, the RGoB is making good progress towards strengthening financial management, and the Public Finance Act was submitted to the CoM in February 2006, meeting this up-front action for DPG-I. The enactment of the Public Finance Act will provide the much needed legal underpinning for the Bhutanese financial management and accountability system. Clearly specifying rules and regulations, including lines of authority and responsibility, will facilitate the timely preparation of in-year budget reports and annual financial statements.

2. Enhancing the Investment Climate for Private Sector Growth and Employment Generation

43. As noted above, the Bhutanese economy is dominated by the public sector, with the nascent formal private sector continuing to be weak and small. Productivity is low and the cost of doing business is high, mainly due to high transport costs, inadequate infrastructure, lack of economies of scale stemming from small market size, and skill shortages. The challenging geography is an important determinant of these factors, compounded by a weak regulatory environment for domestic and foreign investment, rigid labor markets, and difficulties in accessing finance. Overcoming the constraints to private sector development will be important to sustaining robust growth and generating adequate employment. The tourism sector is growing rapidly and holds much potential, and could help absorb an increasing number of Bhutanese job seekers.¹³ Invigorating growth in manufacturing, particularly in agro-processing and forest-based industries also has the potential to provide good paying jobs. In the near term, however, public spending on services, and investment in hydropower development and other areas, like roads, will remain the main drivers of economic growth.

(i) Private Sector in Bhutan: Composition, Growth and Employment

44. The bulk of the formal private sector in Bhutan is small-scale, with nearly 98 percent of all licensed entities being cottage and small enterprises.¹⁴ Most of these enterprises are sole proprietorships with limited scope for growth due to both demand and supply side constraints. The medium and large enterprises—including agro processing units, cement, ferro silicon, calcium carbide, distilleries—account for the major share of private sector's business turnover and revenues.

45. There has been a rapid expansion in the number of licensed private enterprises in recent years (see Table 6).¹⁵ By 2003, there were 32,035 commercial and industrial establishments—an almost threefold increase since 1998. Of these establishments, the majority are in trade (55 percent) and construction (28 percent), followed by services (14 percent), and trailed by manufacturing (just over 2 percent).

Table 6: Licensed Business Establishment in Bhutan

	1998	1999	2000	2001	2003
Manufacturing	447	486	523	569	730
Construction	1,874	2,308	2,606	4,270	9,102
Services	2,530	2,922	3,281	3,773	4,478
Trade	7,045	10,947	11,724	12,455	17,725
Total	11,896	16,663	18,134	21,067	32,035

Source: Department of Industry, Ministry of Trade and Industry, 2004.

¹³ According to a recent projection by the Ministry of Labor, done in connection with the Tenth Five-Year Plan preparation, there will be a minimum of 56,850 job seekers at the end of 2012, out of which only about 36,200 are likely to find employment in the formal private sector. (Source: Kuensel, Vol. XX, No. 72, October 5, 2005.)

¹⁴ The size of establishment is determined by capital input: *cottage* enterprises have a capital base of Nu. 0.5 million (about US\$10,500) or less, *small* enterprises have a capital base between Nu. 0.5 and 5 million (between about US\$10,500 and US\$105,000), *medium* enterprises have a capital base of between Nu. 5 and 20 million (between about US\$105,000 and US\$420,000), and *large* enterprises have a capital base greater than Nu. 20 million (about US\$420,000). The cottage and small firms are largely comprised of small family-run businesses such as restaurants, tea stalls, and rice mills.

¹⁵ In view of limited data, the number of business licenses issued for private sector business is the best available indicator for measuring private sector growth.

46. While hydropower has been and will remain the major source of economic growth in Bhutan, it does not provide much employment directly, and the whole sector probably employs less than 4,000 people, as noted above. Hydropower and infrastructure projects, nonetheless, have led to a boom in labor intensive construction activities, providing substantial employment opportunities. Employment of Bhutanese nationals in the construction industry has grown from 5,592 in 2001 to 7,770 in 2003.¹⁶ As noted above, the agriculture sector is mainly subsistence and employs over 60 percent of the labor force, but its share in GDP has fallen from over 50 percent in 1980 to about a quarter now (see Table 7).

47. Since 1991, tourism is wholly run by the private sector. While it accounts for less than 2 percent of GDP, it is the single largest foreign exchange earner.¹⁷ It also has good potential for further employment generation. While there are important limitations in the employment data, estimates of direct employment suggest that the number of jobs has tripled from less than 1,000 in 1998 to over 5,000 currently. In addition, the sector provides seasonal employment for many workers in both urban and rural communities, as well as helping generate income in the handicraft and transport industries. The tourism industry is thus among the largest employers in the formal private sector. Given that the full potential of the industry has yet to be realized, prospects are good that the sector will enhance broad-based employment over the medium-term, especially among Bhutanese youths.

Table 7: Sectoral Composition of the Economy, Growth and Employment, 2004

Sector (s)	GDP (percentage share)	GDP Growth (percent)	Employment (percentage share)
Agriculture	24.0	3.6	63.2
Construction	23.0	19.0	3.3
Electricity	12.2	7.0	0.5
Manufacturing	7.9	6.0	6.0
Trade (including hotels & restaurants)	10.1	12.0	2.3
Finance, Insurance & Real Estate	5.4	4.0	5.8
Community and Social Services	1.8	6.0	7.5
Transport and Communications	8.7	5.0	1.2
Others	6.9		10.1

Source: Wangyal, T., 2005

(ii) Private Sector Development Reforms

48. One of the four key objectives of the Ninth Five-Year Plan is to promote private sector growth and employment generation. Indeed, the RGoB's ongoing reform initiative in this area is impressive in its breadth and depth of coverage. Expanding infrastructure, including roads, electricity and telecommunications, is a key part of the strategy. The RGoB is also developing several industrial estates with reliable, affordable power, and is planning to build a dry port to facilitate trade. Neighboring India has agreed to explore the potential of extending railway links to the Bhutanese border. Related policy reforms are also underway. In the last couple of years, a foreign direct investment policy was approved, the import tariff structure was simplified, the sales tax and customs duty on a wide range of domestic and commercial goods were abolished, a business facilitation cell was opened as part of the South Asia Sub-regional

¹⁶ Construction work in Bhutan is widely regarded as a low social status job which pays poorly and entails physical hardship. Most of the 32,000 registered expatriate workers in the country are engaged as construction laborers.

¹⁷ Bhutan's hydropower exports to India are paid in Indian rupees.

Economic Cooperation initiative, and new prudential regulations have been implemented towards strengthening the financial system.

49. During the Ninth Plan period (ending in 2006-07), the RGoB hopes to increase tourist arrivals to 15,000 without compromising the country's vision of balanced growth, and cultural and environmental preservation. International access to Bhutan is constrained by the fact that there is only one airport in the country, which is limited to visual approach landings. Recently, Druk Air, a public company and the only carrier flying to Bhutan, purchased two new aircraft, thereby increasing passenger capacity by 42 percent over the existing aircraft, as well as boosting cargo capacity that should help the nascent export sector. Efforts directed at expanding air services, upgrading the quality of hotel accommodations and services, diversifying and expanding tour programs and activities, and implementing more active and creative tourism marketing campaigns, are underway. With Austrian assistance, a Tourism Master Plan has been formulated to guide on-going efforts to scale up and attract the high-value segment of the market. The RGoB also considers the ICT sector an important potential source of direct and indirect employment. The sector holds promise for improving productivity and increasing competitiveness in existing private sector industries. Agri-processing is another potential source of growth in Bhutan, and has been identified as a priority export sector.

50. The Bank Group has been helping Bhutan in promoting private sector growth and in addressing concerns about growing unemployment. As noted earlier, analytical support has been provided through a *Private Sector Survey* (2002) and the *Doing Business Report* (2005). The RGoB has subsequently developed a rich agenda of policy and institutional reforms, covering labor market issues, skill shortages, regulations for facilitating domestic and foreign investment, and access to finance. The Foreign Investment Advisory Service (FIAS) has provided technical assistance in the development of the regulatory framework for foreign direct investment (FDI). The South Asia Enterprise Development Facility (SEDF) has sought to play a catalytic role in the promotion of small and medium enterprises (SMEs), and in the building of capacity in the Bhutan Chamber of Commerce and Industry (BCCI) as well as in financial sector institutions. The pace of reform is slow due to limited capacity and the time needed for institution building, but positive results are expected from ongoing policy initiatives as implementation gathers momentum.¹⁸ The following three key components of the RGoB's PSD reform activities have been included in the DPG program:

- (a) **Improving the functioning of labor markets through the development of flexible labor and employment laws.** As noted above, weaknesses in the functioning of the labor market are key constraints for private sector growth and employment generation. According to the *Doing Business* indicators, Bhutan currently has the least flexible labor market in the South Asia region: on the rigidity of employment index, which captures the rigidity of working hours as well as the difficulties and costs associated with hiring and firing workers, Bhutan's score is 49, compared to a regional average of 42. With the exception of some rudimentary regulation, there is no legislation or policy framework governing labor markets in the country¹⁹. Inflexibility can be partially explained by the segmented nature of the labor market: of total formal wage employment, it is estimated that non-nationals represent approximately 50 percent. Stringent restrictions exist on the recruitment of foreign workers; and when permitted, entail time-consuming procedures. Employment of nationals falls under the draft *Rules and Regulations on Employment of Bhutanese*

¹⁸ Given the recent and nascent nature of private sector activities in Bhutan, the country is starting from a narrow base in the development of key policies, laws, rules and regulations, along with accompanying institutions.

¹⁹ These include: (i) *Charim for Wage Rate, Recruitment Agencies and Workmen's Compensation*, 1994, and (ii) draft *Rules and Regulations on Employment of Bhutanese Nationals in the Private Sector*, December 1997. The latter are still under review and hence, they are not yet enforceable.

Nationals in the Private Sector (1997).²⁰ In practice, these rules are not well-enforced and firms report some flexibility in hiring and firing employees, and setting wages without any influence of organized labor.²¹ The minimum wage applies only to Bhutanese public sector workers, with limited impact on the private sector.²²

To address these issues, the RGoB is developing a comprehensive labor policy, along with legislation and accompanying rules and regulations, in order to streamline processes and help ease employment constraints. A central reform measure in this area is the drafting of a *Labor and Employment Act* to balance the legitimate needs of workers with the promotion of private sector activity. Key provisions of the draft Act that may help alleviate Bhutan's skill shortages and low productivity pertain to employee working hours, restrictions on night work, proscription of activities for 15-18-year olds—the group most affected by stringent labor institutions, and employment of foreign workers. Once effective, this Act will: (i) allow employment in a wide spectrum of economic activities (particularly for youths), (ii) provide for flexible working hours, (iii) permit night work in industries requiring an around-the-clock-work schedule, and (iv) make rules less restrictive on the hiring/firing of foreigners workers. The Bank's support would complement the Asian Development Bank's plans to provide follow-on technical assistance to the Ministry of Labor and Human Resources to help with the framing of accompanying rules and regulations and making the Act fully operational. Process reforms for recruitment of foreign workers are well-advanced. Through the launch of Labor Net - a web-based labor recruitment system - employers are able to apply for foreign workers' permits on-line, thereby facilitating access to applications and reducing the time needed for the approval processes.²³ The draft act was submitted to the CoM at the end of 2005, meeting this up-front action for DPG-I.

On the supply side, shortages of skilled workers are a binding constraint for private sector growth and productivity. The on-going efforts to raise the retention rates of children in school through secondary education, adapting the secondary school curriculum more closely to the needs of the private sector, and strengthening vocational training, job counseling, and entrepreneurship programs will be critical to raising the availability of skilled workers. The success of these programs will be gauged by the improved matching of labor supply from the vocational schools with the demands of the market.

(b) Creating an enabling environment for foreign direct investment: Creating an enabling environment for foreign direct investment (FDI) is an important element of the RGoB's private sector development and employment generation strategy. The overall objectives of encouraging FDI are to broaden employment and training opportunities, benefit from technology and skills transfer, expand the revenue base, and raise foreign exchange earnings. Towards achieving these goals, an FDI Policy was approved in 2002. This provides a clear policy on the regulation of foreign investment, particularly the entry of such investment, and policy on other matters, including guarantees that pertain only to foreign investors. Accompanying FDI Rules and Regulations were approved in December 2005, meeting this up-front action for DPG-I. The approval is considered an important first step in helping operationalize a transparent FDI

²⁰ Every time a new investment is made, a Memorandum of Understanding (MOU) is signed between the employer of the enterprise and the Ministry of Labor and Human Resource on behalf of the Government concerning the gradual replacement of foreign workers by Bhutanese "to meet the national objectives of generating sufficient gainful employment opportunities for Bhutanese nationals and to further economic development in the Kingdom."

²¹ According to the *Bhutan Private Sector Survey* (2002), no company in the sample experienced problems in firing poor performers – either Bhutanese or non-nationals.

²² The minimum wage for Bhutanese workers in the public sector is fixed at Nu100 per day. Some large private sector firms have followed the public sector's lead. Overall wage levels vary considerably with nationalities and regions.

²³ See www.employment.gov.bt/dol.

registration system. Within the regulated Bhutanese economy, it is expected that this will give comfort and protection to foreign investors. Some initial FDI gains have already been made in the manufacturing sector and in the tourism sector - with the establishment of new high-end and internationally renowned hotels. Efforts are also underway to strengthen investment promotion capacity within the Ministry of Trade and Industry. At the same time, the RGoB has drafted an *Industrial and Investment Act*, which would provide legal backing to the FDI Policy 2002. Upon the effectiveness of the FDI rules and regulations, serious FDI inquiries are likely to increase, followed by an increase in the number of MOUs signed. Once fully effective, the strengthened FDI law and set of policies/regulations should result in a significant increase in foreign investment.

- (c) Reducing the cost of doing business by simplifying the business registration process.** The RGoB recognizes that business registration and regulations pose a significant barrier to entry for new firms. As reflected in the *Doing Business* findings, in 2004-05 it took an average firm 62 days to register a company in Bhutan compared to the South Asian average of 47 days. To improve efficiency in the business registration process, the Department of Industries has undertaken a reform initiative to simplify the registration process. In addition, the amendment of the Companies Act and the consolidation of existing rules and regulations are being initiated. Reform efforts are also underway for improving the business environment for micro enterprises by streamlining entry and operational regulations. Capacity building initiatives have been undertaken for key staff of the Registrar of Companies. Once these reforms become effective, the time taken to register a firm is expected to be reduced to at least the regional average of 47 days.

Prior actions for the DPG:

- (3 of 7) *The draft Labor and Employment Act is submitted to the CoM, and the process for recruiting foreign workers is streamlined.*
- (4 of 7) *Foreign Direct Investment rules and regulations are approved.*

Triggers for a future DPG/DPC:

- (3 of 7) *The Labor and Employment Act is submitted to the National Assembly by July 2006.*
- (4 of 7) *The business registration process is simplified, including the number of procedures, time taken, and costs involved by March 2007.*

51. The RGoB's private sector development agenda is moving forward, and the two up-front actions in this area for DPG-I have been met. Over time, the initiative will help generate job opportunities, increase productivity enhancing FDI, and foster greater private sector dynamism. Progress will be monitored following several key indicators, such as the time taken to receive approval for foreign worker recruitment, the amount of FDI entering the country, the number of licensed enterprises, and the number of tourists.

3. Augmenting the Quality of and Access to Education

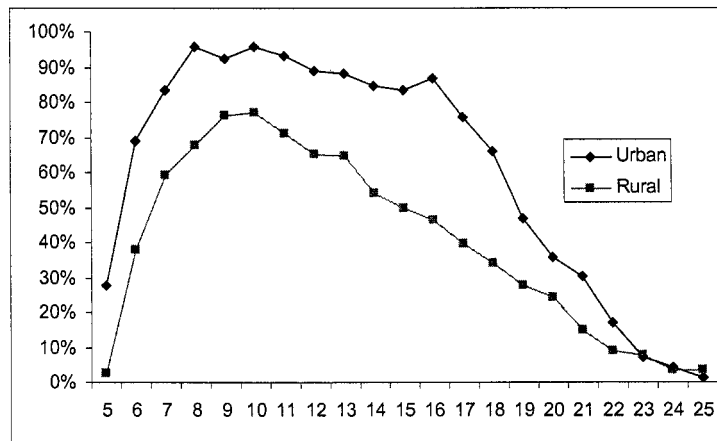
52. As noted above, human development is the cornerstone of Bhutan's development vision, and the Ninth Plan sets ambitious goals for the expanding access to primary and secondary education, as well as raising the quality of education at all levels. To support these goals, the Bank has undertaken a series of education sector projects, and the DPG will further underpin the RGoB's efforts.

(i) School Education: Achievements and Challenges

53. Since the adoption of a modern, western education system in the 1950s, the RGoB has expanded the number of schools and institutes from 11 in 1961 to 476 in 2005.²⁴ The number of students has risen to about 162,000 (as of February 2005). In 2003, according to the BLSS, the gross enrollment rate (GER) at the primary level was 93 percent and the net enrollment rate (NER) was 69 percent. At the lower secondary level, the GER was estimated at approximately 56 percent, dropping to just 13 percent at the higher secondary level. Literacy rates have risen over the last 15 years due to the promotion of basic education throughout the country, and the establishment of non-formal education (literacy/numeracy) classes for out-of-school youth and adults. The BLSS reported literacy in 2003 for the 10 to 14 age group at 75 percent, versus only 13 percent for those over 60. The numbers for girls/women for these two age groups are 70 and 1 percent, respectively. As noted earlier, these numbers indicate sustained progress toward gender parity in primary education.

54. The NER at both the primary and secondary levels is relatively low and early drop-out is a continuing concern. The problem is more acute in rural areas, where the primary NER is estimated at 65 percent, and as low as 27 percent at the secondary level. Drop-out rates rise after the age of 16, corresponding to the transition to higher secondary education, and rural children consistently lag behind their urban counterparts with completion rates below 73 percent. Access is also a major challenge, particularly for girls. In urban areas, about 14 percent of children enrolled in primary school live more than 30 minutes from their school. The issue is exacerbated in rural areas, where nearly 37 percent of primary school students live more than 45 minutes from their school.

Figure 3: School Attendance, by Age and Area, 2003



Source: BLSS 2003

55. High pupil-teacher ratios and overcrowded classrooms are seen as the most important factors impinging quality in Bhutan’s schools. These are largely an outcome of the enormous increases in enrollment over the past ten years, in-line with Bhutan’s commitment to achieving ‘Education for All’ global targets, while the number of available trained teachers has been unable to meet the growing demand. These are key factors contributing to poor learning outcomes, as well as high repetition and drop-out rates.

²⁴ The Bhutanese education system includes seven years of primary (from pre-primary to grade 6), two years of lower secondary (grades 7 and 8), two years of middle secondary (grades 9 and 10) and two years of higher secondary (grades 11 and 12) education. Education is provided by the RGoB free of charge.

56. The RGoB seeks to manage the increased role of the private sector in a measured way to stem rural-urban migration and maintain acceptable levels of quality and consistency for both types of service delivery, public and private. There is a positive relationship between the RGoB and private providers in terms of human resource development and the existence of a sound regulatory environment. Education professionals (teachers, head teachers, principals, and specialists) can move from the public to the private sector for determined periods of time. This provides an enriching professional experience and income earning opportunities for the individual. It also helps the RGoB ensure consistency in education program content, philosophy and administration, and will limit the emergence of gaps in the nature and quality of service delivery between public and private education. There are strong regulatory requirements/procedures for establishing private schools, in order to ensure acceptable quality and accordance with standards related to culture, content, training. The proportion of students enrolled in private schools is small at the primary and lower secondary levels, but rises to almost 50 percent at the higher secondary level. The role of the private sector in the education sector is likely to grow in the coming years.

(ii) Education Sector Reforms

57. Improving access to and the quality of education are major objectives of the RGoB, as described by the Ninth Five-Year Plan (2002-03 to 2006-07) education sector goals:

- Increasing the primary gross enrollment rate to 90-95 percent by 2007;
- Raising the promotion rate from grade 10 to 11 from 38 to 56 percent over the plan period;
- Developing the tertiary education system through the newly-established Royal University of Bhutan;
- Increasing the literacy rate from 54 to 80 percent over the course of the plan;
- Establishing a program of inclusive education for children with special needs; and
- Developing a more sustainable system through private participation and cost-sharing.

Since 1988, the Bank has supported education system development in Bhutan, initially to expand access and increase quality at the primary levels, and more recently at the secondary level. The ongoing Education Development Project (EDP) is the largest IDA Credit ever to Bhutan, and is helping to finance the expansion and improvement of secondary education on the basis of the sector development strategy of the Ninth Five-Year Plan. To assist the RGoB further towards meeting its goals in the education sector, the DPG supports reforms in three key areas:

- (a) Improving access to schooling by establishing new Community Primary Schools (CPSs) in remote and/or underserved areas.** As a result of the rapidly increasing enrollment at each level of schooling, the RGoB has undertaken a large expansion of the education infrastructure. Providing schooling for the significant proportion of children living in remote, sparsely-populated areas is a major challenge. The primary strategy adopted by the RGoB has been the establishment of CPSs with the participation of local communities who contribute labor and locally-available materials for school construction. The Ministry of Education (MoE) contributes non-locally-available materials (such as tin sheet roofing and plexi-glass windows), teaching-learning materials and a teacher(s). These schools are part of the regular education system, supervised by *Dzongkhag* education officers and under the full authority of the MoE.

The CPS model involves: cost-sharing with communities, a high level of community ownership and decentralization of education service delivery, as local authorities have key decision-making authority over their establishment. CPSs also support child welfare as they alleviate the need for children to leave their home areas for schooling. This is of particular importance to young children at the lower primary level (kindergarten to grade 3). The RGoB established 23 new CPSs by the

end of 2005, meeting this up-front action for DPG-I. There are currently 221 CPSs throughout the country.

- (b) Improving the quality of education through the development of a curriculum framework.** Bhutan has made important strides in recent years to improve the quality of curricula at all levels of schooling. Considerable work has been carried out at the primary level to make curricula more relevant and reflective of the unique character of Bhutanese society and culture, as well as of higher pedagogic quality. The MoE's Curriculum and Professional Support Services Division (CAPSD) is responsible for the on-going review, development and implementation of curricula at all levels of education. CAPSD has been supported through the last three IDA-funded operations in the education sector, primarily through human resource development and technical assistance for the development of new curricula and textbooks. CAPSD is now a fully functional unit managing all aspects of curriculum development, and capable of producing high quality outputs.

Recent years have seen a shift from out-dated rote teaching-learning approaches to more modern active-learning, child-centered methodologies. These require extensive pre- and in-service training of teachers, which has proved to be challenging in light of the unfamiliarity to teachers of many new concepts, who themselves were taught using rote learning methodologies. This underscores generational differences in the nature of many key facets of education system reform. With rapid increases in enrollment over the past decade, particularly at the primary level, and the challenge of using child-centered learning approaches in over-crowded classrooms, the impact of good teaching practices has been limited. The RGoB has been concerned, in particular, with students' acquisition in the core subjects of English and mathematics. Under the Ninth Five-Year Plan, emphasis is being placed on improving students' competency in these two key subject areas. This is viewed as an important strategy for improving linkages between employment and later participation in the labor market where acceptable levels of English fluency are required. The DPG supports reforms in this key area, and the development of a curriculum framework for English from classes pre-primary (PP) to 12 is an up-front action that was met in December 2005.

- (c) Strengthening the education management information system (EMIS) to help underpin policy making.** The rapid expansion of schooling and the decentralization of data collection to the Dzongkhag and school levels have raised several challenges for the data management system. The RGoB has sought technical assistance for enhancing the management of education data and generating budget information. Indeed, external donors have provided substantial assistance in training Policy and Planning Division (PPD) personnel. The DPG supports the RGoB's efforts to strengthen monitoring and evaluation, and a concept paper is under preparation on EMIS reform options and strategies to improve data collection, reliability, usability and automation.

Prior actions for the DPG:

- (5 of 7) *As part of the implementation of its policy to expand education coverage through the establishment of new community primary schools (CPSs) in underserved areas, the RGoB will establish 23 new CPSs in remote and/or underserved areas to increase enrollment and completion at the primary level, to support progress toward the achievement of the education-related MDG targets.*
- (6 of 7) *A curriculum framework is to be developed for English from classes pre-primary (PP) to grade 12, by December 2005.*

Triggers for a future DPG/DPC:

- (5 of 7) *In continuing to implement its improved access to schooling policy, the RGoB establishes an additional 20 community CPSs by December 2007.*

(6 of 7) *A reformed EMIS system is piloted, with a first version available for use, learning and capacity building by December 2007.*

58. Each of these areas represents an important challenge, particularly given the difficulty of access to remote parts of the country and the lack of sufficient human resources, especially teachers. The MoE has a strong track record for implementing reform measures, meeting the education sector prior actions for DPG-I, and making good progress on the other related institutional and policy reforms. While the Bhutanese education system could benefit from a variety of inputs at this point in its development, and the MoE is open to dialogue on a range of issues, the actions supported by the DPG are well-placed within the context of other measures being carried out by the MoE with the substantial assistance of bilateral and multilateral development partners. For example, concerns over the extent to which the education system serves the requirements of the labor market are being addressed under the on-going IDA-financed EDP, through mathematics curricula reform at all levels of education, and the carrying out of a tracer study of secondary school leavers. Similarly, pre-service teacher training is supported through Bhutan's long-term collaboration with Switzerland in the education sector.

59. Progress on the education sector reforms is expected to lead to better outcomes over time. The establishment of new CPSs will increase access to primary education (and raise the overall NER). The English curriculum framework is expected to lead, over the course of several years to increased English proficiency among school leavers, as evidenced by employers' perceptions and student evaluation tools (both continual and terminal assessments, such as in examinations). The reformed EMIS system will generate the accurate education data needed to inform improved policy making, as reflected in more targeted interventions, and better planning leading into the preparation of the Tenth Five-Year Plan at the dzongkhag and central levels.

4. Improving Health Care

60. The RGoB places the well-being of people at the center of development. This is shown by the allocation of 30 percent of the national budget to health and education (2005-2006), 43 percent of which is allocated to health (representing 13 percent of recurrent expenditures). Health care in Bhutan is publicly provided and financed. According to Bhutan's constitution, "the state shall provide free access to basic public health services in both modern and traditional medicine" to the population. Thus, the state provides health care free of charge, including essential drugs. BLSS data indicate that 8 percent of health expenditures are financed privately through out-of-pocket spending, primarily for "non-essential" drugs, and other services not provided by the government. Public health spending as a share of GDP and public expenditure has remained stable over the last few years, at about 4.5 percent of GDP and 12 percent of all public spending. However, in absolute terms, expenditures have been increasing. Roughly half of this spending is financed by external donors including mainly DANIDA (financing 18 percent of the Eighth Five-Year Plan and 10 percent of the Ninth Five-Year Plan expenditures in the sector), WHO, the Government of India, and IDA.

61. The Bhutanese health care system is primary care oriented. Public health care is provided through three referral hospitals, 26 district hospitals, a network of 160 Basic Health Units (BHUs), and 447 Outreach Clinics (ORCs) spread throughout the country. Hospitals provide secondary and some tertiary care, though most specialized care is referred to other countries like India and Thailand. Indigenous medical care is provided through the hospital in Thimphu and 18 Indigenous Units attached to District Hospitals.

(i) Health Care: Achievements and Challenges

62. Notwithstanding the scarcity of data on health status, available information clearly indicates that the health and well-being of the Bhutanese population has improved steadily over the past two decades.²⁵ Life expectancy increased from 60 years in 1991 to 66 years in 2003. Bhutan has a relatively young population, with nearly 40 percent under 15 years of age and about five percent over 65 years of age. This age structure is similar to that of India and Bangladesh, with the main difference being a sharp decline in fertility in the last five years in Bhutan, and a somewhat greater proportion of the population over age 65. This places Bhutan midway along the epidemiological and demographic transition, with the main causes of death including communicable diseases and maternal and peri-natal causes, but a growing incidence of non-communicable and chronic conditions including cancer, injuries and cardiovascular problems.

63. As discussed earlier, Bhutan has made significant progress in lowering both infant and child mortality. Infant mortality rate decreased from 102.8 to 60.5 (per 100,000) between 1984 and 2000, and child mortality rate fell from 162.4 to 84.0 (per 100,000) over the same period. Both of these rates are lower than in India, Pakistan, Nepal and Bangladesh. It is likely that the marked reduction in infant and child mortality is partly due to an effective immunization policy and broader access to safe drinking water and sanitation. Immunization in Bhutan is one of the great public health success stories, with universal child immunization having been achieved in 1990. Access to safe drinking water and sanitation increased considerably during the 1990s, rising from about 30 percent in 1994 to about 70 percent in 2001, and Bhutan has met this MDG. Access to safe water plays an important role in reducing the incidence of diarrhea related illness.

64. The prevalence of stunting—an indicator of long-term malnutrition—among children under-five dropped from 56 to 40 percent between 1988 and 1999. This figure is somewhat lower than in the rest of the region where stunting ranges from 43 to 50 percent. The proportion of children who are underweight—which indicates short-term malnutrition—declined from 38 percent in 1988 to 19 percent in 1999, showing that Bhutan has also already achieved this MGD target.

65. Progress with respect to reducing maternal mortality has been marked in the last two decades, with the maternal mortality rate (MMR) declining from 770 per 100,000 live births in 1984 to 260 in 2000. The average MMR for the region is 430. Progress to date can be explained by increased awareness, improved health-seeking behaviors during pregnancy and delivery, increased distribution of iron and folic acid to pregnant women, greater coverage of tetanus immunization, increased use of modern family planning methods, and expanded access to health facilities in general. However, further reductions in the MMR can only be achieved through better access to institutional deliveries by adequately trained personnel and improved access to quality antenatal care (ANC). This means better access to Essential Obstetric Care (EOC) by remote communities, improving the quality and coverage of ANC, and increasing the demand for ANC and professionally delivered births. While interventions at the community level, such as ANC, improved health seeking behavior (through increased knowledge about health and health promotion), and improved nutrition, can reduce the number of complications and facilitate their management, maternal deaths will not substantially decline unless complications can be treated in a timely fashion. This requires a functioning referral system, including transport, timely hospital bed availability, and effective care at higher levels. Extending access to EOC to women living in remote areas is part of the RGoB's strategy to reach the underserved.

66. Although health care is free of charge, utilization is not as high as it could be. According to available surveys, between 15 (BLSS, 2003) and 22 percent (NHS, 2000) of the Bhutanese who are sick or injured do not seek health care. While the main reasons for underutilization by the poor and rural population are

²⁵ Household data are available from the BLSS carried out in 2003, and two National Health Surveys carried out by RGoB in 1994 and 2000. Data are available on reproductive and child health including nutrition. On other health conditions, data are available from annual health bulletins, though the numbers are not as reliable since they are based on service statistics.

related to distance and the time needed to reach service centers, it is clear that the quality of care and limited knowledge about the benefits of maternity care are also important factors. Analysis of the BLSS data also indicates that household income is an important determinant of demand for health care in rural areas, suggesting that even though free of charge, the use of services implies some important costs. Rugged terrain and scattered settlements make communication and transportation difficult, and fragmented health networks limit possible economies of scale in health care delivery, constraining the health sector's reach to remote populations. A general shortage of human resources for health, particularly for specialized care impinges quality. The lack of specialists at the district level is even more pronounced, with a large share of the health system relying on paramedics. Other health inputs are also insufficient, including medical equipment and adequate drug supply. Health regulation and management needs to be strengthened to ensure improved quality, effectiveness and efficiency. Finally, health care expenditures have been increasing rapidly, at about 18 percent per year, and already half of all health financing relies on foreign aid. Options for increased financial sustainability need to be examined.

(ii) Health Care Reforms

67. Improving access and quality of care, particularly to the under served, are the major objectives of the Ninth Five-Year Plan. Although a secondary objective is to increase the sustainability of health care services, the emphasis is not on encouraging private sector delivery and financing but rather on public solutions. DANIDA is working closely with the RGoB on the sustainability of health care financing. The key health goals described in the Ninth Plan include:

- Enhancing the quality of health services;
- Targeting health services to reach those who do not get these services;
- Building self-reliance and the sustainability of health services;
- Intensifying human resource development for health and establishing a system of continuing education;
- Strengthening health management information systems and research;
- Developing appropriate secondary and tertiary health care services, while maintaining the balance between primary, secondary and tertiary health care;
- Strengthening prevention and control of prevailing health problems.

68. The Ministry of Health (MoH) sees the DPG as an opportunity to advance the reform agenda laid out in the Ninth Five-Year Plan, contributing to the achievement of the health MDGs. Building on the work that the RGoB is carrying out with key partners in the health field, including the Bank, DANIDA and the WHO, the DPG supports three policy and institutional reforms being undertaken by the MoH:

- (a) Reducing Maternal Mortality and Morbidity (an MDG)** As noted above, further reductions in the MMR can be achieved mostly by increasing access to institutional deliveries by adequately trained personnel (EOC), improved access to ANC, improved health-seeking behavior, and overall improvements in the quality of care. In 2000, only eight district and referral hospitals could provide EOC. Not only were they insufficient given the distances and difficult terrain, these were often understaffed and lacked the necessary inputs. Realizing the need to prioritize adequate obstetric care to reduce maternal mortality—which affects primarily remote, rural populations—the RGoB shifted its policy in 2000 from an emphasis on promoting safe home deliveries to expanding access to EOC and institutional deliveries. However, a clear strategy for rolling out EOC, in light of human resource constraints is still lacking. The adequacy of existing referral systems needs to be assessed and strengthened, and community support needs to be garnered to bring women to the necessary facilities when locally available health sector resources are

insufficient. Overall, communities need to take a more active role in improving community health. The goal of the Ninth Plan is to establish functioning EOC facilities in the 26 referral and district hospitals by 2007. The goal is very ambitious, and adequate progress will only be achieved with a clear strategy in place. Thus, the development of a draft strategy to increase institutional deliveries was included as an up-front action for DPG-I and has been met, but more effort will be needed to refine the draft further.

- (b) HIV/AIDS, Tuberculosis and Malaria (an MDG)** Bhutan is at an early stage of the HIV/AIDS problem—UNAIDS estimates a current 0.01 percent HIV prevalence rate—but the number of detected cases is growing exponentially and the presence of risk factors is significant, such as high rates of sexually transmitted infections, multiple sexual partners, commercial sex, and high mobility within and outside the country. To avoid a full blown epidemic, which would have a devastating impact on the country's human development gains, prevention efforts need to be focused on highly vulnerable subpopulations (people engaging in high risk behaviors and their partners) and on high transmission areas, such as border towns. Prevention needs to focus on communication aimed at high risk groups to encourage changed behavior, promotion of condom use, and reduction of the incidence of sexually transmitted diseases, which have been found to increase the risk of becoming infected with HIV. The national prevention program is currently being scaled up with support from an IDA Grant for US\$5.8 million.

Sexually Transmitted Infections (STIs) are on the increase in Bhutan and there is some evidence that antibiotics currently used to treat STIs are becoming ineffective due to the growing resistance of existing strains to penicillin (the main drug currently used to treat STIs). The RGoB needs to assess the extent of resistance and adjust its treatment protocols to include more effective treatment. The RGoB is conducting a Gonococcal Susceptibility Study to determine the level of resistance to currently used drugs, in order to adjust its policy on STI management and supply all health care facilities with new drugs. This is a crucial input to the RGoB's efforts to combat the epidemic, and progress on the analysis of the data collected and on the adoption of an adjusted STI treatment policy are included in the DPG reform measures.

- (c) Overall Quality of Health Care.** Having significantly expanded the health care infrastructure in recent years, the RGoB has shifted its focus from expanding coverage to improving the quality of services, a critical thrust of the Ninth Five-Year Plan. To this end, the MoH has established a Quality Assurance and Standardization Division (QASD), and has developed a conceptual framework for the institutionalization of quality assurance (QA). Four areas are being prioritized, focusing on: (a) clients, (b) systems rather than inputs, (c) measurement/results, and (d) teamwork. The QASD will be responsible for accreditation and licensing. Quality assurance and standardization includes the development of guidelines for practice (standard operating procedures, SOPs) and standardization of services, staffing levels and equipment across facilities. With roles and responsibilities for the various actors already defined, and some QA activities already being rolled out, the MoH seeks to institutionalize QA at all levels of the health sector, from the center to all BHUs. QA teams are being set up in all 26 hospitals and will begin to establish an MIS to monitor hospital service quality. Relevant staff have been trained on the principles of QA, and discussions are being held on the need to reestablish the Health Technology and Quality Committee (HTQC) in order to manage the process, which was disbanded when the Education and Health Ministries were split into separate ministries.

Other reforms to improve the quality of care and health regulation involve the partial restructuring of the MoH to establish separate, semi-autonomous bureaus including: the Information and Communication Bureau, the Bhutan Medical and Health Council, the Drug Regulatory Authority, and the Health Trust Fund. At the central level, emphasis has been placed on systems development, including the Planning, Budgeting and Monitoring (PBM) tool and the Health Management Information System (HMIS), as well as several other service specific management

information systems (MIS). At the Dzongkhag level, the roles and responsibilities of the Dzongkhag Health Officer and Senior Medical Officer were specified and training on the use of health data for management is being carried out. Most training at the district level, however, continues to be focused on technical aspects rather than on management. Much remains to be done at the central level as well, as only 13 of the 21 posts in the Policy and Planning Division (PPD) had been filled by June 2005, and several components of the MIS are under development. Improved quality and better regulation will increase utilization, efficiency and effectiveness.

Prior action for the DPG:

(7 of 7) *A draft strategy to increase institutional deliveries (child birth) is developed, and two districts where the strategy is to be piloted are selected.*

Trigger for a future DPG/DPC:

(7 of 7) *Guidelines for the establishment of improved patient referral networks (for institutional deliveries), quality of care and measures to increase demand at the community level on the basis of lessons from the pilots are prepared by June 2007.*

69. The RGoB has taken meaningful steps towards implementing the policy and institutional reforms needed to achieve better health outcomes. The up-front action on preparing a draft strategy for institutional child birth has broadly been met, and other reforms are moving forward. These are to be monitored over time through indicators on the proportion of births delivered at EOC facilities, the percentage of STIs treated with effective drugs, and the doctor attendance records of hospitals.

V. OPERATION IMPLEMENTATION

70. The key elements of implementing the proposed operation are described below:

1. Poverty and Social Impacts

71. The 2003 BLSS indicates an aggregate poverty rate of 31.7 percent in Bhutan. Disaggregated analysis suggests that health and education outcomes are lower for the poor compared to the non-poor. Poor individuals are less likely to consult health care professionals and send their children to school. The poor are more dependent on agriculture for employment, with fewer opportunities for remunerative off-farm employment.

72. The proposed operation seeks to provide sound macroeconomic and fiscal underpinnings for continued steady economic growth which will help improve the quality of life for all sections of the population, especially the poor. Measures to enhance access to education and health services—with a special focus on remote, under-served areas—will be particularly beneficial to the poor. Efforts to enhance the investment climate for private sector growth and employment generation will create new opportunities and reduce the dependence of the poor on agricultural employment.

73. No update of the BLSS is proposed during DPG-I, though the RGoB plans to introduce a system of surveys and/or censuses on a quinquennial basis. However, changes in social indicators will be tracked through the EMIS and the HMIS. The findings from the first statistical census in the country are to be available in the first half of 2006, and are expected to provide further indications of progress.

2. Implementation, Monitoring and Evaluation

74. The Department of Aid and Debt Management (DADM), Ministry of Finance will be responsible for overall implementation of DPG-I. The RGoB has established a multi-ministerial group of officials, headed by the Secretary, Ministry of Finance to provide overall coordination for DPG-I. This group has been working with the Bank team since the inception of the proposed operation.

75. The Bank team's supervision plan will monitor actions and review implementation progress of the proposed operation. The Policy Program Matrix (Annex I) of the proposed operation provides a results framework that describes expected outcomes at the end of the program, as well as indicators to measure success. During the supervision phase of the operation, these benchmarks will be regularly evaluated and the interim steps taken by the RGoB will be monitored.

76. While considerable gains have been made to strengthen technical capacity in the sectors directly involved in the DPG, a lack of technical capacity is a major constraint to Bhutan's overall development (see below the sub-section on risks). This is often cited as a reason for delayed progress in project activities across sectors, and wide-ranging technical assistance inputs are included as a part of most donor-financed operations in Bhutan. As the DPG-I operation evolves, country circumstances, including technical capacity may change. Decision-making on the identification of feasible options for achieving development goals will need to be flexible. Hence, while maintaining a clear focus on the desired impact/outcomes of the program, the Bank team also recognizes the importance of linking ongoing monitoring to decision-making on appropriate adjustments to reflect these realities.

3. Fiduciary Aspects

77. **Financial Management.** As part of the project preparation process, the Bank team supplemented the Country Financial Accountability Assessment (2002) with an update of the ongoing reforms and other medium- and long-term improvements being considered in the public financial management area.²⁶ As noted above, the update shows that while the core elements of an effective financial management system are largely in place, several major challenges remain, including the timeliness of accounting and reporting, the monitoring of financial performance, the effectiveness of internal audits, and the execution of other control functions. There is also a need to further strengthen the capacity of the accountability and oversight institutions, and to establish the necessary legal underpinnings they require in order to meet the financial management and transparency demands arising from the increased revenues and spending expected over the coming years.

78. The RGoB has been actively pursuing several reform initiatives, outlining a positive trajectory for improvements in public finance management (PFM) and demonstrating its commitment. Key components of the RGoB's ongoing PFM reform program are included in the Policy Program Matrix (Annex I) and aim to: (a) provide a satisfactory legal and institutional framework for PFM; (b) improve the timeliness, quality, transparency and reliability of the RGoB's accounting and reporting functions, and (c) strengthen accountability on public financial management issues. These positive steps, as well as the RGoB's demonstrated results and the strong commitment for continued PFM reforms provide a satisfactory basis for proceeding with the DPG.

79. The IMF has not carried out a Safeguards Assessment of the Royal Monetary Authority, Bhutan's central bank. Hence, as part of the appraisal for the DPG operation, the audit report and published annual financial statements for the year ended June 30, 2005 were reviewed by the Bank. The audit opinion

²⁶ For more information, see "A Note on Public Financial Accountability and Management," World Bank Note, October 2005, World Bank.

provided by the auditor, a private firm of chartered accountants from Kolkata, India is unqualified. The accounts are compiled on the basis of generally accepted accounting standards and the audit was conducted in accordance with generally accepted audit standards. Based on the audit report and the satisfactory track record of in the operation of special accounts in several IDA-financed investment operations which have been held in the RMA, it may be concluded that the Bank has reasonable assurance that the control environment for foreign exchange at the RMA is satisfactory for the purposes of this operation.

80. **Procurement.** Last revised in 1998 with assistance from the Asian Development Bank, the Bhutanese procurement system is described in Chapter 17 of the Financial Manual and provides a good basis for procurement in the country. With over six years of experience in applying the legal framework, and having identified some weaknesses and areas for improvement, the RGoB is currently in the process of revising the procurement manual. While external donors have looked favorably on the national procurement system, and have relied on it to a significant degree, it is recognized that there are a number of areas which need to be further improved. Bhutan's development partners, including the Bank, are working together to harmonize around the use of Bhutan's fiduciary (including procurement) and safeguards systems. The South Asia Region's Procurement and Financial Management units are currently in the process of drafting a workplan for the RGoB to assist them with the relevant reforms to allow for such universal reliance on country owned systems.

81. While there are also a number of technical details that should be improved, a weakness of the system lies with implementation and enforcement. In the area of implementation, additional work is required to improve the scope and quality of supporting documentation, particularly with regard to standard form bidding, contract documents, and specialized guidelines and manuals. More effort is also needed to strengthen procurement capacity, which may become a major constraint in the RGoB's move towards greater decentralization of procurement functions.

82. Whilst poor implementation can be linked to a lack of capacity and a deficit of supporting documents and guidelines, weak enforcement is also an issue. There is only an informal complaints mechanism in place to deal with failures to comply with the provisions of the Financial Manual. This has been a cause for concern not only within the RGoB, but also among its development partners and is one of the areas that are to be addressed under the above-mentioned workplan.

83. Overall, the procurement risk can be gauged as medium. To mitigate this risk, actions should be taken to improve the legal framework, strengthen implementation through the development of specialized bidding documents and guidelines, support the introduction of a sustainable national capacity building program using existing Bhutanese institutions, and encourage the creation of an effective enforcement mechanism to ensure that the provisions of the Financial Manual are implemented as intended. In partnership with other donor agencies, a Bank team is working with the RGoB to develop fiduciary reforms necessary to facilitate progress in these areas.

4. Disbursement and Auditing

84. Once the Grant is approved by the Board and becomes effective, the RGoB will submit to the IDA a withdrawal application. IDA will disburse the US dollar proceeds of the Grant in one tranche to the credit of the RGoB's account with the RMA. This account will be part of Bhutan's official foreign exchange reserves. An amount equivalent to the grant proceeds will be credited into an account of the Government that is available to finance budgeted expenditures. Transactions and balances of the Government account will be promptly and fully incorporated into the Government's accounting records and financial statements (in the Consolidated Fund). The RGoB will confirm to the Bank within 30 days of disbursement, the receipt of these funds and its credit into the Consolidated Fund of the country (including the date and name/number of the government's bank account in which the funds have been deposited). The administration of this grant will be the responsibility of the Ministry of Finance.

85. Disbursement of the grant proceeds would not be linked to specific purchases. However, the RGoB would not use the grant proceeds to pay for expenditures included in the Bank's standard negative list which includes expenditures on military hardware and environmentally hazardous goods. If any portion of the Grant is used to finance ineligible expenditures as so defined in the Development Grant Agreement, IDA shall require the RGoB to refund the amount to IDA. As disbursement will not be tied to specific expenditures, no procurement requirements are necessary.

5. Environmental Aspects

86. Bhutan is rich in natural resources with an abundance of forests, biodiversity, water and hydro-power potential. These have provided the platform for sustaining growth and rural livelihoods. Recognizing the significance of its natural assets, environmental issues occupy a central place in the RGoB's development priorities. The country's environmental policies and institutional structures have been described in numerous documents including Bank assessments (including the CAS, the Country Policy and Institutional Assessment (CPIA), and numerous project documents) and academic papers.

87. The RGoB has committed to maintaining 60 percent of the land under forest cover, and has further reaffirmed this policy in the draft Constitution. Indeed, the fiscal transfer system being considered under the Alternative Planning Framework is to include criteria on the contribution of the district to maintaining forest cover. The Environmental Assessment Act (2000) remains the centre-piece of Bhutan's approach to environmental protection. The Act makes environmental assessments mandatory for activities that could have an adverse environmental impact. To support the Act, the National Environmental Commission has issued regulations and sectoral guidelines. Guidelines exist for all major sectors of the economy including roads, power, industry, public utilities and tourism. This is complemented by the Forest Conservation Act (1991), which places priority on the conservation of biodiversity and environmental services such as soil and water conservation. Economic benefits from forests are considered secondary. The legislation is enforced through a series of rules and ordinances, which cover development activities, agriculture, forest management and wildlife conservation.

88. By the standards of most developing countries, environmental policy implementation in Bhutan is strong. Accordingly, the Bank's 2005 CPIA ranked Bhutan's environmental institutions as the best in the South Asia region. Other appraisals such as the Environmental Sustainability Index, confirm the Bank's assessment.²⁷

89. **Environmental Impacts of the Development Policy Grant.** Overall, the environmental impact of the four components of the DPG is not likely to be significant:

1. *Ensuring the maintenance of a sound macroeconomic framework, strengthening fiscal policy, and bolstering financial management and accountability.* These macro policy reforms are unlikely to have any direct environmental impact and are therefore judged to be environmentally benign.
2. *Enhancing the investment climate for private sector growth and employment generation.* These reforms are aimed at improving the investment climate through labor market reforms, streamlining business registration processes and changes to FDI rules. These are unlikely to have any direct environmental impact. In so far as the reforms promote economic diversification, the

²⁷ The most comprehensive measure of environmental performance is the Environmental Sustainability Index (ESI). It ranks Bhutan as an environmental exemplar with the highest rating in South Asia. This score reflects both low levels of environmental stress and an institutional and policy environment that is capable of addressing emerging pressures. The regional ESI scores are (from low [worse] to high [better]): Pakistan – 39.9; Bangladesh – 44.1; India – 45.2; Nepal – 47.7; Sri Lanka – 48.5; and Bhutan – 53.5.

operation can be expected to ease some of the demographic pressures on agricultural lands and could generate indirect environmental benefits.

3. *Augmenting the quality of and access to education and improving health care.* These reforms have no discernable environmental impact and are therefore environmentally benign.
4. *Improving health care.* These reforms also have no discernable environmental impact and are therefore environmentally benign.

90. This is also described in the environmental screening matrix in Annex II.

6. Risks and Mitigation

91. Major risks to the RGoB's medium-term reform program and associated risk mitigation strategies are characterized as follows:

- **Technical capacity risks.** Like most small developing countries, Bhutan's workforce faces major skill shortages, and accountants, engineers, economists, lawyers, statisticians and other professionals are in short supply. There are few think-tank institutions, public or private, engaged in professional research and advisory services. Very little, if anything, is done in research and development. Low technical capacity and skill shortage is a major and arguably the leading factor impeding Bhutan's overall development progress. As much of this risk is difficult to overcome in the short-term, donor-supported development programs and their expected results must be designed to reflect existing capacity constraints. For example, well-crafted legislation can be enacted, but would be largely ineffective in the absence of a threshold number of technically-competent individuals to ensure its proper implementation. The design of the proposed DPG is mindful of these limitations, and in seeking to mitigate these risks, recognizes that technical support, provided in collaboration with other development partners, will continue to be an important feature of the Bank's assistance to Bhutan.
- **External shocks.** All economies, particularly small ones, are vulnerable to external shocks. In this regard, Bhutan is no exception. Hydropower currently accounts for 12 percent of the economy and 32 percent of total revenues. With the commissioning of the Tala Hydropower Project in mid-2006, these numbers are expected to increase to 25 and 50 percent, respectively. Any shocks, natural or otherwise, have the potential of creating major problems in the economy. The RGoB takes into account natural shocks to hydropower (such as reduced water level in the project canals) when calculating its potential electricity generation in any given year. Yet, dependency on exporting all electricity to one buyer, India, is a risk; even though Bhutan's excellent relationship with India continues to yield rich dividends. There have been continuous efforts to expand the tourism sector to promote economic diversification, and the proposed DPG program supports that strategy.
- **Reform inertia and political risks.** It is possible that the pace of reform will not accelerate due to political developments. There are two mitigating factors for this risk. First, the Bhutan program has full country ownership, and actions supported by the proposed operation are anchored in the Ninth Five-Year Plan that was put together through a wide consultative process over the course of two years. Experience suggests that reform programs are more likely to succeed when there is strong country ownership. Second, the design of the Bank's proposed development policy program seeks to minimize such risks. While DPG-I will support selected components of the RGoB's medium-term reform program, each programmatic operation would provide financial support on the basis of progress made, as measured against a set of monitorable actions identified through the previous operation.



MINISTRY OF FINANCE ROYAL GOVERNMENT OF BHUTAN

Tashichho Dzong
Thimphu- Bhutan.

February 24, 2006

Mr. Paul Wolfowitz
President
The World Bank
Washington D.C.
USA.

Dear Mr. Wolfowitz,

Letter of Development Policy

This Letter of Development Policy outlines how the proposed Development Policy Grant (DPG), financed by the World Bank, will support the Royal Government of Bhutan's (RGoB) ongoing medium-term policy and institutional reform program as articulated in its Ninth Five-Year Development Plan. The Ninth Plan has five overall goals: (i) improving quality of the life and income, especially for the poor, (ii) ensuring good governance, (iii) promoting private sector growth and employment generation, (iv) preserving and promoting cultural heritage and environmental conservation, and (v) achieving rapid economic growth and transformation. The strategies outlined to reach these goals include infrastructure expansion, maintaining sound macroeconomic policy, ensuring good governance, improving access, and enhancing social services.

The DPG selectively supports these goals and strategies, and the RGoB is strongly committed to implementing the institutional and policy reforms described in the attached Policy Program Matrix as a part of its effort to foster development and accelerate poverty reduction. The proposed DPG is the first programmatic budget support operation in Bhutan by the World Bank, and will also mitigate the need for domestic financing in FY06 by helping to close the expected fiscal gap. Under the overarching themes of enhancing economic growth, reducing poverty and achieving the Millennium Development Goals (MDGs), the following four components of the RGoB's interrelated developmental reform strategies are being supported by the DPG operation: (i) ensuring the maintenance of a sound macroeconomic framework, strengthening fiscal policy, and bolstering financial management, (ii) enhancing the investment climate for private sector growth and employment generation, (iii) augmenting the quality of and access to education, and (iv) improving health care. Before turning to these four areas, I would like to provide some information on recent developments regarding the economy, the implementation of the Ninth Plan/PRSP and initiatives in good governance.

A. Recent Developments

Macroeconomic Outlook

Bhutan's economic performance is strong, and over the past two decades, real GDP growth has averaged over 6 percent. Growth has been supported by sound macroeconomic management, generous donor support and the development of hydropower resources. Indeed, the large Tala hydropower project that has been under construction since 1997 is nearing completion, and when it is commissioned later in 2006, GDP will rise sharply. Tourism is also contributing increasingly to growth and employment generation. The policy of pegging the Ngultrum to the Indian rupee has served the country well, and inflation has been close to 3 percent for some years.

The RGoB aims to keep the overall fiscal deficit including grants to below 5 percent of GDP, but volatility remains a major challenge. In recent years, volatility in fiscal outturns has been the result of delayed donor grants, lumpy expenditures (like the two new replacement aircraft for DrukAir, the only carrier serving Bhutan), and delays in the completion of Tala. The latter is part of the reason for the emergence of a significant fiscal gap in the RGoB's 2005-06 budget, which the DPG will help address. Volatility is also manifested in the balance of payments, and in 2004/05, for example, the purchase of the two aircraft led to a current account deficit of almost 25 percent of GDP.

As described in greater detail below, the DPG will contribute to the maintenance of the positive macroeconomic trend, by helping the RGoB meet its goal of strengthening macroeconomic and fiscal management, and fostering greater private sector dynamism.

Ninth Plan /PRSP Implementation Update

A mid-term review of the Ninth Plan/PRSP implementation was undertaken in mid-2005, and found that despite some short-comings, there has been substantial progress. The review showed that implementation has been slower than expected, due to lower levels of donor assistance, funding delays, the introduction of the more decentralized planning approach, and capacity constraints. Still, activity has been gathering pace in the later years of the five-year plan (as has been the norm over the past few decades), and the stable macroeconomic environment together with the people-centered development approach have brought rapid socio-economic progress towards Gross National Happiness.

These steps forward are also reflected in positive trends on the Millennium Development Goals (MDG), as described in the MDG Progress Report released by the RGoB at the end of 2005. While any assessment of development trends in Bhutan is constrained by data limitations, available information suggests that most of the targets are on track, and some have already been achieved. For example, the target on reducing the percentage of under-weight, under-five children (part of the first MDG) has already been achieved. Similarly, the targets on increasing the proportion of households with access to improved water sources and sanitation (under the seventh MDG) have also been attained. One area requiring attention is the ratio of females to males attending tertiary institutes (part of the fourth MDG), where efforts will be strengthened for meeting the MDG by 2015.

It is worth noting that the Joint Staff Advisory Note on Bhutan's Poverty Reduction Strategy Paper/Ninth Plan (discussed by the Board of the World Bank in February 2004) emphasized three areas: the need to strengthen the macroeconomic framework, the importance of bolstering public expenditure management, and the necessity of adequate arrangements for monitoring and evaluation. Seeking improvements in these areas is an enduring objective of the RGoB, and good progress has been made over the past years. The prospects for growth within the macroeconomic framework are good, especially once Tala comes on-stream later this year and growth is raised on a more sustainable basis through the private sector reforms supported by the DPG. Efforts to improve public expenditure management are ongoing, and the preparation of a Medium-Term Fiscal Framework is central to the initiative, also being supported by the DPG as a first step towards implementing multi-year rolling budgets. Finally, the first national level census was carried out in mid-2005 (results expected shortly), and other improvements in monitoring and evaluation are also being sought (such as in the education and health sectors), again supported by the DPG.

Governance

The transformation of Bhutan's political system is gaining momentum with nationwide public consultation of the draft Constitution taking place and with the establishment of an Election Commission Office. The Constitution is to be adopted in 2008, and the first government under a system of parliamentary democracy is to be elected in the same year. With the establishment of a constitutional monarchy, His Majesty the King has decided to pass on the throne to the Crown Prince in 2008. The vision of good governance articulated in the draft Constitution is based on accountability of the government, responsible management of state resources, independence of Constitutional Offices, rule of law, and legal protection of human rights. In keeping with this vision, a month long exercise to look into the institutional mechanism to enhance good governance was undertaken at the end of 2005. The exercise focused on transparency, accountability, efficiency and professionalism. The review recommended several legislative initiatives and institutional changes, including restructuring government at the central and local levels, empowering the Planning Commission to lead the formulation of policy and impact evaluation, enabling the Ministry of Finance to develop a Medium Term Fiscal Framework, and to allocate resources to agencies following an explicit set of criteria, based on the Alternative Planning Framework.

The results of the exercise called "GG plus" also calls for the adoption of strong anticorruption measures, by making the government more transparent and accountable to the public. Towards this end, the RGoB has established the Office of the Anti-corruption Commission and emphasizes the role of the media, civil society and the use of ICT. One recommendation which has already been implemented is that the post of CEOs of state owned enterprises is now open to competition. To further strengthen the decentralization process and devolve greater power to lower levels of government, implementation manuals for the 2004 GYT and DYT Chathrimis (Local government Acts) were drafted, and elected representatives were trained in their use. In addition, a Department of Local Governance was created in the Ministry of Home and Cultural Affairs to support local governments. In sum total, promoting good governance remains an enduring goal of the RGoB.

B. Ensuring the Maintenance of a Sound Macroeconomic Framework, Strengthening Fiscal Policy, and Bolstering Financial Management

Macroeconomic Framework

As a result of sound macroeconomic and fiscal management diligently pursued by the government, Bhutan saw strong economic performance in the last twenty years or so. To further enhance its budgetary management and monitoring of fiscal and debt indicators many initiatives are being under taken. A notable intervention is the establishment of a Macroeconomic Framework Coordination Committee (MFCC) to facilitate and coordinate the generation of reliable fiscal projection and expenditure forecasting. Careful fiscal monitoring is crucial for Bhutan given the small size of the economy. The information generated by MFCC will not only help the government monitor fiscal developments but will help in the implementation of Multi-Year Rolling Budgets (MYRB). In addition, to strengthen the debt management system, debt management software has been procured and staff are being trained in the use of the software.

Public Expenditure Management

The Budget Manual was revised in 2001 indicating the government's move towards more dynamic budgeting by following MYRBs. Due to capacity constraints coupled with decentralized implementation of programs and activities, the government is yet to fully integrate MYRBs in the budgeting system. As a first step toward instituting MYRBs, the MFCC has undertaken several iterations of a preliminary MTF. The exercise was completed in January 2006, and was subsequently endorsed by the Council of Ministers (CoM).

As shown in Table 1 below, revenues are projected to grow sharply with Tala coming on-stream of in 2006/07. Still, the expansion of the overall resource envelope is less than expected because the increase in revenue from Tala is partially offset by a fall in program grants and the start of high debt service payments on Tala (the loan portion of Tala is to be amortized in 12 years). The overall resources picture in 2007/08 is also tight, as program grants are yet to be finalized, and project tied borrowing falls as well. The continuing challenge of volatility for the overall, fiscal situation cannot be over-emphasized. In particular, the timing of the coming on-stream of Tala has major implications – a delay of even a couple of months, will have a substantial impact on GDP growth, revenue and other variables. Another example is the projected excise duty refund from the Government of India, where the RGoB has applied for two years' worth of refunds in 2005/06, but if only one year's worth materializes, revenues may be up to 10 percent lower in 2005/06 than budgeted.

Still, the MTF is proving a useful tool in helping the RGoB develop projections for sound macro/fiscal management, manage expectations on the part of line agencies, address compositional issues (linking capital and recurrent spending), mobilize resources from donors, and meet the RGoB's other public expenditure management goals such as the MYRB and the Alternative Planning Framework (APF).

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
	<i>Actual</i>	<i>Actual</i>	<i>Est.</i>	<i>Budget</i>	<i>Proj.</i>	<i>Proj.</i>
	<i>(in millions of Ngultrum)</i>					
Total Revenue & Grants	7054	10423	11099	12866	17194	16312
Domestic Revenue	4785	5055	6066	7388	10038	11129
<i>of which Tala</i>					2000	3000
Grants	2269	5367	5033	5478	7156	5183
Program Grants	800	1750	1750	1894	1194	42
Project-tied Grants	1469	3617	3283	3584	5962	5141
Expenditure + NL+ORP+IA&S	9945	9843	15206	14701	17114	17891
Total Expenditure	9890	9802	15562	14652	18217	19174
<i>(without DrukAir planes)</i>	9890	9802	13809	14652	18217	19174
Current expenditure	4581	5149	6506	6888	8756	9471
<i>of which Interest on account of Tala</i>					1297	1297
Capital expenditure	5310	4653	9056	7764	9461	9703
Project tied capital expenditure	3228	4767	5084	5267	7171	6836
Financed by project-tied loans	1759	1149	1801	1683	1209	1695
Financed by project-tied grants	1469	3617	3283	3584	5962	5141
Discretionary capital expenditure	2082	-114	3972	2497	2290	2867
Net lending (NL)	-48	-6	39	49	-1103	-1283
<i>of which Tala</i>					1433	1433
Other receipts/payments (ORP) (net)	14	-22	-395	0	0	0
Increase in Advances & Suspense (IA&S) (net)	89	69	0	0	0	0
Fiscal Balance (including all grants)	-2891	-580	-4106	-1835	80	-1579
Financing, net	2891	-580	4106	1835	-80	1579
Project-tied loans, net	1537	932	1415	1054	-702	-274
Disbursements	1759	1149	1801	1683	1209	1695
Repayments	221	217	386	629	1911	1969
<i>of which Tala</i>					1433	1433
Resource gap, net	-1354	-1512	2692	780	622	1852
Domestic financing, net	1354	-1512	2692	780	622	1852
Ways and Means, net	1104	-2541	2202	980	622	2152
Bonds, net	250	1029	490	-200	0	-300
Foreign financing, net	0	0	0	0	0	0

Indeed, the MTFE was used as the basis for the budget calls that were issued by the Ministry of Finance at the end of 2005, and it features prominently in the Alternative Planning Framework that is under development. The MTFE was also used to facilitate resource mobilization at the Round Table Meetings in Geneva in mid February. Following some refinements, the RGoB plans to share the MTFE more widely and integrate it into the budget preparation process. As the MTFE is to include information on sectoral expenditure envelopes, it will be instrumental in implementing MYRB, which is to be piloted in at least one sector.

Financial Management

In tandem with the government's effort to enhance good governance practices in the country, the Public Finance Act was drafted to provide legal underpinning for financial management. The draft Public Finance Act underscores the importance of public financial management and accountability (PFMA) system. The draft Public Finance Act amongst others will: (a) establish lines of responsibility for the use of public financial resources and provide a legal framework for the RGoB's financial rules, (b) provide a framework for scrutiny by the National Assembly for the management of public assets and liabilities, including expenditure and revenue proposals, (c) encourage sound fiscal policy by specifying rules for fiscal sustainability and transparency, (d) establish financial management incentives to encourage the effective and efficient use of financial resources by the government agencies, (e) specify the minimal financial reporting obligations of the RGoB's budgetary bodies and public enterprises, and (f) safeguard public assets by providing statutory authority and control for raising loans, issuing securities, giving guarantees, operating bank accounts, and investing funds.

To provide closer attention to accounting and treasury functions and to enable timely preparation of government financial statements, the Department of Budget & Accounts has been segregated into two separate departments in December 2005 as: (i) Department of National Budget, and (ii) Department of Public Accounts. This change will assist in bringing efficiency and timeliness to the accounting and reporting functions.

The adoption of the computerized Budgeting and Accounting System (BAS) in line ministries/agencies and the Central Budgeting and Accounting System (CBAS) in DBA has brought about significant improvements in the financial management system over the past several years. However, the progress is hampered by the lack of adequate networking facilities. The process of compiling and preparing consolidated financial statements is time consuming. At present, the releases are made through a manual Letter of Credit system with intimation to the respective bank. To ensure speedy releases of funds, the DBA has started releasing funds electronically for the spending agencies in Thimphu in December 2005. Piloting the networking of the BAS between DBA and three selected spending agencies in Thimphu will be carried out in June 2006.

The Royal Audit Authority (RAA) ascertains and evaluates whether public resources are handled in accordance with the established rules and regulations; and assesses whether public agencies within its audit jurisdiction, achieve the purposes for which they were established and for which resources have been made available. The Royal Decree for the RAA provides a broad scope and a wide coverage for the audit function, and ensures that the RAA is fully independent. In order to provide a legal framework for the RAA, a draft Act has been prepared and submitted to the CoM in September 2005. The RAA actively tracks and monitors responses by public spending units of audit observations until settlement/adjustment. To further enhance transparency and accountability, audit reports are published in the national newspaper and made available on the RAA website.

C. Enhancing the Investment Climate for Private Sector Growth and Employment Generation

The development of the private sector has been accorded high priority by the RGoB since the Sixth Five Year Plan. The private sector has been designated as an engine of growth in light of its potential contribution to employment and revenue generation. In spite of the RGoB's concerted efforts in developing and providing an enabling environment for the sector, it is still weak and in a nascent stage.

The RGoB is trying to develop more flexible labor laws and employment policies to reduce employment constraints for young people. A key reform measure in this area is the drafting of a Labor and Employment Act to balance the legitimate needs of workers with the promotion of private sector activity. The Act was submitted to the CoM in October 2005.

A Private Sector Development Committee (PSDC) was established in 2000 as a public-private consultative forum for maintaining regular and structured dialogue on cross-cutting and sector-specific issues to foster private sector development. The Committee ceased operation in 2003 owing to the lack of a clear mandate and weak follow-up actions. A 12 member PSDC was re-invigorated in September 2005 chaired by the Minister of Trade and Industry and the Minister of Information and Communications as the Vice Chairman. The terms of reference and the procedural rules of the PSDC were finalized during its first meeting in November 2005.

Creating an enabling environment for foreign direct investment (FDI) is an important element of the RGoB's private sector development and employment generation strategy. The overall objectives of encouraging FDI are to broaden employment and training opportunities; to benefit from technology and skills transfer; to expand the revenue base, and to raise foreign exchange earnings. Towards achieving these goals, a revised FDI Policy was approved in 2002, which provides a clear direction on the regulation of foreign investment. More recently, accompanying FDI Rules and Regulations were approved in October 2005 to help operationalize a transparent FDI registration system. It is expected that this will give comfort and protection to foreign investors.

The RGoB recognizes that business registration and regulations pose a significant barrier to the entry for new firms; and seeks to reduce the cost of setting up a business. Some of the ongoing efforts to improve the efficiency of the business registration process are: (a) the simplification of the registration process, (b) the amendment of the Companies Act, (c) the strengthening of capacity at the Registrar of Companies, and (d) the rationalization of entry and operational regulations to improve the business environment for micro-enterprises.

D. Augmenting the Quality of and Access to Education

Increasing access to education has been a key priority of the RGoB since the start of formal schooling system in the late 1950s. In line with Bhutan's commitment to achieving the 'Education for All' global targets, there has been considerable expansion of schooling at the primary and secondary levels. Improving access to and the quality of education are major objectives of the RGoB, as described in its Ninth Five-Year Plan.

Goals include: (a) increasing the primary enrollment rate to 90-95 percent by 2007, (b) increasing the promotion rate from grade 10 to 11 from 38 to 56 percent by 2007, (c) developing the tertiary education system through the newly-established Royal University of Bhutan, (d) enhancing the literacy rate from 54 to 80 percent, (e) establishing a program of inclusive education for children with special needs, and (f) developing a more sustainable education system through the introduction of private participation and cost-sharing measures. The DPG supports education reforms to meet these goals by helping the RGoB (a) increase access to schooling, (b) improve the quality of education, and (c) strengthen the education management information system.

A major challenge for the RGoB is the provision of educational access to children in remote, sparsely-populated areas, where a significant proportion of the population is found. With a relatively low number of students in any given area and constraints on the availability of resources overall, the RGoB has established 'community primary schools' (CPSs) with the participation of local communities, which contribute labor and locally-available materials for school constructions. The Government contributes payment for skilled labour and non-locally-available materials (such as tin sheet roofing or plexi-glass windows), teaching-learning materials, and teachers as well as providing for regular recurrent costs. Over the past several years, the number of CPSs has been growing and as of December 2004, there were 198 CPSs in Bhutan. Based on analytical work that examined existing policies for increasing enrollment and completion rates, the RGoB is implementing policy reforms concerning the location of new CPSs.

Bhutan has made important strides in recent years to improve the quality of the curricula used at all levels of schooling. Considerable work has already been carried out at the primary level (grades PP-6) to raise pedagogic quality and make curricula more relevant and reflective of the character of Bhutanese society and culture. The RGoB has been particularly concerned with the extent to which students at all levels of education are acquiring sufficient competency in the core subjects of English and Mathematics. The RGoB seeks to improve quality by developing a School English Curriculum Framework (SECF) which will guide the production of Programs of Study (PoS) for each grade level. This would be followed by the development of English textbooks and the training of teachers in their use.

Implementing adequate arrangements for the monitoring and evaluation of education sector results is a key priority of the RGoB. Data are prepared on gross enrollment, repetition, drop-out and promotion rates, and include some information on the characteristics of students, but because the system is not automated, the recorded information faces problems of accuracy and reliability. Financial information is also difficult to obtain. In order to generate accurate and timely statistics, which can be used to facilitate policy making, it is necessary to institute a user-friendly, functional, reliable and automated education management information system. To this end, the RGOB prepared a concept note for the adoption of an Education Management and Information System (EMIS) in December 2005, which will be piloted between January 2006 and June 2007.

E. Improving Health Care

The RGoB continues to put great emphasis on the health sector, as evidenced by the policy of providing health care free of charge and the achievement (given our terrain and scattered population) that 90 per cent of the population now live within 3 hours walking distance from health facilities. The Ninth Five-Year Plan places an important emphasis on improving the health of its citizens. The key health goals of the Ninth Plan include: (a) enhancing the quality of health services, (b) targeting health services to reach the unreached, (c) building self-reliance and the sustainability of health services, (d) intensifying human resource development for health and establishing a system of continuing education, (e) strengthening health management information systems and research, (f) developing appropriate secondary and tertiary health care services, while maintaining the balance between primary, secondary and tertiary health care, and (g) bolstering the prevention and control of prevailing health problems. With the support of the DPG, the RGoB will implement policy and institutional reforms, aimed at (i) reducing maternal mortality (an MDG), (ii) curbing the spread of HIV/AIDS and STIs (also an MDG), and (iii) improving the overall quality of care. The difficulty of access to some remote areas and the lack of sufficient human resources pose significant challenges.

Available information suggests that significant progress has been made in reducing maternal mortality, which declined from 770 per 100,000 live births in 1984 to 260 in 2000. Further reductions in the MMR are a major challenge, however, and can be achieved mainly through improved access to quality antenatal care (ANC) as well as to Essential Obstetric Care (EOC) by remote communities (institutional deliveries by adequately trained personnel). Cognizant of the need to prioritize adequate obstetric care to reduce maternal mortality, the RGoB shifted its policy in 2000 from an emphasis on promoting safe home deliveries to expanding access to EOC and institutional deliveries. In 2000, Bhutan had eight health facilities providing EOC. Given the distances and difficult terrain, the number and distribution of these facilities has proven to be inadequate. The goal of the Ninth Five-Year Plan is to reach 100 percent coverage of institutional deliveries by establishing 29 functioning EOC facilities by 2007.

Bhutan is at an early stage of the HIV/AIDS problem—UNAIDS currently estimates a 0.01% HIV prevalence rate—but is experiencing exponential growth of detected cases and a significant presence of risk factors, such as high rates of sexually transmitted infections, multiple sexual partners, commercial sex, and high mobility within and outside the country. To avoid a full-blown epidemic, the RGoB is working to focus prevention efforts on highly vulnerable subpopulations (people engaging in high risk behaviors and their partners) and on high transmission areas, such as border towns. Although Bhutan is at an early stage of the epidemic, there is a strong political commitment to fighting and containing the spread HIV/AIDS.

Having significantly boosted the health infrastructure in recent years, the RGoB is increasingly focusing on improving the quality of services, a critical thrust of the Ninth Five-Year Plan. To this end, the RGoB has established a Quality Assurance and Standardization Division, and has developed a conceptual framework for the institutionalization of quality assurance (QA). With roles and responsibilities for the various actors already defined, and some QA activities already being tested, the RGoB seeks to institutionalize QA at all levels of the health sector. Relevant staff has been

trained on the principles of QA, and discussions are being held on the need to reestablish the Health Technology and Quality Committee (HTQC). It is expected that these initiatives will improve the utilization and effectiveness of existing services, and contribute significantly to improving health outcomes.

F. Summing-up

We remain very much committed to our reform agenda – including the medium-term institutional and policy reforms supported by the Development Policy Grant seeking to strengthen fiscal and financial management, accelerate private sector development, and improve outcomes in the education and health sectors. Attached to this letter is the RGoB's reform program (supported by the DPG) in the form of a policy program matrix. It will also serve as a framework to analyze and evaluate the reform program over time.

We would like to express our appreciation for the support and assistance from the World Bank. The Bank has played a very important role in our development process since the early 1980s and we look forward to continuing this productive and very positive collaboration in the years ahead.

Yours sincerely,



(Wangdi Norbu)
Finance Minister

The Royal Government of Bhutan
Medium Term Reform Program: 2002-03 to 2007-08
(Supported by Development Policy Operations)

Fiscal Year: July 1 – June 30

Reform Area	Reforms Undertaken and Progress Made		Future Reform Measures		Outcomes & Progress Indicators	Medium-Term Outcomes & Progress Indicators
			2005-06*	2006-07 and 2007-08**		
Theme 1: Macroeconomic, Fiscal and Financial Management						
<i>Ensuring the maintenance of a sound macroeconomic framework, strengthening fiscal policy, and bolstering financial management.</i>						
1.1 Strengthening the macroeconomic framework by preparing forecasts with inputs from all relevant agencies/line ministries of the RGoB.	While the RGoB has been projecting key economic variables as a part of the five-year planning process, it is now taking steps to build projections more frequently and systematically. Through regular updates, these projections are to help underpin policy formulation in general, and budget preparation through the Medium Term Fiscal Framework (MTFF) in particular.	(a) A Macroeconomic Framework Coordination Committee (MFCC)--- chaired by the Secretary of Finance and drawing membership from across all relevant government agencies/line ministries--- is to be set up in December 2005. Terms of reference will be developed, specifying the mandate of the MFCC, including the roles and responsibilities of its members.	(b) The Ministry of Finance (MoF) plans to develop and document the methodologies used to prepare macroeconomic projections and compile the MTFF	(a) Improved coordination of the government agencies/line ministries involved in providing timely inputs required for sound macroeconomic management. Progress is documented in the minutes of at least two meetings of the MFCC, including the tables and briefs written by participating line ministries/agencies. (b) A manual outlining forecast and MTFF methodologies is prepared in 2006-07. Necessary training and implementation of the forecast methodologies are carried out in 2007-08.	(a) Closer macroeconomic monitoring and management, facilitating the maintenance of sound underpinnings for the continued development of Bhutan, and enabling early detection of possible economic concerns and timely policy responses. Indicators Sustained and balanced economic growth.	

*Items in bold are "up-front" actions for DPG I.

**Items in bold are "triggers" (indicative actions) for a potential second DPG/IDPC.

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Reform Area	Reforms Undertaken and Progress Made	Future Reform Measures		Outputs & Progress Indicators	Medium-Term Outcomes & Progress Indicators
		2005-06*	2006-07 and 2007-08**		
1.2 Improving debt management systems.	Effective debt management is an increasingly critical part of managing the Bhutanese economy, especially with the rising indebtedness associated with the development of the Tala Hydropower Project and other large expenditures. Ongoing efforts aim to adopt a new debt management system and build capacity.	(a) The Ministry of Finance is to acquire new software, the CD-CRMS, for improving debt management, and train needed personnel.	(b) The MOF intends to implement this strengthened debt management system, including generating regular reports and debt sustainability analyses.	(a) The new debt management software is operational, and the necessary training is undertaken. (b) New debt management tools are operational as shown by the generation of regular reports on the evolving debt situation.	Outcome Better monitoring and management of debt. Indicator Publication of periodic reports on the path of debt stocks, raising the awareness of policy makers, and ensuring that debt is sustainable over the medium and long-term.
1.3 Bolstering the budget preparation and implementation process by developing and institutionalizing the MTF, as part of the process of moving towards multi-year rolling budgets (MYRBs).	In 2001, the single volume Financial Manual of 1988 was revised and expanded into separate manuals on budgeting, accounting, procurement, and revenue and property management, which together comprise the Financial Rules and Regulations 2001 (FRR-2001). The revised budget manual seeks to link the five-year plans more closely to the annual budget process through the adoption of three-year rolling budgets. The RGoB is making progress towards this goal.				Outcome Fiscal policy is strengthened through the development and adoption of a multi-year budget process, which emphasizes systematic projections of resource availability, closer links between sectoral goals and budgets, and transparency.

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Reform Area	Future Reform Measures		Outputs & Progress Indicators	Medium-Term Outcomes & Progress Indicators
	Reforms Undertaken and Progress Made	2005-06*			2006-07 and 2007-08**
	<p>(i) Medium term fiscal framework (MTFF). The development of a functioning MTFF is an important first step towards MYRB. Preliminary rounds of MTFF preparation were undertaken in 2005, detailing a sound macroeconomic and fiscal framework.</p> <p>(ii) Multi-year Rolling Budgets. As a part of its commitment to increasing budget discipline and transparency, the RGoB has initiated plans to pilot MYRB in two sectors. The development of sectoral MYRBs will become an important part of the evolving planning process over the next plan period (starting in 2008).</p>	<p>(i) RGoB's MTFF will specify target ranges for key fiscal indicators, including overall balance, the resource gap and debt, based on and consistent with a sound macroeconomic framework. It will be submitted to the Committee of the Council of Ministers (CoM) in January 2006 and the CoM's endorsement of the MTFF will be sought as a basis for the preparation of the 2006-07.</p> <p>(ii) (a) The Ministry of Finance will work with line ministries to develop a template and guidelines for MYRB, which will then be piloted in one sector.</p>	<p>(i) (b) The MTFF is circulated as a part of the annual budget preparation process starting in 2007-08, and annual budget numbers (expenditure, revenue, deficits and debt) are developed in accordance with MTFF targets. This will also involve implementing the strengthened debt management system.</p> <p>(ii) (b) MYRB is to be piloted in one key sector.</p>	<p>Indicators Annual budget numbers are increasing in accordance with the MTFF. Greater fiscal marksmanship with a reduction in the variance between the budgeted expenditures and subsequent spending.</p>

*Items in bold are "up-front" actions for DPG I.

**Items in bold are "triggers" (indicative actions) for a potential second DPG/DPG.

The Royal Government of Bhutan
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Reform Area	Reforms Undertaken and Progress Made	Future Reform Measures		Outputs & Progress Indicators	Medium-Term Outcomes & Progress Indicators
		2005-06*	2006-07 and 2007-08**		
1.4 Strengthening financial management practices and their legal underpinnings.	<p>(i) <i>Legal framework.</i> The draft Public Finance Act has been prepared and is awaiting submission to the CoM. This act establishes lines of responsibility for the use of public financial resources and provides the legal underpinning of the financial rules of the RGoB.</p> <p>(ii) <i>Institutional framework.</i> Discussions are underway with a view to separating the Department of Budget and Accounts (in the Ministry of Finance) into a Department of Budget and a Department of Public Accounts. This would allow improved focus and strengthening of the accounting and reporting function of the RGoB.</p> <p>(iii) <i>Financial management information system.</i> Supported by the Asian Development Bank, the RGoB developed a computerized Budget Accounting System (BAS).</p>	<p>(i) (a1) The RGoB will submit the draft Public Finance Act to the CoM.</p> <p>(i) (a2) The RGoB will submit the Public Finance Act to the National Assembly before end-2006.</p> <p>(ii) (a1) Government Order will be issued to separate the Department of Budget and Accounts.</p> <p>(ii) (a2) Staff re-assigned to the separated departments of Budget & Accounts and roles and responsibilities of key staff clarified.</p> <p>(iii) (a1) The electronic transfer of fund releases to be operational in all spending units in Thimphu by June 2006.</p> <p>(iii) (a2) The BAS system is to be networked in three selected spending units in Thimphu by June 2006, on a pilot basis.</p>	<p>(i) (b) The rules and regulations for the effective implementation of the Public Finance Act will be issued by June 2007.</p> <p>(ii) (b1) In-year budget reports and annual financial statements prepared on a timely basis.</p> <p>(ii) (b2) Systems are in place for timely and regular accounts reconciliation.</p> <p>(iii) (b) The BAS system operational at all the spending units and fully networked.</p>	<p>(i) (a1,2) The Public Finance Act is submitted to the CoM, and the National Assembly before end-2006.</p> <p>(ii) (b) The rules and regulations are issued by June 2007.</p> <p>(ii) (a1,2) Government Order to bifurcate the DBA, Department Heads, staff re-assigned and roles and responsibilities of key staff clarified.</p> <p>(ii) (b1,2) Improved quality and timeliness of financial information available for decision making.</p> <p>(iii) (a1) The electronic transfer of fund releases is operational in Thimphu.</p> <p>(iii) (a2) The piloting of the BAS system is completed in three selected spending units by June 2006.</p> <p>(iii) (b) The BAS system networked and used by all spending units.</p>	<p>Outcomes</p> <p>Improved Management of Public Finances through:</p> <ul style="list-style-type: none"> • Satisfactory legal and institutional framework for PFM. • Improved transparency, reliability and timeliness of RGoB finances. • Improved quality of financial information for decision making for each fiscal year. • Improved accountability on public financial management issues. <p>Indicators</p> <ul style="list-style-type: none"> • Reconciliation and clearance of suspense accounts and advances take place at least quarterly within a month from end of period and with few balances brought forward. • Improved timeliness and reliability in availability of funds to the spending departments.

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**Items in bold are "triggers" (indicative actions) for a potential second DPG/DPG.

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		2005-06*	2006-07 and 2007-08**		
	<p>(iv) Oversight of public finances. The draft Audit Act has been prepared and is awaiting submission to the CoM. This act determines service conditions of the Auditor General and prescribes the duties and powers connected to the audit functions of the Royal Audit Authority (RAA).</p> <p>The Annual Audit Report 2003 was the fourth annual report issued by the RAA. The total amount of irregularities reported in this report has declined by 20% from that of the previous year's report. A year after publication, 28% of the reported irregular activities have been adjusted and/or recovered.</p> <p>The draft Constitution provides for the setting up of a five member Public Accounts Committee to review and report on the Annual Audit Report to the Parliament. In the interim, in accordance with the National Assembly Committees Act, 2004, a Public Accounts Committee has been set up and Rules of Procedures of the Public Accounts Committee drafted.</p>	<p>(iv) (a1) The Audit Act is to be submitted to the CoM by December 2005.</p> <p>(iv) (a2) The RAA will set up systems to improve tracking and audit responsiveness by June 2006.</p> <p>(iv) (b1) Rules and regulations are to be issued for the effective implementation of the audit act by December 2006.</p> <p>(iv) (b2) The new tracking systems are implemented.</p>	<p>(iv) (a1) The Audit Act is submitted to the CoM.</p> <p>(iv) (b1) The Audit Act is submitted to the National Assembly, and rules and regulations are issued for the implementation of the Act.</p> <p>(iv) (a2) Improved tracking and audit response systems are set up.</p> <p>(iv) (b2) There is a reduction in the amounts of pending audit observations, and an improvement in the amounts of audit irregular activities adjusted and/or recovered.</p>	<ul style="list-style-type: none"> At least 40% of the total audit irregularities resolved and/or recovered a year after publication of the Annual Audit Report. Scrutiny of audit reports completed by the National Assembly within six months of the receipt of the reports; actions recommended to the executive and implemented according to existing evidence. 	
Theme 2: Private Sector Development					
<i>Enhancing the investment climate for private sector growth and employment generation</i>					
2.1 Improving the functioning of labor markets through the development of flexible labor and employment laws.	<p>Generating adequate employment is a key part of the RGoB's desire to promote private sector development. A new ministry—the Ministry of Labor and Human Resources (MoLHR)—was created in 2003 to help address growing concerns about employment.</p>	<p>(a1) The draft Labor and Employment Act to be submitted to the CoM by December 2005</p> <p>(b1) The Labor and Employment Act is to be submitted to the National Assembly by July 2006.</p>	<p>(a1) The draft Act is submitted to the CoM.</p> <p>(b1) The Labor and Employment Act is submitted to the National Assembly.</p>	<p>Outcome</p> <p>More flexible labor markets, leading to a better business environment for potential investors and more job opportunities.</p>	

*Items in bold are "up-front" actions for DPG I.

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Reform Area	Reforms Undertaken and Progress Made	Future Reform Measures		Outputs & Progress Indicators	Medium-Term Outcomes & Progress Indicators
		2005-06*	2006-07 and 2007-08**		
	<p>A Labor Administration policy, spelling out the mandate and functions of the MoLHR is being drafted.</p> <p>Through a consultative process, the RGoB has also prepared a Labor and Employment Act which aims to balance the needs of workers with the objective of promoting private sector activity.</p>	<p>(a2) The process for recruiting foreign workers' is to be streamlined.</p>	<p>(b2) The Rules and Regulations accompanying the Labor & Employment Act are to be approved by mid 2007.</p>	<p>(b2) The accompanying rules and regulations have been issued.</p>	<p>Indicators (a) The time taken to issue approval for foreign workers' recruitment is reduced from 3 months to 3 weeks. (b) The number of foreign workers hired in foreign direct investment activities is flexible, governed by business needs.</p>
2.2. Creating an enabling environment for foreign direct investment (FDI).	<p>The FDI Policy was approved in 2002 with an objective to provide a clear policy on the regulation of foreign investment, particularly the entry of such investment, and to indicate policy on other matters, such as guarantees that pertain to foreign investors. The overall objective of encouraging FDI is to broaden employment and training opportunities, benefit from technology and skills transfer, and broaden the revenue base and enhance foreign exchange.</p> <p>Accompanying rules have been drafted to operationalize the FDI policy. The RGoB is in the process of drafting an Industrial and Investment Act.</p>	<p>(a) FDI rules and regulations are approved by December 2005.</p>	<p>(b) The Industrial and Investment Act is to be submitted to the CoM by January 2007.</p>	<p>(a) Increase in the number of FDI inquiries. (b) Increase in the number of provisional FDI registration certifications.</p>	<p>Outcome Improved FDI environment in the country. Indicator A 5% increase in FDI from 2002/03</p>
2.3. Development of the private sector.	<p>(i) The Private Sector Development Committee (PSDC) was originally established in 2000 as a public-private consultative forum for maintaining regular and structured dialogue on cross-cutting and sector-specific policies and strategies for facilitating private sector development. The committee ceased operation in 2003.</p>	<p>(i) (a) The PSDC committee is to be re-invigorated. Chaired at the Ministerial level, the committee will function with well formulated terms of reference and will have representation by both the</p>	<p>(i) (b) A White Paper, which lays out a comprehensive Private Sector Development Strategy and Action Plan, will be prepared by June 2007. The strategy will cover different facets of private</p>	<p>(i) (a) A Notification order on the revival of the PSDC is issued. Quarterly meetings of the PSDC are held and minutes are prepared. Quarterly meetings of the PSDC are held and minutes are prepared, describing both key decisions and time-bound follow-up actions.</p>	<p>Outcome Increased share of private sector in non-hydro power GDP</p>

*Items in bold are "up-front" actions for DPG I.

**Items in bold are "triggers" (indicative actions) for a potential second DPG/DPC.

**The Royal Government of Bhutan
Medium Term Reform Program: 2002-03 to 2007-08
(Supported by Development Policy Operations)**

Fiscal Year: July 1 – June 30

Reform Area	Reforms Undertaken and Progress Made	Future Reform Measures		Outputs & Progress Indicators	Medium-Term Outcomes & Progress Indicators
		2005-06*	2006-07 and 2007-08**		
2.4 Reducing the cost of doing business by simplifying the business registration process.	<p>(i) Tourism development. The RGoB has drafted a sustainable Tourism Development Strategy for Bhutan with the objective of providing a vision, roadmap and regulatory framework for encouraging private sector entry and growth.</p> <p>(ii) Information and Communications Technology. The RGoB has drafted the Bhutan Information, Communications & Media (CoM) Act. The purpose of the CoM Act includes encouraging local and foreign investment in the ICT and media industry by providing a modern regulatory framework that fosters a convergence of information, computing, media, and communications technologies, and facilitates privatization and competition.</p>	<p>concerned ministries and the private sector by December 2005.</p> <p>(iii) (a) The tourism master plan is to be shared more widely within the RGoB.</p>	<p>sector development.</p> <p>(ii) (b) The RGoB plans to submit the Tourism Act to the National Assembly by November 2006.</p>	<p>(i) (b) A PSD Strategy and Action Plan is produced with inputs from across ministries.</p> <p>(ii) (a) The Tourism Strategy and Tourism Act are prepared through a consultative process.</p> <p>(iii) (b) The Tourism Act is submitted to the National Assembly.</p> <p>(iii) (a) The Bhutan Information, Communications & Media Act is endorsed by the CoM.</p> <p>(iii) (b) The Act is presented to the National Assembly.</p>	<p>Indicator</p> <ul style="list-style-type: none"> A 5% increase in number of operational licenses in manufacturing sector from 2004 A 10% increase in number of tourist arrivals from 2004
		<p>(iii) (a) The Bhutan Information, Communication & Media Act is to be endorsed by CoM by December 2005.</p>	<p>(iii) (b) The Bhutan Information, Communication & Media Act will be presented to the National Assembly.</p>	<p>(a) A diagnostic study of business registration process for firms governed by Companies Act 2001 is to be initiated by February 2006.</p> <p>(a2) For businesses with investment less than Nu 1 million, the RGoB intends to devise a streamlined system where cumbersome licensing</p>	<p>(b1) The business registration process is simplified, including the number of procedures, time taken and costs involved by March 07</p> <p>(b2) Streamlined registration system for micro-enterprises is to be implemented by July 2006.</p>

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The Royal Government of Bhutan
Medium Term Reform Program: 2002-03 to 2007-08
(Supported by Development Policy Operations)

Fiscal Year: July 1 – June 30

Reform Area	Reforms Undertaken and Progress Made	Future Reform Measures		Outputs & Progress Indicators	Medium-Term Outcomes & Progress Indicators
		2005-06*	2006-07 and 2007-08**		
3.1 Improve access to schooling	Capacity building initiatives have been undertaken for key staff of the Registrar of Companies. The business environment for micro enterprises is being improved by rationalizing entry and operational regulations.	shall be replaced by simplified registration by May 2006 (a3) A study is ongoing in the area of Small and Medium Enterprise (SME) development looking at (i) access to finance, (ii) business development services, and (iii) capacity building.	(b3) Based on the findings of the SME study, an action plan will be developed.	2004/05.	
Theme 3: Education Reform					
<i>Augmenting the quality of and access to education</i>					
	In recent years, there has been a considerable expansion (including through World Bank financed projects) of schooling at the primary and secondary levels, as the RGoB continues to focus on broadening access. There has also been an annual increase in the establishment of new community primary schools (CPSs) based on selection of sites by Dzongkhag administrations. The CPS scheme involves cost-sharing with communities, increased community ownership of schools, decentralization of education service delivery and better child welfare as children then do not need to leave their home areas for schooling.	(a) As part of the implementation of its policy to expand education coverage through the establishment of new CPSs in underserved areas, the RGoB will establish 20 new CPSs in remote and/or underserved areas and 3 new primary schools to increase enrollment and completion at the primary level, helping make progress toward the achievement of MDG targets.	(b) In continuing to implement its improved access to schooling policy, the RGoB plans to establish an additional 20 CPS schools by December 2007. (b2) Analytical work is to be undertaken to review current policies to increase enrollment and completion.	(a) Twenty-three new CPSs established by December 2005 (b1) Twenty new CPSs established by December 2007. (b2) Implementation of policy reforms and development of instruments to increase enrollment and retention, as an outcome of the proposed analytical work.	Outcome Wider access to schooling services, helping raise enrollment and completion. Indicator Increase in Net Enrollment Rate (NER) as evidenced by annual MCE statistical summaries.

*Items in bold are "up-front" actions for DPG I.

**Items in bold are "triggers" (indicative actions) for a potential second DPG/DPG.

The Royal Government of Bhutan
Medium Term Reform Program: 2002-03 to 2007-08
(Supported by Development Policy Operations)

Fiscal Year: July 1 – June 30

Reform Area	Reforms Undertaken and Progress Made	Future Reform Measures		Outputs & Progress Indicators	Medium-Term Outcomes & Progress Indicators
		2005-06*	2006-07 and 2007-08**		
3.2 Improve the quality of education.	The RGoB has taken steps to address quality issues that accompanied the rapid expansion of education services, focusing on teacher training and curriculum revision. The Ministry of Education (MOE) is carrying out on-going reviews and reforms of the school curricula. A significant amount of training has been provided in recent years to support curriculum development and subject specialists from the Curriculum and Professional Support Division (CAPSD), including under all three World Bank financed operations in the education sector over the past 15 years. Under the Ninth Five-Year Plan, major reform of the English and Mathematics curricula has been identified as a priority area in order to improve student learning and achievement overall.	(a) A curriculum framework is to be developed for English from classes pre-primary (PP) to 12, by December 2005.	(b) A syllabus and program of studies (POS) is to be completed for English from classes PP to 12.	(a) Completed English curriculum framework for classes PP to 12. (b) POS prepared and teachers trained in the use of the new curriculum.	Outcome Increase quality and relevance of English curriculum leading to long-term goal of improved English proficiency among school leavers. Indicators All teachers of English familiarized with content of newly-developed grade-wise program of studies. Number of resource center- and zongkhag-based workshops for English teachers to provide initial familiarization for using the new curriculum. Inclusion of special supplement in the quarterly CAPSD Newsletter on the content of the new grade-wise program of studies for English.

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The Royal Government of Bhutan
 Medium Term Reform Program: 2002-03 to 2007-08
 (Supported by Development Policy Operations)

Fiscal Year: July 1 – June 30

Reform Area	Reforms Undertaken and Progress Made	Future Reform Measures		Outputs & Progress Indicators	Medium-Term Outcomes & Progress Indicators
		2005-06*	2006-07 and 2007-08**		
3.3 Institutional strengthening through improvement of the Education Information Management System (EMIS)	Data collection has been decentralized to the Dzongkhag and school levels, and efforts are being made to address the impact on the data management system of the rapid expansion of schooling. Considerable training of Policy and Planning Division (PPD) personnel has been carried out under externally-financed schemes on the compilation and presentation of education sector statistics. Technical assistance is being sought for improving the management of education data and generating needed budget information.	(a) A concept paper is to be prepared on EMIS reform options and strategy to improve data collection, reliability, usability and automation.	(b) The reformed EMIS system is to be piloted, with a first version of the EMIS available for use, learning and capacity building by December 2007.	(a) Completion of the concept paper. (b) Implementation of an automated data system and preparation of an evaluation report of the pilot.	Outcome Enhanced capacity to plan and monitor education system progress based on availability of more accurate, user-friendly, and automated data. Indicator Better targeted planning, particularly for preparation of the 10th Five-Year Plan at the dzongkhag and central levels.
Theme 4: Health Sector Reform <i>Improving health care</i>					
4.1 Reduce maternal mortality—one of the MDGs	Maternal mortality declined significantly between 1984 and 2000. However, further improvements will only be possible by expanding access to skilled deliveries backed by the necessary systems, equipment and supplies, and effective referrals to Essential Obstetric Care (EOC) services when necessary). The RGoB shifted its policy to reduce maternal mortality in 2000 from an emphasis on promoting safe home deliveries to expanding access to EOC and institutional deliveries. While some advances have been made with respect to training, protocol development and infrastructure, inputs have been	(a) A draft strategy to increase institutional deliveries (child birth) is developed and two districts are selected, where the strategy is to be piloted.	(b) Design a pilot in two districts involving the District hospital and two of its related BHUs to test key aspects of the strategy including (a) referral networks linking the health system with the community, (b) quality of care initiatives and (c) community awareness and health promotion interventions; and prepare the districts	(a) Document outlining the RGoB's strategy to increase institutional births (including identification of policy changes to be made), mechanisms to ensure increased demand, improved quality and improved patient referral networks for institutional deliveries, January 2006. (b) Procurement and training for pilot to be completed by June 2006.	Outcome Reduced maternal mortality. Indicator Increased proportion of births delivered in Essential Obstetric Care (EOC) facilities from 26.2 percent in 2004 to 36.0 percent in June 2006. The indicator is based on 26 EOC facilities, and the denominator is the estimated number of births for 2004.

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The Royal Government of Bhutan
Medium Term Reform Program: 2002-03 to 2007-08
(Supported by Development Policy Operations)

Fiscal Year: July 1 – June 30

Reform Area	Reforms Undertaken and Progress Made	Future Reform Measures		Outputs & Progress Indicators	Medium-Term Outcomes & Progress Indicators
		2005-06*	2006-07 and 2007-08**		
	insufficient, and an overall strategy to make the system functional is lacking. Furthermore, the focus has been supply driven. Human resource constraints need to be addressed; referral systems need to be carefully worked out and made operational; quality assurance mechanisms should be introduced; demand factors have to be considered.		to launch the pilot, including staffing, training, equipment and upgrading of facilities. The pilot would begin in June 2006.	(b2) Guidelines prepared for expansion to other districts, providing details on the setting up of referral networks; improved quality of care; measures to increase demand at the community level. These should provide options for when resources are lacking. June 2007.	
			(b2) Prepare guidelines for the establishment of improved patient referral networks (for institutional deliveries), quality of care and measures to increase demand at the community level on the basis of lessons from the pilots. June 2007.	(b3) Referral "plans" for each SHU in the district prepared taking into account local conditions (existing human and physical resources) and community organized to promote safe births and provide transport in case of emergency in 4 districts by June 2008.	
			(b3) Implement the new guidelines to increase access to institutional deliveries in 4 additional districts by June 2008.		

*Items in bold are "up-front" actions for DPG I.

**Items in bold are "triggers" (indicative actions) for a potential second DPG/DPC.

**The Royal Government of Bhutan
Medium Term Reform Program: 2002-03 to 2007-08
(Supported by Development Policy Operations)**

Fiscal Year: July 1 – June 30

Reform Area	Reforms Undertaken and Progress Made		Future Reform Measures		Outputs & Progress Indicators	Medium-Term Outcomes & Progress Indicators
			2005-06*	2006-07 and 2007-08**		
4.2 Reduce Sexually Transmitted Infections (STIs) and HIV/AIDS transmission.	<p>Curbing the spread of HIV and STIs is a high priority for the RGoB. A national prevention program is currently being scaled up with support from an IDA Grant. Given that STIs increase the risk of HIV transmission, specific measures to increase access to effective STI treatment and prevention are being introduced.</p> <p>The RGoB has initiated policy discussions to increase the availability of effective antibiotics to treat STIs throughout the health care network. At present only penicillin is used to treat STIs. However, there is evidence worldwide that resistance to penicillin is increasing rendering treatment ineffective and preliminary evidence from Thimphu suggests similar trends. The RGoB is conducting a Gonococcal Susceptibility Study to determine the level of resistance to existing available drugs in order to adjust its policy on STI management, prior to supplying all health care facilities.</p>	<p>(a1) The RGoB intends to revise its National STI Drug Policy by December 2005 based on results of the Gonococcal Susceptibility Study currently under way.</p> <p>(a2) The National Drug Committee (NDC) intends to approve the new STI Drug Policy by April 2006.</p>	<p>(b1) New Draft of National Guidelines for STI Syndromic Management will be prepared, and implementation of new guidelines to begin by June 2006, including training of staff, procurement of drugs</p> <p>(b2) Non-resistant STI treatment to begin to be available at the to BHU level by June 2007.</p> <p>(b3) Non-resistant STI treatment to be available at all BHUs by June 2008.</p>	<p>(a1) Official statement by the Secretary of Health, RGoB outlining proposed adjustments to the National STI Drug Policy supported by two page summary of the patterns of resistance identified by the study and its recommendations (by January 2006).</p> <p>(a2) Training of trainers on new guidelines for STI treatment carried out by June 2006.</p> <p>(b2) Training for key prescribing staff in 10 districts (BHU and district hospitals) completed by June 2007.</p> <p>(b3) Training for key prescribing staff in 10 additional districts (BHU and district hospitals) completed by June 2008.</p>	<p>Outcome Reduced prevalence of STIs</p> <p>Indicator Increase from 0 to 30% of cases of selected STIs that are treated with effective drugs (by June 2007).</p> <p>Increase from 30% to 50% of cases of selected STIs that are treated with effective drugs (by June 2008).</p> <p>(This indicator will be measured on the basis of a review of prescribing practices at a random sample of BHUs and district hospitals)</p>	
4.3 Improve overall quality of care provided.	<p>The RGoB focused on expanding health infrastructure in the Eighth Five-Year Plan and has shifted the focus to increasing the quality of health care services as part of the Ninth Five-Year Plan. This is particularly important in rural areas where quality is most affected and where services are more scarce. To this end, the Ministry of Health</p>	<p>Ministry of Health level: (a1) Re-establishment of Health Technology and Quality Committee (HTQC) at the MoH by January 2006.</p>	<p>Ministry of Health level: (b1) A data base with a minimum of 10 indicators will be established to assess hospital service quality to be piloted in 3 district</p>	<p>Ministry of Health level: (a1) Signed HTQC approval notice from MOH (January 2006).</p> <p>(b1) An assessment of the quality of hospital services</p>	<p>Outcome Improved quality of care at District hospitals.</p> <p>Indicator of improved quality of care</p>	

*Items in bold are "up-front" actions for DPG I.

**Items in bold are "triggers" (indicative actions) for a potential second DPG/IDPC.

**The Royal Government of Bhutan
Medium Term Reform Program: 2002-03 to 2007-08
(Supported by Development Policy Operations)**

Fiscal Year: July 1 – June 30

Reform Area	Reforms Undertaken and Progress Made	Future Reform Measures		Outputs & Progress Indicators	Medium-Term Outcomes & Progress Indicators
		2005-06*	2006-07 and 2007-08**		
	<p>(MoH) has established a Quality Assurance and Standardization Division, and has developed a conceptual framework for the institutionalization of quality assurance (QA).</p> <p>With roles and responsibilities for the various actors already defined, and some QA activities already being tried out, the MoH seeks to institutionalize QA at all levels of the health sector. Relevant staff has been trained on the principles of QA, and discussions are being held on the need to reestablish the Health Technology and Quality Committee (HTQC).</p>	<p>hospitals (from June 2006 to June 2007).</p> <p>(b2) The piloted and improved data base is to be expanded to 10 additional hospitals (June 2008).</p>	<p>in the 3 piloted districts will be presented along with a proposal to roll out the use of the indicators as a routine quality assurance tool in other districts (June 2007).</p> <p>(b2) HMIS collecting regular data on the selected and piloted indicators from the 13 districts (by June 2008).</p>	<p>Percentage of hospitals (including 5 BHU I) that have at least one doctor present between 10-12 am on a given day.</p> <p>The baseline (January 2005) is 72 percent. The estimate for June 2007 is 100 percent. The indicator for June 2008 is modified to reflect the number of hospitals where there were at least two doctors present, and the figure is expected to be 100 percent.</p>	
		<p>District level: (a2) Establish QA teams in all 25 hospitals/BHU I by January 2006.</p>	<p>District level: (b3) QA teams will be functioning in 6 District hospitals by June 2007.</p>	<p>District level: (a2) QA action plan for each hospital (January 2006).</p> <p>(b3) Six QA teams demonstrate that: (a) they are applying the 5 's' principle; (b) having monthly meetings (minutes of the meetings); (c) have developed SOPs (Standard Operating Procedures) for the facility by June 2007.</p>	

*Items in bold are "up-front" actions for DPG I.

**Items in bold are "triggers" (indicative actions) for a potential second DPG/DPG.

The Royal Government of Bhutan
Medium Term Reform Program: 2002-03 to 2007-08
(Supported by Development Policy Operations)

Fiscal Year: July 1 – June 30

Reform Area	Reforms Undertaken and Progress Made	Future Reform Measures		Outputs & Progress Indicators	Medium-Term Outcomes & Progress Indicators
		2005-06*	2006-07 and 2007-08**		
			(b4) CA teams are functioning in 14 remaining districts by June 2008. (b5) A mechanism to identify and reward well performing units within the hospital is to be designed and launched by June 2008.	(b4) A total of 20 district hospital CA teams must demonstrate the 3 above activities are ongoing by June 2008. (b5) Central order/ notification from MoH adopting a mechanism to recognize well- performing units in a hospital (June 2008).	

*Items in bold are "up-front" actions for DPG I.

**Items in bold are "triggers" (indicative actions) for a potential second DPG/DPC.

Environmental Screening

The Royal Government of Bhutan Medium Term Reform Program: 2002-03 to 2007-08 (Supported by Development Policy Operations)

Fiscal Year: July 1 - June 30

Reform Area	Environmental Impacts
<p>Theme 1: Macroeconomic, Fiscal and Financial Management</p> <p><u>Prior action for the DPG:</u></p> <p>(1 of 7) RGoB's MTFF will specify target ranges for key macroeconomic and fiscal indicators, including inflation, the current account balance, the overall balance (including grants), and total debt. It will be submitted to the Committee of the Council of Ministers (CoM) in January 2006 and CoM's endorsement of the MTFF as a basis for the preparation of the 2006-07 budget will be sought.</p> <p><u>Trigger for a future DPG/DPC</u></p> <p>(1 of 7) The MTFF is circulated as a part of the annual budget preparation process in 2006-07 and 2007-08, and annual budget numbers (expenditure, revenue, deficits and debt) are developed in accordance with MTFF target. This will also involve implementing a strengthened debt management system.</p> <p><u>Prior actions for the DPG:</u></p> <p>(2 of 7) The draft Public Finance Act is submitted to the CoM.</p> <p><u>Triggers for a future DPG/DPC:</u></p> <p>(2 of 7) The rules and regulations for the effective implementation of the Public Finance Act are issued.</p>	<p>Benign</p> <p>These reforms are targeted at improving macroeconomic and public finance management. They have no discernable environmental impact.</p>
<p>Theme 2: Private Sector Development</p> <p>Improving the investment climate for private sector growth and employment generation through:</p> <p><u>Prior actions for the DPG:</u></p> <p>(3 of 7) (i) The draft Labor and Employment Act is submitted to the CoM, and (ii) the process for recruiting foreign workers is streamlined.</p> <p>(4 of 7) Foreign Direct Investment rules and regulations are approved.</p> <p><u>Triggers for a future DPG/DPC:</u></p> <p>(3 of 7) The Labor and Employment Act is submitted to the National Assembly</p> <p>(4 of 7) The business registration process is simplified, including the number of procedures, time taken and costs involved.</p>	<p>Benign</p> <p>The policies are aimed at labor market reforms, changes in FDI rules and simplification of the business registration process. These have no direct environmental impacts.</p>
<p>Theme 3: Education Reform</p> <p>Improving the quality and access to education</p>	<p>Benign /Not applicable</p>
<p>Theme 4: Health Sector Reform</p> <p>Improving health outcomes.</p>	<p>Benign/Not applicable</p>

Statistical Tables

ANNEX III
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February 10, 2006

Table A1: Bhutan: Key Economic Indicators

	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
				Est.	Proj.	Proj.	Proj.
Growth and prices				<i>(Annual percentage change)</i>			
Real GDP	7.8	7.0	8.2	6.2	5.0	28.4	3.7
Consumer prices	2.7	1.8	3.5	3.7	3.1	3.1	3.3
Central government Finances				<i>(Percent of GDP)</i>			
Revenue and grants	35.3	26.8	35.4	33.8	35.3	35.4	31.0
Of which: Grants	15.0	8.6	18.2	15.3	15.0	14.7	9.8
Expenditure and net lending	40.2	37.7	33.4	46.3	40.3	35.3	34.0
Of which capital spending	21.8	20.1	15.8	27.6	21.3	19.5	18.4
Current balance (excluding grants)	2.4	0.8	-0.3	-1.3	1.4	2.6	3.2
Overall balance (excluding grants)	-19.9	-19.6	-16.3	-27.9	-20.1	-14.6	-12.8
Overall balance (including grants)	-4.9	-11.0	2.0	-12.5	-5.0	0.2	-3.0
Financing	4.9	11.0	-2.0	12.5	5.0	-0.2	3.0
Foreign financing	5.6	0.0	0.0	0.0	0.0	0.0	0.0
Domestic financing	-0.7	11.0	-2.0	12.5	5.0	-0.2	3.0
Monetary Survey (a)				<i>(In millions of ngultrum)</i>			
Foreign assets (net)	14,352	17,507	16,452	18,615	..	..	..
Domestic credit	2,275	3,810	4,288	5,996	..	..	..
Central government, net	-744	-110	-746	-761	..	..	..
Non-financial public enterprises	292	257	268	235	..	..	..
Private sector	2,727	3,663	4,765	6,522	..	..	..
Broad money	10,971	14,255	14,832	16,849	..	..	..
Money	4,914	6,794	7,737	8,088	..	..	..
Quasimoney	6,057	7,461	7,095	8,760	..	..	..
Balance of payments				<i>(In millions of US dollars)</i>			
Current account balance	-48.3	-67.0	-55.4	-189.8	-149.7	-67.6	-37.6
(In percent of GDP)	-9.8	-12.2	-8.5	-25.8	-18.0	-6.2	-3.3
Trade balance	-82.9	-76.8	-87.3	-224.5	-229.5	-119.1	-7.7
Exports, f.o.b.	103.6	112.8	157.6	186.0	234.2	348.6	460.0
Imports, c.i.f.	-186.5	-189.6	-244.9	-410.6	-463.7	-467.8	-467.7
Services (net)	-4.5	-16.7	-8.0	-10.1	-26.5	-45.1	-66.8
Income (net)	-4.9	-11.4	-16.3	-16.6	-19.5	-51.0	-84.8
Current transfers (net)	44.1	37.9	56.2	61.5	125.8	147.7	121.8
Of which grants	85.6	84.7	94.4	122.7	155.1	175.8	128.7
Non-monetary capital (net)	103.1	225.9	178.9	214.7	146.9	37.2	23.5
Of which foreign aid (loans, net)	59.0	94.5	102.8	77.7	75.1	-15.8	-6.0
Net errors/omissions.	-29.0	-104.4	-115.3	7.7	44.4	77.0	69.7
Overall balance (change in reserves)	25.8	54.5	8.1	32.7	41.6	46.6	55.6
Gross official reserves	315.3	373.3	383.3	419.8	467.1	504.4	548.9
(In months of imports of goods and NFS)	17.2	19.4	16.2	10.8	10.3	10.6	11.0
External debt (year-end)	307.9	459.1	529.4	667.2	769.0	757.4	782.7
(In percent of GDP)	62.7	83.5	81.6	90.7	92.4	69.7	68.0
Debt service	7.5	9.6	70.1	4.9	15.2	78.9	84.7
(In percent of exports of goods and NFS)	5.6	7.0	37.1	2.1	5.3	19.4	16.2
Exchange rate (ngultrum/US\$ period average, year to June)	48.21	47.93	45.41	44.61	43.80	44.70	45.70
Memorandum items:							
Nominal GDP at factor cost (millions of nu)	23,677	26,363	29,458	32,814	36,439	48,543	52,625
Nominal GDP (millions of U.S. dollars)	491.1	550.0	648.7	735.6	831.9	1,086.0	1,151.5
GDP Per Capita (in U.S. dollars)	695	758	872	965	1065	1356	1403

Sources: Statistical Year Book, 2004, National Statistical Bureau, Selected Economic Indicators, June 2005, Royal Monetary Authority, Macroeconomic Framework Coordination Committee, Ministry of Finance, RGoB, and Bank staff estimates.

Statistical Tables

ANNEX III

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February 10, 2006

Table A2: Bhutan: Gross Domestic Product at Factor Cost by Sectoral Origin

	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
				Est.	Proj.	Proj.	Proj.
	<i>(Millions of ngultrum, constant 2000 prices)</i>						
Gross domestic product	21955	23485	25411	26994	28339	36401	37747
Primary	5941	6084	6231	6427	6610	6776	6947
Agriculture (Crops)	2653	2705	2757	2829	2904	2981	3060
Livestock	1915	1956	2009	2089	2151	2194	2238
Forestry	1373	1422	1465	1509	1554	1601	1649
Secondary	9067	10104	11290	12039	12554	19820	20321
Mining	371	396	416	445	477	510	546
Manufacturing	1844	1914	2039	2151	2259	2372	2490
Electricity	2628	2890	3220	3404	3605	10267	10125
Construction	4225	4904	5614	6038	6214	6671	7160
Tertiary	6947	7298	7891	8528	9175	9804	10479
Trade & services	2042	2207	2506	2757	3004	3244	3503
Transport, storage, and communication	2066	2158	2314	2545	2760	2953	3160
Financial, insurance and real estate	1253	1297	1389	1446	1512	1581	1653
Government services	1926	2043	2188	2319	2458	2605	2762
Less: imputed bank service charges	-340	-408	-505	-539	-558	-579	-599
	<i>(Annual percentage change)</i>						
Gross domestic product	7.8	7.0	8.2	6.2	5.0	28.4	3.7
Primary	4.1	2.4	2.4	3.2	2.8	2.5	2.5
Agriculture (Crops)	3.4	2.0	1.9	2.6	2.6	2.6	2.6
Livestock	5.4	2.1	2.7	4.0	3.0	2.0	2.0
Forestry	3.6	3.6	3.0	3.0	3.0	3.0	3.0
Secondary	13.8	11.4	11.7	6.6	4.3	57.9	2.5
Mining	13.4	6.7	5.2	7.0	7.0	7.0	7.0
Manufacturing	5.4	3.8	6.6	5.5	5.0	5.0	5.0
Electricity	5.7	10.0	11.4	5.7	5.9	184.8	-1.4
Construction	24.0	16.1	14.5	7.6	2.9	7.3	7.3
Tertiary	3.9	5.1	8.1	8.1	7.6	6.9	6.9
Trade & services	5.0	8.1	13.5	10.0	9.0	8.0	8.0
Transport, storage, and communication	5.9	4.5	7.2	10.0	8.4	7.0	7.0
Financial, insurance and real estate	1.4	3.5	7.1	4.1	4.6	4.6	4.6
Government services	5.2	6.1	7.1	6.0	6.0	6.0	6.0
	<i>(Percent of GDP)</i>						
Primary	27.1	25.9	24.5	23.8	23.3	18.6	18.4
Agriculture (Crops)	12.1	11.5	10.8	10.5	10.2	8.2	8.1
Livestock	8.7	8.3	7.9	7.7	7.6	6.0	5.9
Forestry	6.3	6.1	5.8	5.6	5.5	4.4	4.4
Secondary	41.3	43.0	44.4	44.6	44.3	54.4	53.8
Mining	1.7	1.7	1.6	1.7	1.7	1.4	1.4
Manufacturing	8.4	8.1	8.0	8.0	8.0	6.5	6.6
Electricity	12.0	12.3	12.7	12.6	12.7	28.2	26.8
Construction	19.2	20.9	22.1	22.4	21.9	18.3	19.0
Tertiary	31.6	31.1	31.1	31.6	32.4	26.9	27.8
Trade & services	9.3	9.4	9.9	10.2	10.6	8.9	9.3
Transport, storage, and communication	9.4	9.2	9.1	9.4	9.7	8.1	8.4
Financial, insurance and real estate	5.7	5.5	5.5	5.4	5.3	4.3	4.4
Government services	8.8	8.7	8.6	8.6	8.7	7.2	7.3
Memorandum items:							
Nominal GDP (millions of ngultrum)	23,677	26,363	29,458	32,814	36,439	48,543	52,625
Nominal GDP (millions of US\$)	491	550	649	736	832	1086	1152
GDP per capita (US\$)	695	758	872	965	1065	1356	1403
Implicit GDP deflator (percent change)	4.8	4.1	3.3	4.9	5.8	3.7	4.5
CPI (percent change)	2.7	1.8	3.5	3.7	3.1	3.1	3.3

Sources: Statistical Year Book, 2004, National Statistical Bureau, Selected Economic Indicators, June 2005, Royal Monetary Authority, Macroeconomic Framework Coordination Committee, Ministry of Finance, RGoB, and Bank staff estimates.

Table A3: Bhutan: Balance of Payments

	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
				Prov.	Proj.	Proj.	Proj.
	<i>(In millions of U.S. dollars)</i>						
Current account	-48.3	-67.0	-55.4	-189.8	-149.7	-67.6	-37.6
Trade balance	-82.9	-76.8	-87.3	-224.5	-229.5	-119.1	-7.7
Exports, f.o.b.	103.6	112.8	157.6	186.0	234.2	348.6	460.0
Imports, c.i.f.	-186.5	-189.6	-244.9	-410.6	-463.7	-467.8	-467.7
Services	-4.5	-16.7	-8.0	-10.1	-26.5	-45.1	-66.8
Credit	29.4	24.9	31.3	46.4	53.0	58.3	64.0
Debit	-33.9	-41.6	-39.3	-56.5	-79.5	-103.4	-130.7
Income	-4.9	-11.4	-16.3	-16.6	-19.5	-51.0	-84.8
Credit	10.9	11.7	9.6	12.0	13.2	14.0	14.8
Debit	-15.8	-23.1	-25.9	-28.6	-32.8	-65.1	-99.6
Current transfers	44.1	37.9	56.2	61.5	125.8	147.7	121.8
Credit	91.7	91.1	107.1	135.8	198.7	223.7	201.6
Of which grants	85.6	84.7	94.4	122.7	155.1	175.8	128.7
Debit	-47.7	-53.2	-50.9	-74.3	-72.9	-76.0	-79.8
Capital and financial account	103.1	225.9	178.9	214.7	146.9	37.2	23.5
Capital transfers	41.9	121.4	102.8	93.3	61.6	40.3	13.7
Foreign direct investment	2.1	2.5	3.5	9.0	11.4	14.0	17.1
Portfolio investment	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign aid (loans net)	59.0	94.5	102.8	77.7	75.1	-15.8	-6.0
Disbursements	..	..	..	86.5	89.4	26.9	37.0
Principal repayments	..	..	..	8.8	14.3	42.7	43.1
Other loans	0.0	7.6	2.0	2.0	-1.3	-1.3	-1.3
Disbursements	..	..	..	2.0	0.0	0.0	0.0
Principal repayments	..	..	..	0.0	1.3	1.3	1.3
Other Investment	0.0	0.0	-32.1	32.7	0.0	0.0	0.0
Net Errors and Omissions	-29.0	-104.4	-115.3	7.7	44.4	77.0	69.7
Overall balance (change in reserves)	25.8	54.5	8.1	32.7	41.6	46.6	55.6
Memorandum items:							
Current account balance as % of GDP	-9.8	-12.2	-8.5	-25.8	-18.0	-6.2	-3.3
Gross international reserves (millions of U.S. dollars)	315.3	373.3	383.3	419.8	467.1	504.4	548.9
(In months of imports of GNFS)	17.2	19.4	16.2	10.8	10.3	10.6	11.0
Exchange rate (ngultrum per U.S.dollar)	48.2	47.9	45.4	44.6	43.8	44.7	45.7
Nominal GDP (US\$ Millions)	491.1	550.0	648.7	735.6	831.9	1086.0	1151.5

Source: Royal Monetary Authority, Macroeconomic Framework Coordination Committee, Ministry of Finance, RGoB, and Bank staff estimates

Table A4: Bhutan: Debt and Debt Service

	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
				Est.	Proj.	Proj.	Proj.
<i>(In millions of U.S. dollars)</i>							
Stock							
Total Debt	307.9	459.1	529.4	667.2	769.0	757.4	782.7
Total domestic debt	17.1	46.0	13.9	73.8	93.1	105.1	143.6
Bonds	11.3	17.2	40.8	51.6	48.2	47.2	39.7
Ways and Means	5.8	28.8	(26.9)	22.2	45.0	57.9	103.8
Total external debt	290.9	413.1	515.4	593.4	675.9	652.3	639.2
Medium- and long-term (DOD)	290.9	413.1	515.4	593.4	675.9	652.3	639.2
Official creditors	290.9	413.1	515.4	593.4	675.9	652.3	639.2
Multilateral	107.7	142.0	152.5	177.3	207.5	226.8	260.7
Asian Development Bank	55.4	75.8	79.2	88.6	101.8	110.6	127.0
EFIC (Australia)	0.3	0.2	0.1	-	-	-	-
IFAD	13.7	19.6	20.0	21.3	23.5	25.7	27.9
KFAED	5.1	3.6	2.5	1.8	1.4	1.0	0.6
World Bank (IDA)	33.2	42.9	50.7	65.6	80.9	89.5	105.2
Bilateral	183.2	271.1	363.0	416.1	468.4	425.4	378.5
Government of Austria	23.0	34.7	47.3	54.9	54.9	53.9	52.9
Government of India	160.17	236.3	315.6	356.1	408.4	362.4	318.0
of which Tala	108.1	178.2	259.4	306.2	363.6	324.5	286.9
Government of Denmark	-	-	-	5.0	5.0	9.1	7.6
Private creditors	-	-	-	-	-	-	-
Short-term debt	-	-	-	-	-	-	-
Flows							
Disbursements							
Total Disbursements		130.4	128.8	147.3	111.4	40.8	84.1
Domestic		28.0	28.5	59.9	22.3	13.9	47.0
Foreign - Others		50.0	26.0	40.1	38.3	26.9	37.0
- GoI		69.9	74.6	47.3	50.9	-	-
Of which Tala		64.6	74.6	47.3	50.9	-	-
Debt service	7.5	9.6	70.1	4.9	15.2	78.9	84.7
Amortization	4.9	5.9	65.1	2.5	12.6	42.5	48.9
Domestic	-	-	62.2	-	4.5	-	6.6
Foreign - Others	3.2	4.0	2.9	2.5	8.1	42.5	42.3
- GoI	1.8	1.9	4.0	6.1	6.2	38.0	37.3
Of which Tala		-	-	-	-	31.9	31.3
Interest payments	2.5	3.7	5.0	2.4	2.6	36.4	35.8
Domestic	0.8	1.5	2.1	-	-	-	-
Foreign - Others	1.1	1.7	2.8	2.4	2.6	36.4	35.8
- GoI	0.6	0.5	0.5	4.9	4.9	33.6	32.8
Of which Tala		-	-	-	-	28.9	28.3
Memorandum items:							
Nominal GDP (millions of U.S. dollars)	491.1	550.0	648.7	735.6	831.9	1,086.0	1,151.5
Exchange rate (ngultrum/U.S. \$)	48.2	47.9	45.4	44.6	43.8	44.7	45.7
Exports of goods & nonfactor services	133.0	137.7	188.9	232.4	287.2	406.9	524.0

Source: Department of Aid and Debt Management, Macroeconomic Framework Coordination Committee, Ministry of Finance, RGoB, and Bank staff estimates

Table A5: Bhutan: Medium-Term Fiscal Framework (2005/06-2007/08)
Central Government Budget Summary

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
			Est.	Budget	Proj.	Proj.
	<i>(In millions of ngultrum)</i>					
Total Revenue & Grants	7054	10423	11099	12866	17194	16312
Domestic Revenue	4785	5055	6066	7388	10038	11129
of which Tala	..	..	..	..	2000	3000
Grants	2269	5367	5033	5478	7156	5183
Program Grants	800	1750	1750	1894	1194	42
India	800	1750	1750	1750	1050	0
Others	0	0	0	144	144	42
Project-tied Grants	1469	3617	3283	3584	5962	5141
India	129	537	878	1980	3759	3000
Others	1340	3080	2405	1604	2203	2141
Expenditure + NL+ORP+IA&S	9945	9843	15206	14701	17114	17891
Total Expenditure	9890	9802	15562	14652	18217	19174
(without DrukAir planes)	9890	9802	13809	14652	18217	19174
Current expenditure	4581	5149	6506	6888	8756	9471
of which Interest on account of Tala					1297	1297
Capital expenditure	5310	4653	9056	7764	9461	9703
Project tied capital expenditure	3228	4767	5084	5267	7171	6836
Financed by project-tied loans	1759	1149	1801	1683	1209	1695
Financed by project-tied grants	1469	3617	3283	3584	5962	5141
Discretionary capital expenditure	2082	-114	3972	2497	2290	2867
Net lending (NL)	-48	-6	39	49	-1103	-1283
of which Tala					1433	1433
Other receipts/payments (ORP) (net)	14	-22	-395	0	0	0
Increase in Advances & Suspense (IA&S)	89	69	0	0	0	0
Fiscal Balance (including all grants)	-2891	580	-4106	-1835	80	-1579
Financing, net	2891	-580	4106	1835	-80	1579
Project-tied loans, net	1537	932	1415	1054	-702	-274
Disbursements	1759	1149	1801	1683	1209	1695
Repayments	221	217	386	629	1911	1969
of which Tala					1433	1433
Resource gap, net	1354	-1512	2692	780	622	1852
Domestic financing, net	1354	-1512	2692	780	622	1852
Ways and Means, net	1104	-2541	2202	980	622	2152
Bonds, net	250	1029	490	-200	0	-300
Foreign financing, net	0	0	0	0	0	0

Source: Macroeconomic Framework Coordination Committee, Ministry of Finance, RGoB, and Bank staff estimates.

Table A6: Bhutan: Central Government Revenue

	2001-02	2002-03	2003-04	2004-05	2005-06 Budget	2006-07 Proj.	2007-08 Proj.
	<i>(In millions of ngultrum)</i>						
Total Revenue	5100.0	4785.3	5055.2	6066.1	7388.2	10038.3	11129.4
Tax Revenue	2035.9	2403.9	2113.7	2826.8	3787.6	3205.4	3193.7
Direct Tax	1119.7	1191.6	1331.8	1458.0	1500.2	1620.0	1701.6
Corporate Tax	394.9	383.7	419.1	447.9	508.3	493.8	518.5
Business Income Tax	317.2	350.2	404.0	423.2	435.3	466.5	489.9
Personal Income Tax	73.6	100.5	113.5	84.6	85.5	97.7	102.6
Other Tax Revenue	333.9	357.2	395.2	502.4	471.2	562.0	590.6
Motor Vehicle Tax	53.2	77.0	85.8	91.1	97.4	105.2	110.5
Business & Prof. licence	20.7	18.8	22.4	24.2	27.7	27.1	28.4
Foreign Travel Tax	5.0	5.8	6.7	9.6	8.1	11.6	12.8
Municipal Tax	7.8	12.7	4.8	9.2	7.2	10.1	10.7
Health Contribution	23.4	26.9	30.7	36.0	42.3	41.6	43.7
Royalties	214.3	214.7	243.3	332.2	288.3	366.3	384.6
Rural Tax	9.6	1.5	1.4	..	..	..	..
Indirect Tax	916.2	1212.3	781.9	1368.7	2287.3	1585.4	1492.1
Sales Tax	360.0	435.0	495.5	567.9	813.1	626.1	657.4
Export Tax	12.3	0.8	0.5	0.9	1.0	1.0	1.0
Excise Duty	444.9	657.8	129.3	565.6	1313.8	700.0	700.0
Import Duty	94.5	115.2	153.3	230.8	155.3	254.4	129.6
Other Tax Revenue	4.5	3.5	3.3	3.6	4.2	3.9	4.1
Non Tax Revenue	1223.3	760.1	713.4	1286.8	1070.6	2365.6	2408.4
Admin. Fees & Charges	137.0	148.4	128.9	169.0	201.5	186.3	195.6
Capital Revenue	34.7	25.0	73.5	232.6	102.3	81.1	85.1
Revenue from Govt. Dept	500.0	34.1	40.6	78.7	53.1	86.8	91.1
Dividend	179.0	205.5	121.3	172.1	193.5	189.8	199.3
Transfer of Profit	315.4	317.2	198.4	384.5	226.6	241.4	253.4
Other Non Tax Revenue	57.3	29.8	150.6	7.5	9.5	8.3	8.7
Interest Receipt from Corporat	..	..	..	242.3	283.9	1572.0	1575.1
GOI Loan	..	..	..	215.9	213.7	1506.4	1503.3
KHPC	..	..	..	201.7	201.7	201.7	201.7
Tala	..	..	..	..	..	1297.0	1297.0
CHPC	..	..	..	14.2	12.0	7.7	4.6
Other loans(On-lending int	..	..	..	26.4	70.2	65.6	71.8
Other Revenue	1840.8	1621.3	2228.1	1952.6	2530.1	4467.3	5527.3
KHPC	..	..	..	..	..	..	60.0
CHPC	1840.8	1621.3	2205.8	1924.3	2461.2	2398.4	2398.4
Tala	..	..	..	..	..	2000.0	3000.0
Basochu	..	..	22.3	28.3	68.9	68.9	68.9
Online Lottery	..	..	..	..	..	..	0.0

Source: Department of Revenue and Customs, Macroeconomic Framework Coordination Committee, Ministry of Finance, RGoB, and Bank staff estimates

Table A7: Economic Classification of Central Government Expenditure

	2001-02	2002-03	2003-04	2004-05	2005-06 Budget
	<i>(In millions of ngultrum)</i>				
Expenditure + Net Lending+Other Receipts & Payments(net)+Increase in Advances & Total Expenditure	10073.9	9945.3	9842.8	15205.6	14700.8
	9780.4	9890.5	9802.3	15561.6	14651.8
Current Expenditure	4467.9	4580.9	5149.2	6505.9	6887.8
Pay & Allowances	1563.9	1615.7	1726.1	2129.1	2496.4
Other Personnel Emoluments	181.9	229.1	253.6	293.1	300.5
Medical Benefits	26.7	39.1	86.0	99.4	92.7
Special Allowance	30.8	30.5	29.0	35.7	36.2
Stipends	124.7	134.0	139.1	179.2	184.5
Travel	592.3	604.6	677.9	808.1	850.6
Utilities	130.7	142.3	163.4	208.1	232.3
Rental of Properties	50.0	56.5	48.6	62.0	56.8
S & M	462.3	493.7	635.3	831.7	786.1
Maintenance of Property	351.9	338.8	357.1	438.7	443.6
Op. Exp.	281.2	153.9	172.8	277.7	253.3
Hospitality & Entertainment	41.6	42.7	45.1	46.3	43.1
Write Off - Stocks, Loss of Cash/Goods	0.4	9.5	0.0	0.0	0.0
Current Grants	293.8	347.8	393.9	525.4	404.0
Subscriptions to International Organisation	21.0	19.1	61.6	34.8	35.9
Contributions	151.4	107.1	107.2	125.0	132.8
Retirement Benefits	47.7	47.7	32.3	31.8	8.8
Interest Payment	115.8	168.9	220.3	380.0	530.3
Interest Payment - Internal	37.9	68.0	98.0	43.1	174.7
Interest Payment - External	77.8	100.9	122.3	336.9	355.6
Capital Expenditure	5312.6	5309.6	4653.1	9055.7	7763.9
Acquisition	38.3	76.7	16.3	35.6	50.9
Training	385.8	471.8	493.5	914.6	827.4
Exp. on Structure	2552.8	1940.1	2221.2	4269.1	4742.9
Plant & Equipt.	1179.7	484.4	461.8	479.8	521.6
Purchase of Vehicles	85.0	50.4	116.8	177.8	15.1
Furniture	61.8	48.1	76.4	116.5	108.6
Office Equipment	46.8	29.1	54.8	114.5	85.8
Computers & Peripherals	73.1	70.5	92.1	199.3	128.8
Professional Services	220.8	356.7	169.0	404.9	364.8
Capital Grants	359.2	792.3	260.0	113.6	297.2
Acquisition of Equities/Shares	309.2	989.4	691.3	2229.9	620.9
Net Lending	129.8	-48.4	-6.5	39.0	49.0
Loans	249.3	99.4	662.5	422.5	360.5
Recoveries	119.4	147.8	669.0	383.5	311.5
<u>Other Receipts & Payments(net)</u>	21.83	14.00	-22.4	-395.0	0.0
<u>Increase in Advances & Suspenses</u>	141.83	89.2	69.3	0.0	0.0

Source: Department of Budget and Accounts, Ministry of Finance, Royal Government of Bhutan

Table A8: Functional Classification of Central Government Expenditure

	2001-02	2002-03	2003-04	2004-05	2005-06 Budget
	<i>(In millions of ngultrum)</i>				
Expenditure & Net Lending	10121	10063	10263	15993	15111
Total Expenditure	10240	10211	10932	16376	15423
General Services	2780	3523	4661	7344	6149
Public Order and Safety Affairs	482	520	553	692	690
Education Affairs and Services	1434	1477	1303	2086	2364
Health Affairs and Services	1143	849	832	1469	1171
Housing and Community Amenity Affairs	341	411	502	996	799
Recreation, Culture, & Relig. Aff. & Serv.	184	140	156	120	112
Fuel and Energy Affairs and Services	1835	1016	790	580	654
Agriculture/Forestry/Fish./Hunt. Aff. & Ser	883	1115	989	1075	1655
Mining/Mineral Res./Manu./Const. Aff. & ;	106	156	75	102	132
Transportation and Communication Aff. &	979	947	1043	1826	1595
Other Economic Affairs and Services	72	58	29	85	100
Recoveries	119	148	669	383	312

Source: Department of Budget and Accounts, Ministry of Finance, Royal Government of Bhutan

**Bhutan—Assessment Letter for the World Bank
May 18, 2006**

As requested, this note provides the IMF staff's assessment of Bhutan's macroeconomic developments and prospects for the IDA Development Policy Grant being considered by the Executive Board of the World Bank on May 18.

Bhutan continues to enjoy robust growth, moderate inflation, and manageable fiscal and balance of payments positions. Macroeconomic conditions appear to be evolving broadly in line with the 2005 Article IV projections:

- Real GDP is expected to grow by about 7 percent in 2005/06 (July/June), somewhat lower than anticipated at the time of the 2005 Article IV owing to the delay in the Tala hydropower project coming on-stream to September 2006.
- Inflation is expected to rise to 5½ percent in 2005/06 reflecting in part the pass-through of a 2005 civil servant wage increase. With interest rates broadly stable, credit growth has remained strong with total credit extended by the financial sector rising by about 19 percent year-on-year in December 2005.
- The overall fiscal deficit is expected to fall in 2005/06. The 2004/05 fiscal deficit rose to 6.4 percent of GDP due to exceptional outlays for the purchase of an aircraft as well as a wage increase. The 2005/06 budget aims to reduce the overall deficit to about 5 percent of GDP mainly through reduced expenditure. External loans are expected to finance about two-thirds of the anticipated budget deficit, with the remainder financed through domestic borrowing. Public sector debt is expected to peak at about 84½ percent of GDP in 2005/06, largely due to the impact of the external borrowing undertaken in recent years to finance the Tala hydropower project.
- The current account deficit is projected to decline in 2005/06 after peaking at over 23 percent of GDP in 2004/05 on account of imports for the Tala Hydropower project and the purchase of aircraft. Donor inflows should be sufficient to finance the deficit and permit a small increase in international reserves. This will leave the reserve import coverage ratio comfortable at just over 10 months.

Macroeconomic policy implementation has been satisfactory and while the commencement of Tala will bring substantial benefits, it will also create some challenges.

- The initiation of the Tala hydropower project is likely to result in a significant improvement in Bhutan's medium-term growth and export prospects. GDP growth is expected to spike at close to 18 percent in 2006/07 when Tala comes on stream which should push the annual growth rate between 2006/07–2009/10 to about 9 percent. The current account should improve further as the effects of a 250 percent increase in

power exports to India and the phasing-out of Tala related imports will only be partly offset by the start of Tala debt service.

- The exchange rate peg to the Indian rupee has served Bhutan well, helping to anchor inflation expectations and facilitate trade with India, Bhutan's largest trading partner. As Tala comes on stream, the challenge will be to manage the real appreciation pressures on the ngultrum in the context of the peg. The onus will largely fall on the private sector to raise its efficiency so as to counter any real appreciation effects. However, the Royal Monetary Authority needs to remain watchful that excess liquidity in the banking system does not contribute to overheating pressures. Fiscal tightening would also help contain demand pressures.
- The key challenge for fiscal policy will be to ensure that the revenue gain from Tala will be used to reduce debt and promote development. Part of the increase in the debt-to-GDP ratio in recent years will moderate once Tala comes on stream and debt service should remain manageable. If debt is to remain on a downward trajectory, the authorities will need to ensure that their ambitious public expenditure program is managed prudently. As envisaged in the authorities' medium-term fiscal framework, the current budget balance will need to move into surplus so the extra revenue generated by Tala (estimated at 4½ percent of GDP, net of debt service on a full year basis) can be directed to infrastructure and social needs. Although grants inflows are likely to moderate from the recent five-year average of about 14 percent of GDP per annum, the fiscal deficit should fall to between 3-3½ percent of GDP provided grant inflows remain at about 7 percent of GDP. Such a strategy would limit recourse to external debt financing—which should remain at concessional terms—while keeping domestic financing to between ½–1 percent of GDP per annum to ensure that the debt burden continues to fall. The placement of the annual budget in a medium-term budgeting framework will help in this regard by strengthening the links between annual spending targets and long-term goals and aiding better prioritization in the event of revenue shortfalls.
- Meeting the employment needs of Bhutan's expanding labor force will require steps to promote growth in the non-power sectors of the economy, including tourism. Efforts are underway to raise education levels to improve skill levels and to create a more competitive labor force including through the opening of vocational training institutes, particularly for the tourism sector. The authorities are also well aware of the need to create an enabling environment for private sector development which will require the streamlining of the regulatory regime and improved infrastructure.

Status of IMF Relations

- The 2005 Article IV Consultation was concluded by the IMF's Executive Board on July 11, 2005 and an interim staff visit was conducted in Bhutan between April 3-5, 2006. The next Article IV consultation is anticipated in 2007.



MAP SECTION

