



Program Information Document (PID)

Concept Stage | Date Prepared/Updated: 25-Apr-2019 | Report No: PIDC27030



BASIC INFORMATION

A. Basic Project Data

Country Bhutan	Project ID P168166	Project Name Strengthening Fiscal Management and Private Sector Employment Opportunities (P168166)	Parent Project ID (if any) P164290
Region SOUTH ASIA	Estimated Board Date Jun 11, 2019	Practice Area (Lead) Macroeconomics, Trade and Investment	Financing Instrument Development Policy Financing
Borrower(s) Ministry Of Finance	Implementing Agency Ministry of Finance		

Proposed Development Objective(s)

This Development Policy Credit series will support the government in its efforts to (i) strengthen the policy framework to improve fiscal management (Pillar 1) and (ii) enhance policies to promote private sector employment opportunities (Pillar 2).

Financing (in US\$, Millions)

SUMMARY

Total Financing	30.00
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DETAILS

Total World Bank Group Financing	30.00
World Bank Lending	30.00

Decision

The review did authorize the preparation to continue

B. Introduction and Context

Country Context

1. The proposed US\$30 million operation is the second in a programmatic series of three operations focused on strengthening the policy framework to improve fiscal management and promote private sector employment opportunities in Bhutan. Bhutan’s state-led hydropower development has yielded an annual average growth rate of 7.5 percent since the early 1980s and the hydropower sector currently accounts for 25 percent of GDP, 39 percent of fiscal



revenues and 37 percent of exports. Fiscal revenues from hydropower have helped finance investments in physical and human capital and raised living standards. However, hydropower led development has also resulted in macroeconomic vulnerabilities and the private sector in Bhutan is still at a nascent stage and creates few jobs. Further improvements in the living standards of Bhutanese will require a stable macroeconomic environment, enhanced private sector competitiveness, and investments in human capital. Some of these objectives will be supported by this operation through reforms in fiscal and public financial management, improved access to finance, support to e-commerce, and investments in human capital.

2. Parliamentary elections were completed in 2018 and the new government remains committed to reforms supported by this DPC series. An interim government (that was not authorized to undertake strategic reforms) was installed between August to October 2018. The newly elected government assumed office in November 2018, and has since taken ownership of ongoing reforms, aligning it to its own priorities. However, the process of installing the new government and establishing ownership of the reforms initiated under the previous government has resulted in changes to some elements of the reform agenda, especially the timing of reforms. These changes are reflected in the policy matrix for this second operation in the programmatic series and the new government has expressed strong commitment to the reforms supported by this DPC series.

3. Bhutan's macroeconomic policy framework is adequate for the proposed DPC. Moderate downside risks persist regarding further delays in the completion and commissioning of on-going hydropower projects. Given the size of the hydropower sector, further delays could adversely impact the projected narrowing of the current account deficit and impact the fiscal space needed to implement the 12th FYP. Improving domestic revenue collection poses a big challenge, and delays in the implementation of Bhutan's own GST law would reduce fiscal space as well. In addition, with sustained growth, donor financing is getting scarcer and since domestic debt markets are not yet developed, limited financing sources could constrain necessary government spending. RGoB's efforts to develop domestic public debt markets with a focus on marketable government securities could support both government financing and Bhutan's monetary policy framework. Finally, Bhutan faces the risk of an overheating economy in the coming years. The expected pick-up in economic activity due to swelling hydropower exports will boost domestic demand. Reforms supported by this series of DPCs is expected to help expand production and keep inflation at sustainable levels. The expected increase in demand would need to be well managed to mitigate the risk of increased spending pressures on wages, given the large public sector. In this regard, the Fourth Pay Commission will emphasize performance-based increase (as opposed to broad based pay increases). The establishment of a stabilization fund to manage the injection of hydro revenues into the economy coupled with the adoption of fiscal rules (both supported by this DPC series) is also a step in the right direction. However, these measures will only be effective if overall RGoB expenditures are limited to a fiscal path consistent with sound macroeconomic management.

Relationship to CPF

4. The DPC series is consistent with the FY2015-19 Country Partnership Strategy and supports all the three pillars of the CPS: (i) improving fiscal and spending efficiency; (ii) increasing private sector growth and competitiveness; and (iii) supporting green development. It is also well aligned with Bhutan's 11th (2013-18) and 12th Five Year Plans, FYP (2018-23). The CPS includes a number of technical assistance activities to support capacity and improved coordination across agencies. These TAs include the following initiatives: Bhutan Macro-Fiscal Monitoring, Analysis and Management Program; Bhutan Tax Rationalization Technical Assistance; Bhutan: Implementation of Financial Sector Development Action Plan; Improving Bhutan Investment Climate; Roadmap for Remaining Untapped Hydropower Potential; and the World Bank administered Public Financial Management Multi-Donor Fund (PFM MDF) that provides Technical Assistance on key PFM reforms based on the 2017 PFM Reform Action Plan.



C. Proposed Development Objective(s)

5. This Development Policy Credit series will support the government in its efforts to (i) strengthen the policy framework to improve fiscal management (Pillar 1) and (ii) enhance policies to promote private sector employment opportunities (Pillar 2).

Key Results

6. **Expected results under pillar 1 are:** (i) appointment of all members of the governing board of the Stabilization Fund; (ii) the non-hydropower fiscal deficit as a share of GDP maintained below 3 percent; (iii) at least one detailed project report prepared as per the new hydropower guidelines, (iv) collection of GST revenues of at least Nu. 4 billion; (v) all budget agencies adopt e-PEMS; and (vi) number of registered bidders in the eGP system increased.

7. **Expected results under pillar 2 are:** (i) increase in the number of CSIs under incubation; (ii) increase in the value of noncash transactions in Bhutan; (iii) increased FDI inflows; (iv) increased number of financial entities reporting to CIB; (v) increased external commercial borrowings by the private sector; (vi) increase in the transition rate to higher secondary schooling; (vii) increased proportion of pregnant women completing all 8 antenatal care (ANC) visits; (viii) increased number of teachers tested by the new Teachers Standards and Professional Development Program; (ix) Lower energy consumption in buildings, the industrial sector and the transport sector.

D. Concept Description

8. **The proposed operation is structured around two pillars.** The first pillar supports reforms that will strengthen macroeconomic management, domestic resource mobilization and public financial management. Some of the reforms under this pillar include the establishment of the stabilization fund and adoption of fiscal rules, measures to reduce cost overruns in hydro projects, adoption of the Goods and Services tax (GST) and improvements in public procurement. The second pillar supports measures that will improve access to finance, facilitate trade and investments and enhance skills and human capital. Some of the reforms under this pillar include strengthening of the credit information bureau, measures to ease FDI restrictions, and improvements in the education and health sector. This will also contribute to a more stable financial sector that is better able to achieve the objective of the second pillar, which seeks to unlock employment opportunities in tourism, agriculture and MSMEs ('cottage and small industries' or CSIs) and to create a more efficient education sector that develops the skills that Bhutan's private sector is seeking. This DPC series also supports the government's efforts to ensure an inclusive and sustainable economic growth model by promoting gender equality policies and climate change initiatives. Overall, the operation is designed to have a positive impact on economic growth through a renewed focus on private sector development by promoting macro-economic sustainability and more employment generation. In terms of macro-economic sustainability, supported reforms will help curb revenue volatility and create more fiscal space through greater revenue enhancing policies and improved quality of spending.

9. **The proposed operation is strongly aligned to the Government's program.** The new government finalized the 12th Five Year Plan (FYP) and approved the full FY2018/19 state budget. The 12th FYP for 2018-23 (which was completed June 2018, by the previous government) was finalized and adopted in January 2019 under the new government. The 12th FYP recognizes the need to diversify the non-hydropower economy. In addition, RGoB wants to ensure that there is a strong private non-hydropower sector that will be able to absorb Bhutan's growing working-age population. Parliament approved an interim budget for FY2018/19 in mid-2018, including recurrent expenditures and ongoing capital expenditures, but excluded new capital expenditures. During the first parliamentary session of the new government (that took place in January 2019), the full FY2018/19 state budget was approved including new capital projects



E. Poverty and Social Impacts and Environmental Aspects

Poverty and Social Impacts

10. The policy measures supported under DPC2 are expected to have positive effects on poverty reduction. Actions linked to adoption of the GIFT and improved supervision of the CIB could help improve e-commerce and mobile banking which would benefit micro-enterprises and small businesses, with potential positive effects for the poor. Improved access to and better utilization of financial services could help small agribusinesses and cottage and small industries which comprise 95 percent of firms in Bhutan. Moreover, new regulations that govern the provision of mobile banking and payments services could particularly help populations that are living in remote areas that are difficult to reach with traditional banking systems. The adoption of the Non-Formal Education Equivalency Framework would help potential employers evaluate the education credentials of candidates who may have missed the opportunity to pursue formal education but opted for alternative pathways. This policy reform could increase access to jobs among the low-skilled and have a positive impact on poverty. All other prior actions are expected to have a neutral impact on poverty. Overall, the results suggest that the poverty and social effects will be positive in the medium- to long-term

Environmental Impacts

11. The proposed operation is likely to have an overall positive effect on the environment. The adoption of the hydropower guidelines is likely to have a potentially positive effect on the environment given its emphasis on the environmental and social aspects of sustainable hydropower development and management which are aligned with international good practice. The environmental and social provisions are in two broad areas. The first one includes Environmental and Social Impact Assessment (ESIA) and Environmental and Social Management Plan (ESMP) processes and methods. The second part provides specific guidance on eleven topics which are consistently the most important for hydropower projects globally. The climate change considerations included in the amended procurement rules could also have a potentially positive effect for the environment. The NFE framework could also have a potentially positive effect if environmental issues are reflected in the curriculum for teachers and students. All other prior actions supported by this operation will have no significant effects on the environment

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APPROVAL

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