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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT FOR A PROPOSED CREDIT

IN THE AMOUNT OF SDR 17.5 MILLION (US$24 MILLION EQUIVALENT) TO

THE KINGDOM OF BHUTAN

FOR THE

SECOND FISCAL SUSTAINABILITY AND INVESTMENT CLIMATE DEVELOPMENT POLICY CREDIT

November 28, 2016

Macroeconomics & Fiscal Management and Trade & Competitiveness Global Practices
South Asia Region

THE KINGDOM OF BHUTAN - GOVERNMENT FISCAL YEAR
July 1 – June 30

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of November 24, 2016)
US$1.00=Nu. 68.6

Currency Unit = Ngultrum

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
APAs	Annual Performance Agreements
ASA	Advisory Services and Analytics
B2G	Business-to-Government
BEA	Bhutan Electricity Authority
BICMA	Bhutan InfoComm and Media Authority
BPC	Bhutan Power Company
CIB	Credit Information Bureau
CPS	Country Partnership Strategy
CRD	Company Registry Division
DB	Doing Business
DPC	Development Policy Credit
DSA	Debt Sustainability Analysis
EDP	Economic Development Policy
FDI	Foreign Direct Investment
FSDAP	Financial Sector Development Action Plan
FY	Fiscal Year
FYP	Five-Year Plan
G2B	Government-to-Business
G2C	Government-to-Citizen
G2G	Government-to-Government
GDP	Gross Domestic Product
GNH	Gross National Happiness
GNHC	Gross National Happiness Commission
GRS	Grievance Redress Service
ICR	Implementation Completion and Results
ICT	Information and Communication Technology
IDA	International Development Association
IFC	International Finance Corporation
IMF	International Monetary Fund
KPI	Key Performance Indicator
MDGs	Millennium Development Goals
MoEA	Ministry of Economic Affairs
MoF	Ministry of Finance
MSME	Micro, Small, and Medium-sized Enterprise
MTR	Mid-Term Review
MW	Megawatts

NKRA	National Key Result Area
NLC	National Land Commission
Nu	Ngultrum
PDO	Project Development Objective
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PPP	Public Private Partnership
RAMIS	Revenue Administration Management Information System
RENEW	Respect Educate Nurture Empower Women
RGoB	Royal Government of Bhutan
RISE	Rapid Investment in Selected Enterprises
RMA	Royal Monetary Authority (Central Bank)
SDGs	Sustainable Development Goals
SDR	Special Drawing Rights
TA	Technical Assistance
TFSCB	Trust Fund for Statistical Capacity Building
WB	World Bank
WBG	World Bank Group

Vice President: Annette Dixon
Country Director: Qimiao Fan
Senior Practice Directors: Carlos Felipe Jaramillo and Anabel Gonzalez
Practice Managers: Deepak Mishra (Acting) and Esperanza Lasagabaster
Task Team Leaders: Yoichiro Ishihara and Massimiliano Santini

THE KINGDOM OF BHUTAN
PROGRAMMATIC DEVELOPMENT POLICY SERIES:
SECOND FISCAL SUSTAINABILITY AND INVESTMENT CLIMATE DEVELOPMENT POLICY CREDIT

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This Development Policy Credit was prepared by a World Bank Group team led by Yoichiro Ishihara (Resident Representative and Senior Country Economist, TTL, SACBT) and Massimiliano Santini (Senior Economist, co-TTL, GTCIC), and consisting of A.K.M. Abdullah (Sr. Financial Sector Specialist, GFM06), Taneem Ahad (Private Sector Specialist, GTCIC), Iqbal Ahmed (Environmental Specialist, GEN06), Christian Eigen-Zucchi (Program Leader, SACBN), Junko Funabashi (Lead Counsel, LEGES), Sebastian James (Senior Economist, GGO28), Tenzin Lhaden (Operations Officer, SACBT), Francesca Lo Re (Sr. Financial Sector Specialist, GFM06), Antonia Menezes (Sr. Financial Sector Specialist, GFM2A), Satish Kumar Shivakumar (Finance Officer, WFALN), Sabin Raj Shrestha (Sr. Financial Sector Specialist, GFM06), and Hiroki Uematsu (Economist, GPV06). Administrative support was provided by Igor Kecman (Sr. Country Program Assistant, SACBN) and Isaac Solomon Lawson (Program Assistant, GTC06).

SUMMARY OF PROPOSED CREDIT AND PROGRAM
THE KINGDOM OF BHUTAN
SECOND FISCAL SUSTAINABILITY AND INVESTMENT CLIMATE DEVELOPMENT POLICY CREDIT

Borrower	The Kingdom of Bhutan
Implementation Agency	Ministry of Finance
Financing Data	International Development Association (IDA) Credit. Terms: 5 years' grace period, 25 years of repayment, 1.25 percent interest rate, 0.75 percent service charge, commitment charges up to 0.50 percent, principal repayable at 3.3 percent and 6.7 percent per year for 6–15 and 16–25 years, respectively. Amount: SDR 17.5 million (US$24 million equivalent).
Operation Type	Programmatic (second of two), single-tranche.
Pillars of the Operation and Program Development Objectives	The Program Development Objectives are to promote fiscal discipline, improve access to finance for enterprises, and improve the climate for business entry and investment in Bhutan. The programmatic series has three pillars: (i) strengthening fiscal sustainability and self-reliance; (ii) increasing access to finance; and (iii) improving the investment climate and increasing domestic and foreign investment.
Result Indicators	1. Non-hydropower debt below 25 percent of GDP by FY2017/18. 2. Tax revenues reach Nu. 23.2 billion by FY2017/18. 3. Number of micro, small, and medium-sized enterprise (MSME) loans in collateral registry increases by at least 40 percent by 2017. 4. The *Doing Business* Strength of Legal Rights Index increases to 6 out of 12 by 2017. 5. CIB coverage increases to 30 percent of adult population by 2017. 6. 40 percent of adult population (age 15+) has a bank account by 2017. 7. The number of days required to transfer a property title decreases to 47 days by 2017. 8. The number of days required to start a business decreases to 10 days by 2017. 9. Cumulative foreign direct investment (FDI) increases to US$150 million by 2017. 10. A public-private partnership (PPP) pipeline based on related rules and regulations is prepared by the PPP steering committee by end-2017. 11. The number of tax payments per year decreases to 6 by 2017.
Overall Risk Rating	Moderate
Climate and Disaster Risks *(required for IDA countries)*	Are there short- and long-term climate and disaster risks relevant to the operation (as identified as part of the SORT environmental and social risk rating)? No.
Operation ID	P157469

IDA PROGRAM DOCUMENT FOR A PROPOSED CREDIT
TO THE KINGDOM OF BHUTAN

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed Second Development Policy Credit (DPC2) of US$24 million supports policy and institutional reforms based on three pillars:** (i) strengthening fiscal sustainability and self-reliance; (ii) increasing access to finance; and (iii) improving the investment climate and increasing domestic and foreign investment. This is the second of two operations in a programmatic series aimed at supporting Bhutan's 11th Five-Year Plan (2013–2018) objectives of green socioeconomic development and self-reliance.

2. **Bhutan has made significant socioeconomic progress supported by a solid development management system.** Bhutan's peaceful transition from an absolute monarchy to a democratic constitutional monarchy in 2008 has been associated with rapid poverty reduction, continuing shared prosperity, and improved public service delivery. The economy has grown at an annual average rate of 7.5 percent over the past decade, registering the 16th highest growth rate among 135 countries for which comparable data are available. Per capita income almost doubled during this period to reach US$2,600 in 2015. Building on significant progress in achieving the Millennium Development Goals, Bhutan has been selected as one of the early mover countries in the Asia Pacific region for Sustainable Development Goals' (SDGs) localization by the United Nations Development Program.[1] The country's development approach based on Gross National Happiness (GNH)[2] is anchored in the Constitution. The Royal Government of Bhutan (RGoB) regularly articulates its medium-term development strategy in a five-year plan (FYP), which anchors development objectives and their implementation to GNH principles. The 11th FYP institutionalizes regular monitoring mechanisms, such as through the introduction of the GNH survey.

3. **To realize rapid economic growth, the RGoB continues to focus on "five economic jewels": hydropower, agriculture, tourism, cottage and small industries, and mining.** The hydropower sector remains the backbone of the economy. The country has an existing installed capacity of 1,606 megawatts (MW) out of the total generation capacity of 30,000 MW, and is in the process of constructing five new projects with a total additional capacity of 3,685 MW. Agriculture is the main source of livelihood for more than half the population, despite only 7 percent of the total area being cultivable. The RGoB continues to implement policies aimed at raising agricultural productivity and boosting the profitability of the sector. Tourism is a key sector underpinning growth, with a total of 141,898 visitors in 2015, providing direct employment to 25,517 people. At present, there are 16,548 cottage and small industries established in the country. Finally, mining has significant potential, and His Excellency the Prime Minister in his State of the Nation address reiterated that "mineral deposits are our state resources and the benefits must be shared by citizens of our country." The finalization of the Mineral Development Policy and the revision of the mineral rent and royalty are expected to drive the future growth of the mining sector.

4. **Implementation of the development management system has supported poverty reduction and gender equality.** Poverty reduction in Bhutan has been rapid and broad-based. Other social indicators have also improved. Bhutan has mostly eliminated extreme poverty, with the poverty rate falling to 2 percent in 2012 using the international poverty line of US$1.90 per person per day (at 2011 purchasing-power parity conversion factors). This is among the lowest in South Asia and substantially lower than the regional average of 19 percent. Even using the higher international poverty line of US$3.10 per day, the poverty rate halved from 29 percent in 2007 to 14 percent in 2012. During the same period, the average expenditure of the bottom 40 percent of the distribution grew virtually at the same rate as the overall average, and the income of the bottom 40 percent of

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[1] As part of the exercises, the gap analysis between the SDG targets and the 11th Five-Year Plan was conducted in late 2015 (https://undg.org/wp-content/uploads/2016/06/RIA_Bhutan_Key_Observations-18.12.2015-1.pdf).
[2] http://www.gnhc.gov.bt/wp-content/uploads/2013/04/GNH-FAQs-pdf.pdf

the population remained at 17 percent of total income. Primary drivers of poverty reduction are commercialization of agriculture, expansion of rural infrastructure, and spillovers from the construction of hydropower projects. Equally impressive improvements have been made in access to basic services and asset ownership. The GNH survey in 2015 showed continued gains: 98 percent of the households own mobile phones and 99 percent have access to grid electricity. Bhutan has also made considerable strides in gender equality, making it comparable to that achieved in upper-middle-income nations. Areas where gender gaps persist include: (i) agricultural land holdings and inheritance practices, and (ii) labor markets and job quality.

5. **To sustain these achievements, two key economic challenges must be addressed: sustaining macroeconomic stability and boosting private-sector development.** Past economic growth has been driven mainly by the public sector, including through the development of hydropower projects. While public-sector-driven economic development has been successful, it has resulted in elevated current account deficits, reliance on donor financing, and accumulation of public debt. Current account deficits have exceeded 25 percent of GDP in recent years, and public-sector debt reached nearly 100 percent of GDP in 2015. Also, the capacity of the economy to absorb new entrants to the labor market is limited. While the overall unemployment rate stood at 2.5 percent, the youth unemployment rate exceeded 10 percent. Under these circumstances, achieving rapid sustainable and inclusive growth requires maintaining macroeconomic stability and transitioning to more private-sector-led economic development.

6. **The high current account deficits are the result of elevated imports associated with the construction of hydropower projects, which are covered by long-term donor financing.** The current account deficits started to increase in the late 2000s, widening from about 3 percent of GDP in the mid-2000s. In 2015, domestic revenues covered 63 percent of total expenditures; the rest was financed by resources from development partners. Tax collection excluding hydropower as a ratio of non-hydro GDP was 13 percent in 2011 and 13.6 percent in 2014. The corresponding numbers including hydropower in both tax collections and GDP were 15.4 percent and 14.5 percent, respectively, reflecting the outsized influence of this sector in skewing the ratios. With grants covering about one third of total expenditure, the average budget deficit over the past five years was 0.4 percent of GDP. Nevertheless, as the economy expands in the medium term, ensuring the buoyancy of domestic revenue, managing current account deficits and relying on grant financing by development partners may become more challenging. Given that Bhutan is a small country with the exchange rate pegged to the Indian rupee, fiscal policy will need to continue playing a prominent role in managing these twin deficits by increasing domestic revenues, improving the effectiveness and efficiency of public expenditures, and maintaining debt sustainability.

7. **Private-sector-led economic development will depend on further improving the investment climate.** In the past, the public sector was the main source of job creation. The public sector accounts for about half of all non-agriculture jobs. However, the sector's ability to absorb new, young workers is limited. The World Bank's (WB) analytical work on Bhutan's labor market recommends policies aimed at facilitating a rebalancing between the public and private sectors by providing demand-side opportunities for the private sector to grow. Currently, the private sector is comparatively small and plays a limited role in the economy. The size of the private sector in 2015 was approximately 30,000 formal businesses, out of which 99 percent were micro and small businesses. There are currently about 350 limited liability companies and a handful of joint-stock companies and partnerships. The remaining businesses are de facto sole proprietorships, with or without employees. The competitiveness of Bhutan's nascent entrepreneurial sector is affected by the country's challenging terrain, the limited access to finance and markets, a difficult business environment, and low productivity. Bhutan's ranking on *Doing Business* (DB) for the ease of doing business decreased slightly to 73 (out of 190 economies) in DB2017, from 71 in DB2016. Bhutan ranks 97th out of 138 countries in the World Economic Forum's most recent Global Competiveness Report, which shares the finding of the World Bank's 2015 and 2009 Enterprise Surveys that access to finance is the

greatest constraint to doing business.[3] Other key areas where improvements are needed in order to boost investment are starting a business and resolving insolvency.

8. **Risks in achieving the Project Development Objective (PDO) are moderate.** Among the categories considered to involve moderate risk are (i) political and governance, (ii) macroeconomic, (iii) sector strategies and policies, (iv) fiduciary, and (v) stakeholder risks. Environmental and social conditions risks are deemed low. The next general election is scheduled in mid-2018, after the closing date of the Operation. Also, the formulation of development strategies (such as the ongoing 12th FYP) is fully participatory, including members of opposition parties. Thus, political and governance risks are moderate. While maintaining macroeconomic stability is a key challenge, the assessment of the macroeconomic policy framework (section 2) supports the conclusion that macroeconomic risk is moderate. On fiduciary risk, the 2016 Public Expenditure and Financial Accountability (PEFA) assessment confirmed significant improvement in most aspects from 2010. However, risk ratings on the technical design of project or program, and on institutional capacity for implementation and sustainability, are substantial. Through ongoing and planned technical assistance (TA), these risks will be mitigated.

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

Real Sector Developments

9. **Economic growth accelerated over the past three years.** Bhutan's economy recovered strongly from the aftermath of the Indian rupee shortage in 2012 and the resulting growth deceleration. With prudent fiscal and monetary policies, as well as robust contributions from the hydropower sector, growth recovered to 5.7 percent in 2014 and 6.5 percent in 2015 (Table 1). The growth acceleration had a positive impact on the labor market, with the overall unemployment rate falling from 2.9 percent in 2013 to 2.5 percent in 2015.

External Sector Developments

10. **Despite high current account deficits, the external sector remains on a sustainable path.** The current account deficit increased from US$0.5 billion in 2014 (25 percent of GDP) to US$0.6 billion in 2015 (32 percent of GDP). Even with elevated current account deficits, however, adequate financing has enabled the maintenance of gross international reserves equivalent to about 9 months of next year's goods and services imports. This is because current account deficits are related mainly to the development of the hydropower projects that are financed directly by loans from India. As these projects come on-stream and electricity is exported to India, export receipts and government revenues will rise sharply. Thus, the most recent debt sustainability analysis (DSA) in June 2016 maintained the moderate risk rating. To manage its international reserves more effectively, the Royal Monetary Authority (RMA) – the central bank – introduced a new policy allowing the RMA to exchange hard currency (such as U.S. dollars) for Indian rupees.

Monetary, Exchange Rate, and Financial Sector Policies and Developments

11. **Macroeconomic stability, as measured by inflation and the exchange rate, has been maintained.** The rate of inflation, as captured by the Consumer Price Index, decelerated from 8.3 percent in 2014 to 4.5 percent in 2015, and slowed further to 3.2 percent in the first half of 2016. While inflation of both domestically produced and imported goods has been easing, inflation of imported goods decelerated faster, reflecting the decline in global commodity prices.

[3] http://www.enterprisesurveys.org/data/exploreeconomies/2015/bhutan

12. **Bhutan's economy is closely linked with India.** About 90 percent of Bhutan's international trade is with India, and the Bhutanese ngultrum is pegged to the Indian rupee at par. After having depreciated by 5 percent against the U.S. dollar in 2015, the ngultrum has been stable so far in 2016, depreciating marginally by 0.4 percent against the U.S. dollar in the first half of 2016.

13. **Strong credit growth of 16.7 percent in 2015 has been supporting economic activity.** The expansion of credit is mainly due to a rapid increase in personal loans, housing, and automotive financing, rather than lending to enterprises. To direct credit to productive sectors for growth and job creation, the RMA introduced a Minimum Lending Rate in August 2016, which takes into account the marginal cost of funds and operating costs of commercial banks. Also, with the support from the World Bank Group (WBG), the RGoB and the RMA have been developing a Financial Sector Development Action Plan (FSDAP, prior action 5).

Fiscal Policies and Developments

14. **Given the large size of the public sector, fiscal policy is the main tool to realize Bhutan's development strategy.** Fiscal policy has become more expansionary in recent years to support the implementation of the 11th FYP. The overall balance swung from a surplus of 2.7 percent of GDP in 2014 to a deficit of 0.7 percent of GDP in 2015 (Table 2), and is to widen further in the 2016/17 budget, before rebalancing in the outer years of the forecast period. The deficits largely reflect increases in capital expenditure for infrastructure development, such as roads. While tax revenues have been rising in nominal terms, the gains have not been able to keep pace with hydropower-fueled GDP growth.

15. **Expenditure composition is guided by the objectives articulated in the 11th FYP.** To sharpen the link between budget allocations and results, the RGoB recently introduced Annual Performance Agreements (APAs) with all budget agencies. Also, to ensure budget sustainability, borrowings are limited to economically viable sectors. In 2014, current expenditure accounted for 55 percent, while capital expenditure accounted for 45 percent of total expenditure. Districts and sub-districts accounted for 24 percent of total expenditure. The Ministry of Works and Human Settlements (including roads, 12 percent), and the Ministry of Agriculture and Forests (8 percent) received relatively larger shares. Debt service accounts for 13 percent of the total budget. Among current expenditures, 40 percent is allocated for wages and salaries, followed by interest payments (11 percent), operations and maintenance (8 percent) and subsidies (7 percent).

16. **To ensure fiscal sustainability, the RGoB introduced a new debt policy in August 2016 (prior action 1 of this Operation).** The debt policy, inter alia, provides for debt thresholds outside the hydropower sector, as well as financing of the hydropower sector. Efforts to boost domestic revenue mobilization and ensure buoyancy are underway, including the introduction of a goods and services tax in the coming years (supported by the technical assistance from the WBG) and tax rationalization measures (prior action 2 of this Operation). Fiscal and monetary policy are coordinated through the RGoB's Macroeconomic Framework Coordination Committee and the newly established Department of Macroeconomic Affairs, and as mandated by the RMA Act 2010, consultations were undertaken with the RMA on the 2016/17 budget, especially concerning domestic financing requirements.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

17. **Economic growth is likely to accelerate in the medium term due to three factors: (i) the construction and commission of hydropower projects, (ii) the maintenance of macroeconomic stability and support from fiscal and monetary policy, and (iii) the positive outlook for the Indian economy.** Three hydropower projects are to start construction in 2016 and 2017, and two projects are to come online in 2018. During the construction phase, the projects contribute to growth through the construction subsector. When the projects start operations, they contribute to growth through the electricity and water supply subsector, potentially leading to double-digit overall GDP growth rates. Gross fixed capital formation is projected to increase between 11 percent and 14 percent per annum during the projection period. In order to help

manage jumps in revenue inflows when hydropower projects come online, the RGoB started discussions on the establishment of a stabilization fund, and is considering other related initiatives (including recommendations by the WBG Public Finance Think Piece to bring hydropower investment on budget and adopt medium-term balanced-budget rules – steps that could underpin DPCs in the future). The non-hydropower sector is expected to continue expanding moderately, and almost all growth acceleration is due to the hydropower sector. In the near-term, inflationary pressure and exchange rate depreciation (especially the real effective exchange rate) are expected to be modest. Macroeconomic stability will contribute to increased fiscal and monetary policy flexibility. Economic growth in Bhutan is expected to be robust over the medium term, given strong linkages with the Indian economy and India's projected growth of around 7.7 percent between FY2016/17 and FY2018/19.[4]

18. **While manageable, several risks warrant attention: (i) high current account deficits, (ii) excess domestic demand, and (iii) stagnation of the global economy.** While Bhutan has maintained an adequate level of gross international reserves, the high current account deficits require careful management. Bhutan experienced an Indian rupee shortage in 2012 mainly due to excess domestic demand that resulted in elevated imports of consumer goods. Although macroeconomic stability has been maintained, credit growth and other indicators suggest that private consumption has been accelerating. Going forward, the evolution of credit growth (especially related to private consumption, such as for transport and personal loans), and its implications for consumer goods imports, will have to be monitored closely. Bhutan's linkage with the rest of the world other than India is limited. However, a deceleration of the global economy might affect Bhutan through India, and the balance of payments would be negatively affected if tourist arrivals slow or decline. On balance, these risks are manageable.

19. **To achieve sustainable and inclusive growth in the medium term, it is important to diversify the economic structure as well as to increase productivity.** For this, the private sector will have to play an increasingly important role in the economy, with the public sector shifting from being the driver of growth to being more of a catalyst. Progress in this regard is expected to help address youth unemployment. While the overall unemployment rate stood at 2.5 percent in 2015, youth unemployment exceeded 10 percent.

20. **Overall macroeconomic policy has been moving in the right direction and aims to address key challenges in the medium term.** The RGoB is finalizing the 2016 Economic Development Policy (EDP). The EDP recognizes that unless the constraints to business are systematically addressed, the potential of the private sector as the engine of growth cannot be realized. In this context, the EDP aims to improve the enabling environment for investment. The EDP also calls for both fiscal and monetary policy initiatives to support rapid and sustained growth. On fiscal policy, new tax rationalization measures were approved by the cabinet (prior action 2 of this operation). On monetary policy, the RMA will implement the FSDAP (prior action 5 of this Operation) so that the financial sector can further support the development of the private sector. With the establishment of the Department of Macroeconomic Affairs under the Ministry of Finance (MoF), the institutional structure for macroeconomic policy formulation and coordination has been strengthened.

21. **The findings of the most recent joint World Bank–IMF DSA[5] remain broadly the same as the 2014 DSA, with Bhutan's debt dynamics showing a moderate risk of distress.** The DSA observes that Bhutan's rapid hydropower development has led to a substantial buildup of external debt, with external debt ratios breaching all indicative thresholds and projected to continue doing so for several more years. At the same time, the DSA recognizes key factors mitigating risk. For example, a large share of external debt is linked to hydropower project loans from the Government of India, which covers both financial and construction risks of these projects and buys the surplus electricity output at a price reflecting costs plus a 15 percent net

[4] http://www.worldbank.org/en/news/feature/2016/06/20/india-development-update-june-2016

[5] http://www.imf.org/external/pubs/ft/scr/2016/cr16206.pdf

return. As a result, Bhutan's debt situation is expected to improve in the medium and long term, reflecting significantly higher electricity exports once the hydropower projects come on stream (Figures 1 and 2).

22. **Given recent economic developments, sound policy, and the favorable macroeconomic outlook, Bhutan's macroeconomic policy framework remains adequate for development policy operations.** Bhutan's sound macroeconomic policy stance has enabled the recovery from the Indian rupee shortage in 2012, and the maintenance of macroeconomic stability. Both monetary and fiscal policy have been coordinated and implemented in a prudent manner. This is consistent with the International Monetary Fund (IMF) assessment articulated in the June 2016 Article IV Consultation with Bhutan.[6] Executive Directors welcomed the improvement in Bhutan's macroeconomic performance and commended the authorities for the significant economic and social gains of recent years. Directors considered the outlook favorable.

Table 1 Key Macroeconomic Indicators

	2012 (Act.)	**2013 (Act.)**	**2014 (Act.)**	**2015 (Pre.)**	**2016 (Pro.)**	**2017 (Pro.)**	**2018 (Pro.)**
Real Economy	**Annual percentage change, unless otherwise indicated.**						
GDP (nominal)	14.7	8.1	13.4	10.4	10.2	12.8	14.6
Real GDP	5.1	2.1	5.7	6.5	7.4	9.9	11.7
Per Capita GDP (in US$)	2,452	2,383	2,561	2,656	2,758	3,065	3,463
Contributions:							
Consumption	-1.2	22.2	-3.7	5.9	n.a.	n.a.	n.a.
Investment (incl. change in inventories)	2.3	-22.7	9.8	7.7	n.a.	n.a.	n.a.
Net Exports	4.0	2.6	-0.3	-7.1	n.a.	n.a.	n.a.
Others (incl. statistical discrepancy)	0.0	0.0	0.0	0.0	n.a.	n.a.	n.a.
Imports (nominal)	6.1	13.1	22.7	16.1	11.9	29.7	38.5
Exports (nominal)	8.8	13.4	16.8	14.0	14.4	15.0	13.7
Unemployment rate (ILO def., percent)	2.1	2.9	2.6	2.5	n.a.	n.a.	n.a.
GDP deflator	9.2	5.9	7.3	3.7	2.6	2.6	2.6
Consumer price index	10.9	8.8	8.3	4.5	4.0	4.0	4.0
Selected Monetary Accounts	**Annual percentage change, unless otherwise indicated.**						
Broad Money (M2)	5.9	-0.8	16.4	9.9	n.a.	n.a.	n.a.
Credit to Non-Government	-	-	11.3	16.7	n.a.	n.a.	n.a.
Interest Rate (base rate, percent)	10.4	10.8	10.0	10.5	n.a.	n.a.	n.a.
Balance of Payments	**Percent of GDP, unless otherwise indicated.**						
Current Account Balance	-31.0	-23.1	-24.6	-31.5	-29.4	-23.7	-15.7
Current Account Balance (excl. public current transfers)	-38.2	-30.4	-30.0	-35.9	-32.4	-26.3	-17.9
Imports (goods and services)	64.6	60.6	57.4	60.0	60.6	54.2	47.1
Exports (goods and services)	36.0	37.0	35.8	32.9	30.5	29.5	31.6
Foreign Direct Investment	2.7	0.8	1.6	0.8	0.5	0.8	1.2
Gross Reserves (in millions of US$)	735	796	949	949	n.a.	n.a.	n.a.
In months of next year's imports	7.6	8.6	9.9	8.7	n.a.	n.a.	n.a.
External Debt	85	94	94	97	102	103	98
Exchange Rate (with US$)	53	59	61	64	n.a.	n.a.	n.a.
Memo Item							
GDP (nominal, billions of US$)	1.8	1.8	2.0	2.1	n.a.	n.a.	n.a.

Source: Ministry of Finance, Royal Monetary Authority, National Statistics Bureau and World Bank.
Note: n.a. =not available.

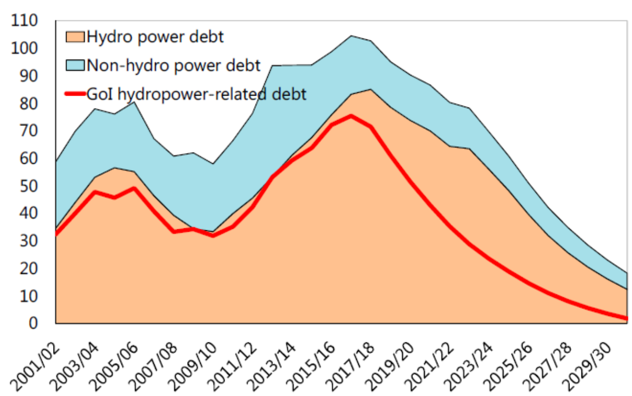
[6] http://www.imf.org/external/np/sec/pr/2016/pr16313.htm

Table 2 Key Fiscal Indicators (percent of GDP)

	2012 (Act.)	2013 (Act.)	2014 (Act.)	2015 (Pre.)	2016 (Pro.)	2017 (Pro.)	2018 (Pro.)
Overall Balance (incl. grants)	**-2.7**	**-0.2**	**2.7**	**-0.7**	**-4.2**	**-3.0**	**4.1**
Primary Balance	-0.3	2.0	4.4	0.8	-2.8	-1.9	6.2
Total Revenues and Grants	**33.0**	**31.9**	**31.3**	**30.1**	**28.8**	**25.1**	**25.1**
Tax Revenues	15.6	14.8	14.5	13.9	12.8	11.8	10.5
Non-Tax Revenues	5.9	5.9	5.8	5.5	5.2	4.5	6.2
Grants	11.6	11.0	10.3	10.0	10.6	8.8	8.5
Expenditures	**35.7**	**32.1**	**28.6**	**30.8**	**33.0**	**28.2**	**21.0**
Current Expenditures	18.1	16.9	16.4	16.9	16.6	15.4	13.5
Capital Expenditures	19.0	16.5	13.6	15.4	17.6	14.0	9.7
Net Lending	-0.9	-1.0	-1.6	-1.6	-1.2	-1.2	-2.2
Public and Publicly Guaranteed Debt	89	98	96	98	102	103	98

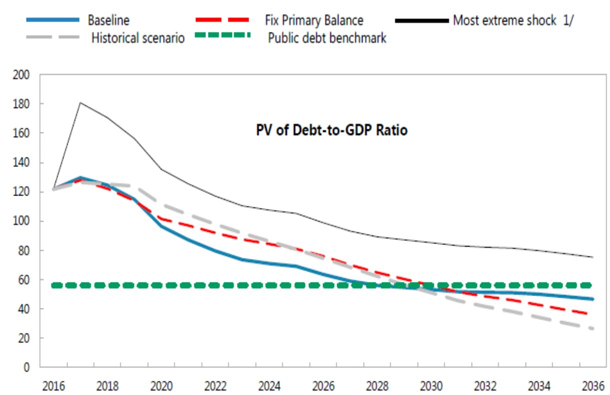
Source: Ministry of Finance and World Bank.

Figure 1 Bhutan's Debt Situation Is Expected to Improve in the Medium and Long Term (in percent of GDP)



Source: World Bank–IMF Joint DSA (June 2016).

Figure 2 Public Debt Sustainability Analysis



2.3 IMF RELATIONS

23. **The most recent Article IV review took place in April/May 2016 (including a joint World Bank–IMF DSA), and was presented to the IMF Board in June 2016 (Bhutan is under a two-year Article IV cycle).** In addition, the IMF provides technical assistance focusing on macro-fiscal, budget, and public financial management, as well as domestic revenue mobilization. A long-term IMF advisor on cash management is based in Bhutan. This Operation is consistent with and reinforces the IMF Article IV recommendations, especially on fiscal and monetary policies. This Operation also complements the macro-fiscal support provided by the IMF, and brings additional depth to key structural reform efforts aimed at improving the investment climate and fostering private-sector development.

3. THE GOVERNMENT'S PROGRAM

24. **"Self-reliance and inclusive green socioeconomic development" are the overarching objectives of Bhutan's 11th FYP**.[7] A notable paradigm shift of the 11th FYP is the adoption of a results-based planning framework that articulates clear outputs and outcomes to realize these objectives. The RGoB identified 16 National Key Result Areas (NKRAs) to be achieved over the next five years. The 16 NKRAs are described under the four pillars of GNH, the philosophy and framework that guides Bhutan's development:

- **Sustainable and Equitable Socioeconomic Development**: Sustained Economic Growth; Poverty Reduced and MDG Plus Achieved; Food Secure and Sustained; and Full Employment. The achievement of these four NKRAs are measured by corresponding Key Performance Indicators (KPIs), such as the rates of GDP growth, inflation, poverty, school enrollment, mortality, employment, cereal sufficiency, and the like.
- **Preservation and Promotion of Culture**: Strengthened Bhutanese Identity, Social Cohesion, and Harmony; and Indigenous Wisdom, Arts, and Crafts Promoted for Sustainable Livelihoods. The corresponding KPIs to measure progress include the GNH Index, rural households engaged in cultural industries, and jobs created.
- **Conservation and Sustainable Utilization and Management of the Environment**: Carbon Neutral/Green and Climate Resilient Development; Sustainable Utilization and Management of Natural Resources; Water Security; and Improved Disaster Resilience and Management Mainstreamed. The NKRAs have corresponding KPIs to measure performance.
- **Promotion of Good Governance**: Improved Public Service Delivery; Democracy and Governance Strengthened; Gender Friendly Environment for Women's Participation; Corruption Reduced; Safe Society; and Needs of Vulnerable Groups Addressed. KPIs for tracking progress toward these NKRAs include: reducing the turnaround times for government-to-citizen (G2C), government-to-business (G2B), and government-to-government (G2G) services; monitoring government performance; drafting legislation to ensure quotas for women in elected offices; reducing female unemployment; implementing the national anti-corruption strategy; and reducing crime per 1,000 population.

25. **Implementation of the 11th FYP has been strengthened.** Formulation and implementation of macroeconomic policies (including fiscal and monetary policy initiatives) have been anchored by the 11th FYP to ensure consistency. To further strengthen key linkages, the RGoB introduced APAs as part of the FY2016/17 budget. The APAs align the allocations of the budget with agreed objectives of respective agencies.

26. **The RGoB, led by the Gross National Happiness Commission (GNHC), has started preparing the 12th FYP**. The preparation commenced with broad stakeholder consultations, including ministries and agencies within the RGoB, members of parliament, civil society organizations, and representatives from the private sector. The GNHC also established a dedicated website to solicit views from all stakeholders.[8] To stimulate discussions, the GNHC prepared a draft inception note providing guidelines for the preparation of the 12th FYP. Also, a new set of NKRAs is under development, with the RGoB focusing on economic diversity and productivity enhancement.

27. **Bhutan's development strategies are consistent with the World Bank's twin goals.** KPIs for NKRA 2 (Poverty Reduced and MDG Plus Achieved) include (i) income poverty reduced from 12 percent in 2012 to

[7] The 11th FYP is the second to be implemented since the introduction of the democratic constitutional monarchy in 2008. It was approved by Parliament in October 2013. Self-reliance is defined as being able to meet national development needs as articulated in the FYPs by 2020. Inclusive Social Development requires reducing poverty and inequality by enhancing the standard of living and the quality of life of the most vulnerable sections of society. Green Development means ensuring carbon-neutral development at all times.

[8] http://www.gnhc.gov.bt/12th-fyp-preparation/

less than 5 percent by 2017-18; (ii) multidimensional poverty reduced from 26 percent to less than 10 percent; (iii) Gini-coefficient reduced from 0.36 in 2012 to 0.30 by 2017-18; and (iv) MDG Plus achieved, ensuring gender parity at tertiary education levels. Also, various government programs aim to support poor households. For example, the GNHC recently introduced the Targeted Household Poverty Program, Bhutan's first social assistance program specifically aimed at poor households.[9]

4. THE PROPOSED OPERATION[10]

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

28. **The proposed Operation supports the sustainable and equitable socioeconomic development pillar of the 11th FYP and related RGoB initiatives on macroeconomic management and investment climate.** These include (i) aligning monetary and fiscal policy, (ii) establishing a stabilization fund, (iii) implementing dynamic reserve portfolio management, (iv) enhancing macroeconomic modeling and analytical capacity, (v) establishing an enabling infrastructure and streamlining business regulations, clearances, labor permits, and land acquisition, and (vi) encouraging the movement up the value chain for existing manufacturing industries. The 11th FYP includes specific objectives in terms of macro-fiscal stability, DB indicators, and gains in FDI. The improvement in the investment climate supported by the Operation is expected to have positive impacts on key sectors for economic growth, such as agriculture, tourism, trade, industries, and mining.

29. **The objectives of the Operation are to promote fiscal discipline, improve access to finance for enterprises, and improve the climate for business entry and investment in Bhutan.** The Operation highlights three pillars. The first pillar focuses on strengthening fiscal sustainability and self-reliance. The second pillar supports increasing access to finance. The third pillar underpins improving the investment climate and increasing domestic and foreign investment. The Operation is based on eight time-bound prior actions. The prior actions of both the first and second operations are discussed in Section 4.2 and summarized in Annex 1.

30. **The design of the Operation incorporates lessons learned**. The 2014 Country Partnership Strategy Completion Report notes that programmatic approaches are advantageous for Bhutan's future lending, providing an important forum for dialogue on key policy and institutional reforms. The programmatic budget support operations help to sustain the momentum of reforms while underpinning WBG engagement with the RGoB for policy reform implementation. The programmatic approach also helps build a constituency for the reform program in a well-sequenced and incremental way. Results and impact are helped by integrating analytical work, technical assistance, and policy financing. The Implementation Completion and Results (ICR) report for the last DPC series underscored the importance of analytics to inform the policy dialogue, support capacity development, link with technical assistance, and underpin programmatic approaches. The design of this Operation has reflected these lessons.

4.2. PRIOR ACTIONS, RESULTS, AND ANALYTICAL UNDERPINNINGS

4.2.1 Pillar 1: Strengthening Fiscal Sustainability and Self-Reliance

31. **Policies supported by the DPC series have contributed to strengthened macroeconomic management.** Aggregate demand of the economy has been carefully managed and macroeconomic stability has been maintained. After lifting the ban on new housing and vehicle loans in July 2014 (part of prior action

[9] http://www.gnhc.gov.bt/wp-content/uploads/2016/03/THPP-Web-Documents.pdf

[10] The preparation of the proposed operation was supported by the Korea-World Bank Group Partnership Facility's Global Facility on Growth for Development.

1 of DPC1), credit to the private sector has accelerated. Nevertheless, the RMA maintains gross international reserves equivalent to about 9 months of next year's goods and services imports. The RMA introduced a new policy on reserve management in June 2015, whereby the RMA can convert hard currency reserves into Indian rupees. As part of a prior action of DPC1, the MoF issued the Tax Public Notification that raised customs duties, sales taxes, and green taxes on selected items. As a result, tax revenues increased by 16 percent from Nu. 15.8 million in 2013 to Nu. 18.4 million in 2015 (preliminary estimates). Self-reliance measured by the share of the total expenditures covered by domestic revenues increased from 60 percent in 2012 to 63 percent in 2015.

Debt Policy

32. **Bhutan's large fiscal gap is funded by donor resources and calls for fiscal consolidation and prudent debt management**. Towards this end, a debt policy was approved by the Cabinet in August 2016 (prior action 1). It aims to ensure that financing decisions are prudent and that public debt is maintained at a sustainable level. Inter alia, the policy provides for: (i) external debt thresholds; and (ii) clarification of institutional arrangements, giving the MoF the mandate to serve as the nodal agency for implementing the policy and establishing a high-level Public Debt Advisory Committee. It strengthens the Debt Management Division by upgrading it to the Department of Public Debt Management, which will consolidate all functions related to public debt management. The policy proposes the formulation of a Medium-Term Debt Management Strategy and regular debt sustainability analyses. The WBG provided advice on the policy.

Prior action 1: The Recipient, through its Cabinet, has approved a debt policy setting debt limits to improve fiscal sustainability.

33. **Expected Results.** Enhanced debt management is expected, with closer monitoring and articulation of debt limits. Given the out-sized role of the hydropower sector in Bhutan's debt dynamics, the appropriate focus is on non-hydropower debt as a share of GDP, which is expected to decline from 27 percent of GDP in FY2014/15 to below 25 percent of GDP in FY2017/18.

Tax Rationalization Measures

34. **Enhancing tax collection is an integral component of increasing fiscal self-reliance**. The overall tax-to-GDP ratio stood at 13.9 percent in 2015. Numerous tax exemptions and holidays have weakened the tax base, without clear evidence of enhanced private-sector development. In 2015, tax expenditures (taxes foregone) were estimated at 15 to 20 percent of total tax revenues. Efforts to address the low tax base in 2014 included a large increase in customs duties, sales taxes and green taxes on selected goods (DPC1 prior action). Though it is too early to observe significant impacts of these measures on domestic resource mobilization, revenues from sales taxes increased by 41 percent, and green taxes by 300 fold between 2013 and 2015.

35. **In 2016, tax incentives (exemptions and holidays) were reexamined, focusing on their efficiency in achieving stated objectives.** Many tax measures, such as tax incentives, are found to be ad hoc and inconsistent, which has caused confusion and inefficiency. Hence, there is substantial scope for tax rationalization measures to improve the efficiency of tax measures and collections (prior action 2). The conduct of this exercise was closely aligned with the formulation of the new EDP, which includes several tax measures for private-sector development. After ministerial approval, the Revised Rules and Regulations on Fiscal Incentives 2016 will be approved by the Cabinet. The WBG has provided hands-on technical assistance in drafting the measures, which include revisions to both general (such as sales tax and customs duty exemptions for imports of plant and machinery) and sector specific incentives (such as tax holidays). Affected sectors include cottage and small industries, cooperatives, tourism, and mining, among others. In addition, recent efforts such as the launch of the online tax filing system of the Revenue Administration

Management Information System (RAMIS) and the computerization of the sales tax administration are expected to help ease the cost of compliance for taxpayers.

Prior action 2: The Recipient, through the MoF, has approved the revised rules and regulations on fiscal incentives in order to broaden the tax base and align with the Economic Development Policy.

36. **Expected Results.** Generation of higher tax revenues through less distortionary tax incentives are expected. Due to the projected increase in the size of the economy from hydropower projects, which do not yield proportionate contributions to tax revenues, the tax to total GDP ratio can be misleading. Thus, the nominal value of tax revenues is used as the results indicator. Tax revenues are expected to increase from Nu. 18.4 billion in FY2014/15 to Nu. 23.2 billion in FY2017/18.

4.2.2 Pillar 2: Increasing Access to Finance

37. **Bhutan's firms, and especially its MSMEs, cite limited access to financial services as key issues.** Both the 2009 and 2015 Enterprise Surveys show that the top constraint that firms face is access to finance, with 16 percent of firms identifying it as the top constraint in the 2015 survey. This survey also shows that, on average, firms need to provide collateral of around 180 percent of the loan amount, though this figure is lower than the 283 percent registered in 2009. While the collateral requirement has come down, fewer firms receive loans or lines of credit: 47 percent in 2015 compared to 59 percent in 2009. Procedures for acquiring loans are complex, collateral requirements remain high, and regulations governing loan use are restrictive. The percentage of adults, including women, using banking services is still very low, even compared to other South Asian countries. The WBG's Global Findex database on financial inclusion shows that only 34 percent of adults had a bank account in 2014.

38. **Since DPC1, some progress has been made, and follow-up policy initiatives have been observed.** Credit bureau coverage increased from 18 percent of adults in 2015 to 23 percent in 2016, according to DB. On the policy front, the RMA introduced the Minimum Lending Rate in August 2016, which is adjusted taking into account the marginal cost of funds, the negative carry charges on the cash reserve ratio, and the operating costs of the lending institution. The new system is therefore designed to provide attractive rates for credit going to productive sectors, with the goal of promoting economic growth, generating employment, and helping contain credit to unproductive sectors.

Resolving Insolvency and Submission of a New Insolvency Bill

39. **DB reports "no practice" of insolvency, and no formal or informal guidelines to facilitate the rehabilitation of distressed businesses and cooperation among banks in order to restructure loans**. Where insolvency regimes are most effective, creditors—confident they will be able to collect on loans—are more likely to lend, including to borrowers with whom they have not had a long-standing relationship. The authorities drafted a new Insolvency Bill, which will replace the current Bankruptcy Act. The new Insolvency Bill aims to introduce a new restructuring and insolvency system that is aligned with best practices, and improve both the reorganization and the liquidation of distressed companies, with specific provisions for MSMEs (prior action 3). In addition, the current Bankruptcy Act generally covers non-incorporated entities, but in specific situations it applies to corporations, which are also regulated by the Companies Act. The new Insolvency Bill will clarify these regulations in order to give investors greater certainty. Overall, the insolvency system will be simplified and modernized.

40. **The Cabinet approved the new Insolvency Bill in October 2016.** The Office of the Attorney General led the drafting of the Bill, which included inputs provided by a Policy Committee comprising officials from several ministries, spearheaded by the MoF. The Policy Committee offered guidance on an ongoing basis, thus ensuring inter-governmental buy-in of the new Insolvency Bill. Following the consultation and finalization of the Insolvency Bill, the Cabinet approved the bill for further submission to the Parliament in late 2016 for the winter session.

Prior action 3: The Recipient, through its Cabinet, has approved for submission to its Parliament the Insolvency Bill to provide a framework for businesses to resolve insolvency and to strengthen the rights of secured creditors.

41. **Expected Results.** An improved legal framework for insolvent companies, in addition to a fully functional collateral registry following international best practice, is expected by July 2018. Together with the amendments to the Movable and Immovable Property Act (DPC1 completed prior action 3) that facilitates the effective usage of movable assets as collateral, these legal and institutional reforms strengthen the environment for lending, helping to accomplish the following:

- Increase access to credit: The number of MSME loans in the collateral registry is expected to increase by at least 40 percent.
- Strengthen the legal rights of secured creditors: The DB Strength of Legal Rights Index is expected to increase from 4 to at least 6 (out of 12).[11]

Credit Information Bureau

42. **Increased credit information reduces the risk of lending and the cost of giving loans by providing accurate information about borrowers.** The Bhutan Credit Information Bureau (CIB) was established in 2010, and collects and distributes information from financial institutions. The current database coverage is 23 percent of the adult population. Since the CIB only collects credit information from banks, the data is limited to borrowers that already have some access to the formal financial system, and hence, its usefulness in promoting greater access to finance is limited. Five years after starting operations, the CIB has yet to collect and make available to subscribing financial institutions the credit information from utility companies. This sophisticated reform (only a few CIBs in Asia collect utility bill information) will help lenders achieve a better know-your-customer process by revealing applicants' utility payments histories. While most post-paid mobile subscribers are likely to be existing borrowers, CIB coverage will likely increase substantially through the addition of rural household clients of the Bhutan Power Company (BPC), who could potentially borrow at the MSME level. The result would be greater access to finance (as a percentage of the adult population). The two mobile companies currently operating in Bhutan have more than 400,000 subscribers, of whom around 10 percent are active post-paid subscribers. BPC has 127,942 households as clients, 80 percent of whom are in rural areas. Utility regulators (Bhutan InfoComm and Media Authority, or BICMA, and Bhutan Electricity Authority, or BEA) have issued a joint directive enabling utility companies to share credit information with the CIB, which upgraded its system to enable the sharing of credit information from utility companies (prior action 4). The CIB is also in the process of including microfinance information. Currently, one of the two licensed microfinance institutions, Rural Enterprise Development Corporation Limited, is using CIB services and provides information. CIB is working with a second microfinance institution, Respect Educate Nurture Empower Women (RENEW), on how to submit information and overcome differences in IT systems.

Prior action 4: The Recipient: (a) through the BICMA and BEA, has issued a directive for utility companies to share credit information with the CIB; and (b) through a letter from the CIB dated October 25, 2016, has certified the completion of the upgrades of its system to enable the sharing of credit information from utility companies.

[11] Measures compiled in the Strength of Legal Rights Index focus on whether collateral and bankruptcy laws include certain features that facilitate lending. The higher the index, the stronger the legal rights of borrowers and lenders. The index was measured on a scale of 10 in DB2013, but it is now measured on a scale of 12 after two new points were added in 2014 to the data collected to assess the overall legal framework for secured transactions and the functioning of the collateral registry.

43. **Expected Results.** Bringing a small portion of utility company subscribers and households into the CIB could enable the bureau to achieve a coverage target of 30 percent of the adult population by 2017, of which males account for 19.5 percentage points, and females account for 10.5 percentage points. Overall, it is expected that this change will have a significant impact in increasing access to finance through the provision of formal financial services to a larger cross-section of the population, as financial institutions are able to get more information through the CIB about the credit behavior of borrowers, particularly those outside the formal financial system.

Financial Sector Development Action Plan

44. **A coherent vision for an integrated and sound financial sector has been formulated seeking to promote financial deepening and greater access to finance.** The Financial Sector Strategy and Action Plan for Implementation (also known as Financial Sector Development Action Plan or FSDAP) provides the vision and concrete actions to be undertaken in order to deepen the financial sector and improve its soundness, efficiency, and inclusiveness (prior action 5). While the action plan will focus on enhancing financial stability, it also identifies ways of expanding MSME access to finance as a key priority.

45. **The development of a financial sector strategy was led by the MoF and the RMA, with technical support from the WBG, following a stocktaking exercise in FY2013/14.** The RMA Board of Directors approved the FSDAP in June 2016, and the Cabinet approved the document on September 26, 2016. The FSDAP includes many actions that are beyond the jurisdiction of the RMA but affect the financial sector. Approval by the Cabinet ensures better coordination between the RMA and other relevant regulatory bodies/authorities in the implementation of the FSDAP. The WBG intends to support implementation of key actions identified as priorities under the FSDAP following approval at the national level (Box 1 on FSDAP).

46. **The FSDAP also addresses initiatives articulated under prior actions 3 and 4.** The FSDAP states that "improvements will also be made in the legal system to better protect lenders. The Bankruptcy Act (i.e. Insolvency Bill) will be amended both to provide a framework for businesses to resolve insolvency and to strengthen secured creditors' rights." The FSDAP states that "steps will be taken to broaden CIB coverage and improve the quality of its analytical support relating to data it collects. Coverage will be expanded to cover credit-related data from the utilities and loans made by the microfinance institutions. The utility regulators, BICMA and BEA, will issue a directive requiring the utility companies to share information with CIB and a system will be designed and implemented. CIB will significantly upgrade its IT package, as needed, to implement this program."

47. **The FSDAP identifies several high priorities.** These include: (a) strengthening the regulatory framework of non-bank financial institutions (such as pensions and provident funds) to enhance supervision, (b) strengthening the regulatory/supervisory structure of the insurance sector to protect policy holders, raise confidence and improve access to insurance, (c) developing suitable regulation to encourage small- and medium-enterprise finance through banks that would help increase access to financial services, and (d) designing a National Payments System Strategy and Policy to bring about greater usage of electronic payments, including to under-banked segments of the population.

Prior action 5: The Recipient, through its Cabinet, has approved the Financial Sector Development Action Plan.

48. **Expected Results**. The adoption and implementation of the strategy and action plan will meaningfully improve the ability of the financial system to contribute to private sector development and channel savings efficiently to productive investments by: (i) prioritizing non deposit-taking micro-finance institutions that set up financial circles in villages, especially those that focus on women, (ii) facilitating the establishment of well-qualified, deposit-taking, micro-finance institutions that focus on small clients, (iii) creating different channels for financial services to enable e-money transactions with the expansion of mobile banking, (iv)

creating a commodity exchange for agriculture products and a warehouse receipts legal/regulatory framework to increase agriculture lending, (v) exploring the establishment of a partial credit guarantee program, (vi) formulating a policy framework and a national strategy for entrepreneurship development, and (vii) finalizing a national financial literacy strategy that would help rural populations obtain the necessary knowledge to choose financial products best suited to their needs. Together with the improvement of the insolvency regime and the wider collection of credit data, following through on these initiatives is expected to increase financial inclusion as measured by bank accounts as a percentage of the population over 15 years of age:

- Baseline (2014): 34 percent (all), 28 percent (women).
- Target (2017): 40 percent (all), 37 percent (women).

Box 1 Bhutan's Financial Sector Development Action Plan

The WBG supported the RGoB in the development of the FSDAP, which was prepared within the context of Bhutan's Vision 2020 document and 11th FYP objectives and priorities. The FSDAP identifies and addresses key financial sector issues that, if not addressed, would sharply undercut progress toward meeting these objectives. As Bhutan's future becomes increasingly linked to a globalized world, building and maintaining a sound and effective financial sector is fundamental to achieving satisfactory economic growth with equity, core pillars of GNH.

The request to help develop the FSDAP was first made by the authorities following the external imbalances with India in 2012 that led to Indian rupee shortages and a credit crunch. The WBG responded by providing assistance in drafting a stock taking report (April 2014) that provided an overview of the state of the financial sector, and the FSDAP in March 2016. The FSDAP identifies key challenges and proposes actions to address them in six areas: (i) Financial Inclusion and Financial Literacy, (ii) the Banking System, (iii) Non-Bank Financial Institutions, (iv) Financial Markets, (v) the RMA, and (vi) Financial Sector Infrastructure.

The FSDAP was endorsed by the RMA Board in June 2016 and approved by the Cabinet in September 2016. The WBG has been approached for assistance in implementing some key actions, which is under consideration. The areas identified are (i) undertaking an institutional and organizational review of the RMA, (ii) promoting financial deepening, (iii) strengthening the regulatory framework of non-bank financial institutions, (iv) strengthening the small- and medium-enterprise sector, and (e) modernizing the payments system.

4.2.3 Pillar 3: Improving the Investment Climate and Increasing Domestic and Foreign Investment

49. **The government recognizes that a credible and predictable business environment that minimizes the cost of doing business, expedites business start-ups, and facilitates domestic investment and FDI is vital to achieving the objectives envisaged in the 11th FYP.** Over the past five years, through a combination of TA, investment, and development policy financing, the WBG has supported the RGoB's reform efforts. The 11th FYP aims to create 82,000 new private-sector jobs through the Rapid Investment in Selected Enterprises (RISE) program.[12] To spur private-sector development, the government formulated and approved a number of policies and laws. They include: (i) the FDI policy and rules and regulations (DPC1 prior action); (ii) the Renewable Energy Policy; (iii) the MSME Policy; (iv) the Licensing Policy (DPC1 prior action); (v) the Enterprise Registration Bill (DPC1 prior action, approved by Cabinet, pending parliamentary

[12] "Selected enterprises" refers to businesses operating in the following sectors: agriculture, construction (including hydropower), construction (excluding hydropower), manufacturing, culture, Information and Communication Technology (ICT), and tourism. The RGoB's RISE initiative aims to encourage private sector development. Specifically, to diversify economic activities, the RGoB required all relevant agencies to revisit their policies to create a business environment more conducive to private sector investment in these selected sectors.

approval);[13] (vi) the Movable and Immovable Property Act Amendments (DPC1 prior action, approved by Cabinet, pending parliamentary approval);[14] and (vi) the amended Companies Act (DPC1 prior action, approved by Cabinet and Parliament). Forthcoming policies and laws include the industrial infrastructure development policy (governing economic zones), the mineral development policy, and the consumer protection bill.

50. **Since the completion of DPC1, the RGoB has followed up with further policy actions.** Following the amendment of the Companies Act (DPC1 prior action 5), it was approved by Parliament in July 2016. The new EDP is expected to be approved by the Cabinet by the end of 2016. The EDP consists of an overarching strategy paper focusing on private-sector development. The RGoB undertook extensive consultations with stakeholders and has thus already improved coordination across ministries and agencies.

51. **Despite recent progress, starting, operating, and closing a business in Bhutan remains a difficult endeavor**. Bhutan's ranking in DB2017 slipped marginally to 73 from 71 the previous year, suggesting that more needs to be done to improve the country's investment climate. In addition, taking into account factors beyond the regulatory environment, such as market size and availability of human capital, Bhutan's overall level of competitiveness as captured by the World Economic Forum's most recent Global Competeveness Report is below comparator countries (97 out of 138 countries). A breakdown of the different aspects of the business environment and competitiveness reveals notable areas of weakness. Besides a lack of financial development and skills at the high end, Bhutan still has much room for improvement in regulations governing access to credit, dealing with construction permits, protecting minority investors, and the three areas targeted by this Operation: resolving bankruptcy, facilitating business registration, and enabling transfer and registration of land titles. Some of these shortcomings are in line with previous assessments of the main constraints to private-sector growth in Bhutan, suggesting that continuing reforms to improve these investment climate areas remain crucial to making the country's businesses more competitive (Table 4). The Investment Climate Assessment in 2010, for example, pinpoints access to finance, transportation, access to a skilled domestic labor force, and regulatory complexity as Bhutan's main challenges.

Land and Property Registration

52. **Currently, two to three months are required to obtain a property title at the Thimphu Municipality, in part because property records are not easily accessible to end users.** Registered property rights play an important role in supporting investment, productivity, and growth. With land and buildings accounting for between one-half and three-quarters of wealth in most countries, an up-to-date land information system matters. When multiple sources must be consulted to obtain relevant information on the property to be transferred, the procedure is time-consuming and potentially subject to errors and corruption. By upgrading the existing electronic system of land-related information and matching records, Bhutan will be able to maintain accurate land information and limit potential land conflicts. After having completed the digitization of all the property titles, the next step is to implement a fully operational online registry, with electronic input and search capabilities (prior action 6). With the support of the WBG, the National Land Commission (NLC) deployed the system online at the beginning of October 2016.

53. **The upgraded platform to transfer property titles fully integrates the NLC's back office operations with those of the Thimphu Municipality's Land Records section.** It gives end users the option to submit online all documents necessary to transfer property titles, even if the user still must physically go to the

[13] The bill was deliberated in the fifth session of the second Parliament (November 2015), and although the National Assembly (Lower House) approved the proposed bill, the agenda was dropped by the National Council (Upper House). The National Council requested the National Assembly to withdraw the bill, after which it propose changes for betterment of the bill.

[14] The amendments were approved by Cabinet and are currently being reviewed by the Office of the Attorney General before submission to the Parliament.

municipality to pick up the final title (as required by law). The new online system will function in parallel with the manual system for a limited period of time in order to adhere to the principles of inclusion in the delivery of public services, until system usage stabilizes and a threshold level is reached. The implementation of this new system proposes a clear shift from the current system, which is internal facing (G2G system), to a citizen-facing system via a citizen services portal (C2G and G2C systems).

Prior action 6: The Recipient, through a letter from its National Land Commission dated October 25, 2016, has certified the establishment of an online property and land registration system in Thimphu.

54. **Expected Results.** An enhanced online property and land registry is expected to shorten the time required to register a property title, as measured by the DB indicator, from 92 days in 2013 to 47 days in 2017 (the global average is about 49 days, but Bhutan law provides a compulsory minimum of 30 days before a title can legally be transferred).

Single Window for Business Registration

55. **Registering a business in Bhutan takes considerable time.** It requires eight procedures, fifteen days, and visits to several different government institutions. To align business registration to best practices worldwide, the RGoB seeks to make the process easier and less costly.

56. **The Ministry of Economic Affairs (MoEA) is leading the establishment of an online single window for business registration, allowing the procedures of business registration to be performed in the same office through the submission of one application, with the option to register online.** This reform will allow the registration of sole proprietors, as required by the new Enterprise Registration Bill (DPC1 prior action),[15] as well as traditional companies. With the support of the WBG, the MoEA's Company Registry Division (CRD) deployed the new business registration system at the end of September 2016 (prior action 7). The system allows end users to create a company online, with options to fetch automatically the tax number issued, thus enabling the CRD and the tax authority to integrate their back-end operations. In a later phase, the online system will also integrate modules for appending Citizenship Identity Card and trade license information, the latter through an enhanced interoperability system with MoEA's Office for Trade Licenses.

57. **To support implementation of the reform, the WBG will assist the CRD (and the NLC) to add modules to the system establishing an end-users business-to-government (B2G) feedback mechanism via mobile applications.** This will be done after the online systems are implemented and the usage of the system starts. The B2G feedback loops will generate just-in-time information from businesses on reform implementation quality for both company registration and land registration reforms, including information for government service delivery. The feedback loops will consist of mobile-based surveys with a small number of granular questions meant to capture businesses' actual experience on the ground. These may be complemented by interviews of public officials tasked with implementation to understand the constraints they face in implementing reforms. If needed, the findings will help trigger corrective actions by the RGoB to close implementation gaps at the NLC and the CRD, with effectiveness on these actions verified through follow-on surveys.

[15] The Enterprise Registration Bill, approved by the Cabinet, introduces the legal form and registration procedures for partnerships and sole proprietorships. As a result of the bill's approval, businesses find it easier to register enterprises. The new bill will (i) eliminate the need for an operating license; (ii) establish a single business identification number for all businesses; and (iii) develop the legal framework for a one-stop-shop for business creation and online registration of new companies.

Prior action 7: The Recipient, through a letter from its MoEA dated October 26, 2016, has certified the introduction of a single window for online business registration.

58. **Expected Results.** As measured by DB, the time taken to register a business is expected to decrease from 32 to 10 days by June 2017 (the global average is about 22 days), the associated cost is expected to fall from 5 to 4 percent of income per capita, and the number of procedures is expected to decrease from 8 to 4.

Public Private Partnership (PPP) Policy

59. **The RGoB has developed a clear policy framework to enable PPPs in infrastructure projects.** Infrastructure contributes significantly to a country's social development. PPP policy and associated rules and regulations (concrete legal framework) are essential to promote more private-sector participation in critical infrastructure projects by way of outlining the responsibilities and duties of the contracting government agency/office. Sound PPP rules and regulations also help ensure transparency in procedures, creating a level playing field for private investors and bringing more certainty to the PPP environment for all stakeholders. Although the RGoB has had a few PPP projects, including a parking facility financed by the International Finance Corporation (IFC), it is important to establish a clear legal framework that builds on actual experience with PPP projects. In the revised EDP, PPP rules and regulations are highlighted as a key reform area, and the RGoB seeks to promote the development of key sectors, such as mining, through PPPs.

60. **During the last decade, PPPs have become increasingly important in leveraging private-sector resources for infrastructure projects.** In Bhutan, with the support of the WBG, the first Information Technology Park was launched in 2012 as a PPP. In addition to providing the framework for future PPP operations for sustainable infrastructure development, a PPP policy ensures adequate security for private-sector investment. It provides for the maintenance of adequate checks and balances through transparency, competition, and regulation. Since 2010, the WBG has been providing support to strengthen PPP capacity within the government, as well as helping to formulate PPP policy and associated rules and regulations (prior action 8). The PPP policy was approved by the Cabinet on March 1, 2016. With support from the WBG, the MoF drafted the rules and regulations and approved them at the end of September 2016. The PPP policy states that PPP projects will be subject to existing laws and regulations, including those related to the environment. In addition, the PPP policy notes qualitative project selection criteria based on "GNH goals, such as employment, the environment, and social equity."

Prior action 8: The Recipient: (a) through its Cabinet, has approved a PPP Policy; and (b) through the MoF, approved PPP rules and regulations at its 54th policy planning and coordination meeting in 2016.

61. **Expected Results**. A pipeline based on PPP rules and regulations will be prepared by the newly formed PPP Agency and reviewed by the PPP Steering Committee by the end of 2017. The enhanced environment for PPPs is expected to boost cumulative FDI from US$100 million in 2013 to US$150 million in 2017.

4.2.4 Program Evolution

62. **Out of ten triggers highlighted in DPC1, eight have been retained as prior actions in DPC2, of which two were strengthened and two were dropped.** Table 3 summarizes the changes between triggers envisaged in DPC1 and prior actions for this Operation. Although prior action 2 on tax rationalization measures remains broadly unchanged from trigger 2, it will be in full alignment with the new EDP and is thereby better positioned to contribute to improving the investment climate and increasing domestic and foreign investment. Prior action 3 (the new Insolvency Bill) has been modified from trigger 3 (amendments to the Bankruptcy Act). This is a meaningful change, as the new bill will address inconsistencies within the Companies Act and introduce an overall system for reorganization and liquidation procedures. Prior action 5 on approving the FSDAP has been strengthened compared with trigger 6, requiring Cabinet approval

rather than RMA approval. This is a significant change as the FSDAP includes agencies not under the supervision of the RMA, and Cabinet approval is expected to enhance coordination among stakeholders. Trigger 9 on the introduction of an electronic registry of building permits was dropped, as this reform lacked the necessary institutional support. Nevertheless, the WBG's TA remains available to introduce an online platform to issue building permits. Trigger 10 on enhancing the customs module of RAMIS has also been dropped. The RGoB informed the World Bank in early 2016 that system development had experienced serious technical problems.

Table 3. Explanation of Changes between DPC1 Triggers and DPC2 Prior Actions

DPC1 Triggers	DPC2 Prior Actions	Explanation of Changes
Trigger 1: Cabinet approves a debt policy setting debt limits to improve fiscal sustainability.	**Prior action 1:** The Recipient, through its Cabinet, has approved a debt policy setting debt limits to improve fiscal sustainability.	No change.
Trigger 2: MoF approves tax rationalization measures to improve its efficiency and broaden the tax base.	**Prior action 2:** The Recipient, through its Ministry of Finance, has approved the revised rules and regulations on fiscal incentives in order to broaden the tax base and align with the Economic Development Policy.	No change.
Trigger 3: Cabinet approves the amendments of the Bankruptcy Act to provide a framework for businesses to resolve insolvency and strengthen the rights of secured creditors.	**Prior action 3:** The Recipient, through its Cabinet, has approved for submission to its Parliament the Insolvency Bill to provide a framework for businesses to resolve insolvency and to strengthen the rights of secured creditors.	Strengthened. Following extensive discussion with stakeholders, it was agreed to replace the Bankruptcy Act with a new, streamlined, and cohesive Insolvency Bill that deals with the financial distress of both incorporated and unincorporated entities.
Trigger 4: National Land Commission improves the electronic property and land registration system in Thimphu with electronic input and search capabilities.	**Prior action 6:** The Recipient, through a letter from its National Land Commission dated October 25, 2016, has certified the establishment of an online property and land registration system in Thimphu.	The language was revised to better reflect the nature of the reform introduced by NLC.
Trigger 5: Utility regulators (BICMA and BEA) issue a directive for utility companies to share credit information with CIB. RMA introduces an inter-operability system between CIB and utility companies.	**Prior action 4:** The Recipient: (a) through the BICMA and BEA, has issued a directive for utility companies to share credit information with the CIB; and (b) through a letter from the CIB dated October 25, 2016, has certified the completion of the upgrades of its system to enable the sharing of credit information from utility companies.	The ownership of this initiative has been shifted from the RMA to the CIB. As the language in the trigger was not clear, it has been revised.
Trigger 6: RMA adopts the Financial Sector Development & Implementation Strategy.	**Prior action 5:** The Recipient, through its Cabinet, has approved	Strengthened to reflect Cabinet-level approval.

	the Financial Sector Development Action Plan.	
Trigger 7: MoEA introduces a single window for online business registration.	**Prior action 7:** The Recipient, through a letter from its MoEA dated October 26, 2016, has certified the introduction of a single window for online business registration.	No change.
Trigger 8: Cabinet approves PPP policy and MoEA approves PPP policy rules and regulations.	**Prior action 8:** The Recipient: (a) through its Cabinet, has approved a PPP Policy; and (b) through the MoF, approved PPP rules and regulations at its 54th policy planning and coordination meeting in 2016.	The MoF will be the ministry in charge of implementing related rules and regulations.
Trigger 9: Thimphu Thromde in consultation with the Ministry of Works and Human Settlement introduces an electronic registry of building permits.	Dropped.	Thimphu Thromde cannot develop and deploy the registry within the DPC2 timeframe. The World Bank TA nevertheless remains available.
Trigger 10: MoF enhances the customs module of RAMIS to allow the electronic submission of custom forms.	Dropped.	RAMIS implementation, supported by the Asian Development Bank (ADB), is on hold due to technical problems.

4.2.5 Analytical Underpinnings

63. **This Operation is underpinned by extensive analytical work.** The ICR report of the last DPC series underscored the importance of analytics to inform the policy dialogue**.** This especially applies for a DPC addressing more than one reform area. When combined with hands-on capacity building, DPCs are likely to yield stronger results. The prior actions of this Operation are supported by past and existing analytical work by the WBG, and are complemented by additional work undertaken by the RGoB and other development partners (Table 4). Several pieces are especially salient in informing the DPCs, including the Public Finance Think Piece (2016), the semiannual Bhutan Economic Updates, joint debt sustainability analyses, the poverty assessment (2014), financial-sector stock-taking (2014), the doing business reform memorandum (2013), and the investment climate assessments. The RGoB proactively draws upon the WBG's analytical work and technical assistance to formulate the key reform programs. This helps ensure that the prior actions of the DPCs are closely linked with analytics.

Table 4. Prior Actions and Analytical Underpinnings

Prior Actions	Analytical Underpinnings
Pillar 1: Strengthening Fiscal Sustainability and Self-Reliance	
Prior action 1: The Recipient, through its Cabinet, has approved a debt policy setting debt limits to improve fiscal sustainability. **Prior action 2:** The Recipient, through its Ministry of Finance, has approved the revised rules and regulations on fiscal incentives in order to broaden the tax base and align with the Economic Development Policy.	▪ IMF Article IV, Joint IMF-WB DSA (Jun 2016): Policy recommendations on fiscal policy, tax revenue reform, hydropower sector through fiscal policy, financial sector and DSA. ▪ Bhutan Tax Rationalization Technical Assistance (P156989): Supporting prior action 2, conceptualization of goods and services taxes. ▪ Bhutan Macro-Fiscal Monitoring, Analysis and Management Program (P152381): Biannual assessment of macroeconomic situation (including fiscal sustainability).

	▪ Public Finance Think Piece (P152382): Analysis of the hydropower sector's impact on the economy and the role of fiscal policy. ▪ IMF Tax assessment report, and macroeconomic and public finance policy: Framing domestic resource mobilization.
Pillar 2: Increasing Access to Finance	
Prior action 3: The Recipient, through its Cabinet, has approved for submission to its Parliament the Insolvency Bill to provide a framework for businesses to resolve insolvency and to strengthen the rights of secured creditors.	▪ Improving Bhutan Investment Climate (P153221): TA supporting prior action 3. ▪ Improving the Investment Climate in Bhutan, Reform Memorandum (2013). ▪ Doing Business reports.
Prior action 4: The Recipient: (a) through the BICMA and BEA, has issued a directive for utility companies to share credit information with the CIB; and (b) through a letter from the CIB dated October 25, 2016, has certified the completion of the upgrades of its system to enable the sharing of credit information from utility companies.	▪ IFC's Financial Infrastructure Project Bhutan (600756).
Prior action 5: The Recipient, through its Cabinet, has approved the Financial Sector Development Action Plan.	▪ Bhutan: Institutional and organization review of the RMA (P159068): TA on reviewing the organizational structure of the RMA, and drafting FSDAP and note on financial sector deepening. ▪ Bhutan Financial Sector Strategy (P147461): Supporting prior action 5.
Pillar 3. Improving the Investment Climate and Increasing Domestic and Foreign Investment	
Prior action 6: The Recipient, through a letter from its National Land Commission dated October 25, 2016, has certified the establishment of an online property and land registration system in Thimphu.	▪ Improving the Investment Climate in Bhutan, Reform Memorandum (2013). ▪ ICT Assessment of Land Registration in Thimphu, Bhutan (2015). ▪ Functional Requirement Specifications for Developing an Online System for Transferring Land and Property Titles in Thimphu, Bhutan (2016). ▪ Improving Bhutan Investment Climate (P153221).
Prior action 7: The Recipient, through a letter from its MoEA dated October 26, 2016, has certified the introduction of a single window for online business registration.	▪ Improving the Investment Climate in Bhutan, Reform Memorandum (2013). ▪ ICT Assessment of Business Registration in Thimphu, Bhutan (2015). ▪ Functional Requirement Specifications for Developing a One-Stop Shop for Business Registration in Thimphu, Bhutan (2016) ▪ Improving Bhutan Investment Climate (P153221).
Prior action 8: The Recipient: (a) through its Cabinet, has approved a PPP Policy; and (b) through the MoF, approved PPP rules and regulations at its 54th policy planning and coordination meeting in 2016.	▪ BHUTAN: Improving Capacity of the Government to Implement Infrastructure PPPs (Phase II) (P150701): TA on drafting PPP policy, and associated rules and regulations.

4.3 LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

64. **This DPC series underpins specific objectives included in the Country Partnership Strategy (CPS) FY2015-19 (IDA/R2014-0280; IFC/R2014-0290).** The CPS organizes its activities under three results areas: (i) improving fiscal and spending efficiency, (ii) increasing private sector growth and competitiveness, and (iii) supporting green development. The CPS states that the CPS will use DPCs to support policy reforms that promote sound fiscal policies and business-friendly regulations. In line with this statement, the Operation is designed to have a positive impact on economic growth by renewing focus on fiscal sustainability and private-sector development.

65. **This Operation is fully aligned with supporting progress towards the WBG's twin goals in Bhutan**. The CPS articulates how it plans to protect Bhutan's recent gains in reducing poverty and boosting shared prosperity through continued focus on improving rural livelihoods and managing urbanization, while protecting its natural assets. At the same time, the CPS recognizes that meeting the challenge of increasing Bhutan's competitiveness and managing the gains of rapid hydropower-fueled growth are critical to continue reducing poverty and boosting shared prosperity. Thus, the CPS aims to support the RGoB's efforts to manage macroeconomic and fiscal imbalances, design a clear fiscal strategy and role for the public sector, and improve the business environment to diversify the non-hydropower economy.

66. **Other World Bank operations/activities complementing the proposed DPC series include:** (i) policy dialogue on macro-fiscal issues, including a macroeconomic and public finance policy note (Public Finance Think Piece, 2016) as an input to a fiscal strategy; (ii) tax-related TA; (iii) financial-sector technical assistance (FIRST); (iv) TA for implementing PPP policy (via the Public-Private Infrastructure Advisory Facility); and (v) investment climate programmatic TA, which specifically supports this Operation by delivering technical assistance to achieve four of its prior actions. Pairing this programmatic TA with the DPC2 has been a powerful way of strengthening client commitment to reform, efficiently using funding provided by the World Bank (WB) and the IFC, and fostering cooperation among development agencies, including the ADB and the IMF. In addition to helping the RGoB achieve selected prior actions, this TA supported the Enterprise Survey 2015, and the preparation of a series of policy notes on agribusiness, productivity, and the labor force.

4.4 CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

67. **Consultations with stakeholders have shown broad-based support for the proposed reforms.** The current government and parliament have been in place for almost three years and have implemented timely reforms backed by solid political and stakeholder buy-in. Macro-fiscal reforms are well supported by most stakeholders, given the large fiscal and external macroeconomic imbalances faced by the country. Investment climate reforms in selected areas measured by the DB report met with collective support: the 11th FYP referred explicitly to DB and specified related targets. The private sector, represented by the Bhutan Chamber of Commerce and Industry, is also supportive.

68. **Coordination with other development partners.** The WBG and the IMF hold regular consultations on macroeconomic developments, debt management, and financial issues. The WBG actively participates and contributes to the IMF Article IV reviews and coordinates closely on a number of technical assistance initiatives. The WBG and the ADB coordinate in the areas of financial and private sector development, with the ADB providing a variety of technical assistance services. Specifically, the ADB is funding CIB's interoperability system hardware (prior action 4). Many donors are involved in supporting good governance initiatives, including the Austrian Development Agency, the EU's European Commission, the Swiss Development Cooperation, the Japan International Cooperation Agency, and the Danish Development Cooperation. The WBG is working with the European Union and the Austria Development Agency on a public financial management (PFM) multi-donor trust fund that is expected to be operationalized by the end of 2016.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

69. **Overall, the policies supported by this DPC are expected to have a positive impact on poverty reduction and social development over the medium and long term.** The three pillars of the DPC series, are expected to improve macroeconomic stability, enhance growth, and create more employment opportunities, which will contribute to the twin goals of poverty reduction and shared prosperity. However,

there is need to ensure that policies with wide-ranging impacts are implemented in an inclusive manner, enabling also the poor and vulnerable to benefit.

70. **The introduction of a debt policy and tax rationalization measures will improve macroeconomic stability and support sustainable economic growth, which are important prerequisites for poverty reduction and shared prosperity.** With market friendly taxation and strengthened macro-prudential measures, policymakers have given themselves the necessary tools to adjust and react to emerging imbalances. The direct impact on the poor and vulnerable should be limited, since the tax rationalization measures are related to enterprises (such as sector-specific incentives) rather than individuals. An increased tax base can boost the government's capacity to address poverty and vulnerability.

71. **Improved access to finance will support private-sector development and job creation, with positive benefits for the poor and the vulnerable population.** The implementation of policy measures aimed at enhancing access to finance is expected to benefit both enterprises and individuals. This is particularly important in Bhutan, where one in two households do not avail themselves of common bank products such as savings accounts and debit/credit cards, participation is even more limited for women-headed households,[16] and access to finance was identified as the top obstacle for many enterprises. For example, allowing the use of utility bill payments to create a credit history and movable collateral to access credit will benefit those who do not currently have a credit record or immovable assets to use as collateral. This may in turn help small businesses to finance expanded operations, leading to job creation.

72. **Enhancing the business environment is also expected to increase economic activities that contribute to poverty reduction.** Simplifying business procedures (licensing, starting and closing a business, transferring property titles) is expected to promote more businesses and thus lead to job creation, in particular by small and medium enterprises. The increase in employment opportunities, complemented by skills development of the poor, will increase the economic opportunities for the bottom 40 percent of the population. Similarly, making it easier for foreign investors to repatriate profits and lowering the minimum threshold for investment is expected to encourage investment in Bhutan, contributing to private sector development, economic diversification, and employment opportunities.

5.2 ENVIRONMENTAL ASPECTS

73. **The Operation is expected to support the development of Bhutan's private sector for green socioeconomic development and self-reliance.** The Operation will not include any physical interventions. The associated risks are low. Overall, the Operation is likely to have positive effects and will not produce adverse environmental impacts**.** Measures to promote fiscal sustainability and financial-sector development are expected to be environmentally neutral. None of the policies supported by the DPC series is likely to have direct, significant effects on the country's environment, forests, or other natural resources.

74. **Bhutan has adequate legislation, policy guidelines, and institutional mechanisms in place to protect against and manage any potential adverse effects on the environment, forests, and other natural resources.** Environmental conservation and sustainable development is a high priority for Bhutan, as reflected in Bhutan's consistently high Country Policy and Institutional Assessment score on environment protection. Bhutan's constitution, its long-term plan (Bhutan 2020), the 11th FYP, and the National Environment Strategy for Sustainable Development, enshrine the concept of sustainable development. The National Environment Strategy for Sustainable Development provides a broad framework for environmental decision-making and guides the planning, mainstreaming and implementation of environmental management actions within the overall context of sustainable development plans and programs at the central, sectoral, and local levels. All development proposals are subject to environmental assessments, as required by the Environmental Assessment Act (2000), the Regulation for the

[16] Bhutan Gender Policy Note 2013, "Connecting the Disconnected" (2012).

Environmental Clearance of Projects (2001), and the Regulation on Strategic Environmental Assessment (2002). Projects and developmental activities are not permitted in protected areas. The Waste Prevention and Management Regulation (2012) governs the treatment of E-waste. The National Environment Protection Act of Bhutan (2007), the umbrella environmental act, is being updated along with the Regulations, the Application for Environmental Clearance Guidelines, and also the Environmental Codes of Practices. Bhutan's main regulatory agency is the National Environmental Commission, which is being strengthened to carry out its compliance functions.

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

75. **The overall fiduciary risk associated with Bhutan's PFM and the use of budget resources is moderate.** While challenges remain, the core elements of an adequate financial management system are in place, including publication of the budget. The positive trajectory of improvements in PFM stems from the government's commitment to: (a) strengthen the legal framework; (b) enhance institutional capacity and the internal control framework; (c) improve the financial management information system; (d) enhance the use of competitive methods and transparent processes in public procurement; (e) develop and build on a government performance management initiative; and (f) strengthen the oversight of public finances. Together, these actions are aimed at increasing accountability and improving the timeliness, quality, transparency, and reliability of the government's accounting and reporting functions. The World Bank has been supporting PFM through TA/capacity building programs and supervision activities on investment projects. The RGoB established a national level apex committee called the PFM-Governance Group to coordinate PFM efforts. To provide sustained resources for the implementation of PFM reforms, a PFM Multi-Donor Fund (PFM-MDF) is being established.

76. **The National Budgets that are discussed and approved by parliament during the June sessions are disclosed on the MoF's public website and made available to the public in printed form.** The budget document is comprehensive and includes an analysis of the previous year's financial statements, the budget for the coming year by economic and administrative classification, a listing of tax measures, a macro-fiscal economic outlook, and a report on state-owned enterprises and government share-holdings, the RMA, and the pension fund. To date, quarterly and monthly execution reports are produced, but not disclosed. Financial statements of the previous year are disclosed after being audited.

77. **In the area of external audit, Bhutan has a reasonably well-functioning public financial accountability system.** The Royal Audit Authority conducts financial audits at two levels - at the national level, to review the consolidated annual financial statements of the RGoB, and at the individual agency level. The Auditor General submits the annual audit report during the fourth quarter of the fiscal year on the audits carried out during the previous fiscal year. The report contains the results of the audit of the annual financial statements of the government. It also highlights overall financial conditions and makes recommendations to improve the economy and boost the efficiency and effectiveness of the government. In addition, the Royal Audit Authority conducts financial and performance audits of donor assisted projects.

78. **The foreign exchange control environment of the central bank is satisfactory.** The external auditors issued an unqualified report for FY2014/2015. The accounts and audits were compiled and conducted in accordance with generally accepted accounting and auditing standards. Based on the audit reports and the satisfactory track record in the operation of special (designated) accounts in several IDA-financed investment operations held in the RMA in the past, it was concluded that the World Bank has reasonable assurance that the control environment for foreign exchange at the RMA is satisfactory. The IMF has not carried out a Safeguards Assessment of the RMA.

79. **Once the DPC is approved by the WBG Board, the credit will become effective provided that IDA is satisfied with the progress achieved by the government in carrying out the Program and with the maintenance of an adequate macroeconomic policy framework**. IDA will disburse the U.S. dollar proceeds

of the credit in one tranche to the Government Consolidated Fund Account maintained by the RMA after which the disbursed foreign currency will be converted within five business days to local currency and made available to finance the government's budgeted expenditures. Transactions and balances of the account will be incorporated into the government's accounting records and financial statements. The government will confirm to the Bank within 30 days of disbursement the receipt of these funds and its credit into the Government Consolidated Account (including the date of receipt, the exchange rate applied to convert the Credit proceeds into Bhutanese ngultrum, and the name/number of the government's bank account into which the funds have been deposited).

80. **Disbursement of the credit proceeds will not be linked to specific purchases**. However, the government would not use the credit 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 credit is used to finance ineligible expenditures as so defined in the Financing Agreement, IDA shall require the government to refund the amount. Money refunded to IDA in respect of payments made for ineligible expenditures would be cancelled.

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

81. **The World Bank will work closely with relevant ministries and agencies to monitor progress.** These include engagements with the Office of the Prime Minister, the MoF, the MoEA, the GNHC, the RMA, the CIB, and the NLC, to monitor and assess reform progress and impacts during the course of the Operation and in the context of the implementation of the 11th FYP. These efforts are aligned with the efforts of the RGoB, which has just completed the mid-term review (MTR) of the 11th FYP. Building on the MTR, APAs have been institutionalized along with the FY2016/17 budget for all government agencies and ministries, setting annual targets to be reviewed regularly.

82. **B2G feedback loop mechanisms will help sustain the reforms and enhance the quality of implementation of prior actions 6 and 7 through online systems at the NLC and the CRD.** Both agencies will develop mobile-based feedback tools to engage with businesses as end-users of the new systems. However, initial usage of both systems might be low due to information gaps and because businesses may not have the confidence to transition quickly from a manual to an automated system. Over time, the RGoB will systematically engage with the business community to seek periodic feedback and bridge any implementation gaps, enhance the system, and encourage more businesses to register online. Both the NLC and the CRD expressed strong interest in piloting feedback mechanisms to underpin the long-term sustainability of reforms.

83. **The World Bank has been supporting statistical capacity building efforts.** Most results indicators will be obtained from existing government statistics or WBG publications such as the DB report. Nevertheless, statistical capacity in Bhutan is underdeveloped. Thus, the Bank has been supporting statistics capacity development through the Trust Fund for Statistical Capacity Building (TFSCB) and Advisory Services and Analytics (ASA). Through the TFSCB, the World Bank supported the formulation of the National Statistics Development Strategy (2014) and is underpinning the household survey and economic census (2017). In order to ensure the sustainability of statistical capacity building, the World Bank has also been implementing the Bhutan Poverty and Shared Prosperity TA (P152474), supporting the RGoB efforts to strengthen their analysis, program design, and policy decisions around poverty and social protection.

84. **Grievance Redress**. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel, which

determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

85. **The overall risk rating to achieve the PDO is moderate.** Among the listed categories, (i) political and governance, (ii) macroeconomic, (iii) sector strategies and policies, (iv) fiduciary, and (v) stakeholder risks are deemed moderate, while environmental and social risks are low (Table 5). The political governance risk is moderate. The next general election is scheduled in mid-2018 after the closing date of the Operation. The government is also engages in participatory processes that include members of the opposition party in formulating development strategies, such as the ongoing 12th FYP. Macroeconomic risk is moderate, as described in Section 2 on the assessment of macroeconomic policy. On fiduciary risk, the 2016 PEFA assessment confirmed significant improvement in most aspects from 2010. However, the risk ratings for technical design of project or program and institutional capacity or implementation and sustainability are substantial.

86. **Technical design of project or program.** Some of the critical reforms supported by the Operation are new to the RGoB. For example, Bhutan has had several PPP deals in the past, even though the legal framework was lacking. The WBG has provided TA to prepare the PPP policy and rules and regulations (prior action 8), and implementation of these reforms toward achieving the PDO requires continuous external support. To mitigate risk, the WBG will continue to provide TA and analytical support. It should also be noted that exogenous factors will affect the achievement of some results indicators, such as those on FDI. There is also a risk that achievement of the results may be delayed given that some of the prior actions are legislative initiatives approved by the Cabinet, and to be finalized, they will also need to be approved by parliament, whose processes can be lengthy.

87. **Institutional capacity for implementation and sustainability.** Limited technical capacity, a complex organizational structure, and weak interagency coordination pose risks to the achievement of the PDO. Due to the crosscutting nature of this Operation, many ministries and agencies are involved in the implementation of the program of policy and institutional reforms. Coordination is challenging, and the RGoB does not have extensive experience collaborating across boundaries. In order to mitigate this risk, the World Bank's existing and future ASAs supporting reform implementation are focusing on capacity development and fostering coordination across the implementing agencies. These TAs include the following initiatives: Bhutan Macro-Fiscal Monitoring, Analysis and Management Program (P152381); Bhutan Tax Rationalization Technical Assistance (P156989); Bhutan: Implementation of Financial Sector Development Action Plan (P161711); Improving Bhutan Investment Climate (P153221); and IFC's Financial Infrastructure Project Bhutan (600756). In addition, there will be close supervision of this Operation to help address emerging challenges related to institutional capacity. To address the potential risk of lack of use and sustainability of the online systems supported through the Operation, the proposed feedback mechanisms related to online system deployment for property and business registration (prior Actions 6 and 7) will be important in strengthening the use and quality of the online systems. The feedback mechanism will support a systematic B2G feedback loop on service delivery by the NLC and CRD, and will create an enabling environment to monitor and enhance the implementation of reforms.

Table 5. Summary Risk Ratings

Risk Categories	Rating (H, S, M, or L)
1. Political and governance	M
2. Macroeconomic	M
3. Sector strategies and policies	M
4. Technical design of project or program	S
5. Institutional capacity for implementation and sustainability	S
6. Fiduciary	M
7. Environment and social	L
8. Stakeholders	M
9. Other	—
Overall	**M**

ANNEX 1: POLICY AND RESULTS MATRIX

<table>
<tr><th colspan="2">Prior Actions and Triggers</th><th rowspan="2">Results</th></tr>
<tr><th>Prior Actions under DPO 1</th><th>Prior Actions for DPO 2</th></tr>
<tr><th colspan="3">Pillar 1: Strengthening Fiscal Sustainability and Self-reliance</th></tr>
<tr><td rowspan="2">Completed prior action 1: The Recipient: (a) through RMA, has issued the RMA Official Communication that lifts the policy ban of March 2012 imposed on the provision of housing and vehicle loans by financial institutions; and (b) through MoF, has issued the Tax Public Notification that raises custom duties, sales taxes, and green taxes on selected goods.</td><td>Prior action 1: The Recipient, through its Cabinet, has approved a debt policy setting debt limits to improve fiscal sustainability.</td><td>Non-Hydropower Debt (percent of GDP)
Baseline (FY2014/15): 27 percent
Target (FY2017/18): 25 percent or less</td></tr>
<tr><td>Prior action 2: The Recipient, through its Ministry of Finance, has approved the revised rules and regulations on fiscal incentives in order to broaden the tax base and align with the Economic Development Policy.</td><td>Tax revenue (Nu. billions)
Baseline (FY2014/15): Nu. 18.4 billion
Target (FY2017/18): Nu. 23.2 billion</td></tr>
<tr><th colspan="3">Pillar 2: Increasing Access to Finance</th></tr>
<tr><td>Completed prior action 2: The Recipient, through its Cabinet, has approved for submission to its Parliament a bill that amends the Movable and Immovable Property Act (MIPA) in order to facilitate the effective usage of movable assets as collaterals.</td><td>Prior action 3: The Recipient, through its Cabinet, has approved for submission to its Parliament the Insolvency Bill to provide a framework for businesses to resolve insolvency and to strengthen the rights of secured creditors.</td><td rowspan="2">Share of MSME Credit in Collateral Registry
Baseline (2014): Number of MSME loans in collateral registry: 348
Target (2017): Number of MSME loans in collateral registry increases by at least 40 percent
Strength of Legal Rights Index under Getting Credit in DB
Baseline (DB2016): Strength of Legal Rights Index is 4/12
Target (DB2018): Index increases to 6/12</td></tr>
<tr><td>Completed prior action 3: The Recipient, through RMA, has issued the CRST Public Notification that improves access to credit by, inter alia, small and medium enterprises through the usage of movable assets as collaterals by requiring the registry of them in the Central Registry for Secured Transaction (CRST).</td><td></td></tr>
<tr><td>Completed prior action 4: The Recipient, through RMA, has issued the CIB Regulations that sets forth, inter alia, the obligation of Data Providers to provide credit information of utility companies to the Credit Information Bureau (CIB).</td><td>Prior action 4: The Recipient: (a) through the BICMA and BEA, has issued a directive for utility companies to share credit information with the CIB; and (b) through a letter from the CIB dated October 25, 2016, has certified the completion of the upgrades of its system to enable the sharing of credit information from utility companies.</td><td>CIB coverage, Individuals and Firms (percent of adult population)
Baseline (2014): 15.9 percent
• Male: 9.6 percent
• Female: 6.3 percent
Target (2017): 30 percent
• Male: 19.5 percent
• Female: 10.5 percent</td></tr>
<tr><td></td><td>Prior action 5: The Recipient, through its Cabinet, has approved the Financial Sector Development Action Plan.</td><td>Bank account (percent of age 15+) from Global Findex
Baseline (2014): 34 percent (all), 28 percent (women)
Target (2017): 40 percent (all), 37 percent (women)</td></tr>
</table>

Pillar 3: Improving the Investment Climate and Increasing Domestic and Foreign Investment		
Completed prior action 5: The Recipient, through its Cabinet, has submitted to its Parliament a bill that amends the Companies Act in order to strengthen the protection of minority shareholders of companies regulated by such act.	**Prior action 6:** The Recipient, through a letter from its National Land Commission dated October 25, 2016, has certified the establishment of an online property and land registration system in Thimphu.	**Doing Business: Registering Property** Time to register property: Baseline (2013): 92 days Target (2017): 47 days
Completed prior action 6: The Recipient, through its Cabinet, has submitted to its Parliament an enterprise registration bill that regulates the usage of a single business identification number and one-stop-shop enterprise registration processes.	**Prior action 7:** The Recipient, through a letter from its MoEA dated October 26, 2016, has certified the introduction of a single window for online business registration.	**Doing Business: Starting a Business** (i) Time Baseline (2013): 32 days Target (2017): 10 days (ii) Number of Procedures Baseline (2013): 8 Target (2017): 4 (iii) Cost Baseline (2013): 5 percent Target (2017): 4 percent of income per capita
Completed prior action 7: The Recipient, through its Cabinet, has approved the Licensing Policy that creates a level playing field for companies and encourages them to participate in the formal economy.		
Completed prior action 8: The Recipient, through MoEA, has approved the Revised Foreign Direct Investment (FDI) Rules and Regulations to lower threshold values for allowing foreign institutional investors and repatriations of profits.	**Prior action 8:** The Recipient: (a) through its Cabinet, has approved a PPP Policy; and (b) through the MoF, approved PPP rules and regulations at its 54th policy planning and coordination meeting in 2016.	**Cumulative Level of FDI** Baseline (2013): US$100 million Target (2017): US$150 million A PPP pipeline based on PPP rules and regulations is prepared by the PPP steering committee by end 2017.
Completed prior action 9: The Recipient, through MoF, has issued the Filing of Tax Return Notification that enhances the tax module of its revenue administration management information system by allowing electronic tax filing and payments.		**Payments (number per year) under Paying Taxes in DB** Baseline (2016DB): 18 Target (2018DB): 6

ANNEX 2: LETTER OF DEVELOPMENT POLICY

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ROYAL GOVERNMENT OF BHUTAN
MINISTRY OF FINANCE
TASHICHHO DZONG

November 7, 2016

Mr. Jim Yong Kim
President
The World Bank Group
1818 H Street, N.W.
Washington, DC, 20433
USA

Re: Letter of Development Policy for Second Development Policy Credit

Dear Mr. Kim,

1. This Letter of Development Policy lays out the key elements of the Royal Government of Bhutan's proposed policy and institutional reform program over the next few years. The Royal Government requests assistance from the World Bank Group in the form of Development Policy Financing (DPF) through the second Development Policy Credit (DPC), which follows the first DPC of US$20 million in 2015, in order to support reform areas articulated in the Eleventh Five-Year Plan (FYP) covering 2013-18. The main objective of the Eleventh FYP is green socio-economic development and self-reliance. The assistance from the World Bank Group is needed especially to support the Royal Government's effort to strengthen fiscal sustainability and improve the investment climate for private sector development.

2. The Royal Government of Bhutan would like to thank the International Development Association for providing extensive DPF in the past. These began with the two Development Policy Grants of US$15 million in FY2006 and US$12 million in FY2007, which were followed by the DPF for Institutional Strengthening of US$20.2 million in FY2009. The subsequent series helped deepen policy and institutional reforms through the First Development Policy Credit (DPC1) of US$24.8 million in 2010, and the Second Development Policy Credit (DPC2) of US$36.8 million in 2012. These operations have supported key components of the Royal Government's program under the Ninth and Tenth FYPs. An evaluation of the key political, economic, physical and social indicators and developments during the Ninth and Tenth FYPs showed significant and tangible achievements. For example, during the Tenth FYP, the country maintained sustained rapid economic growth that was accomplished in a sustainable manner with minimal adverse impacts on the physical, social and cultural environments. There was also remarkable progress made in advancing social and human development conditions in the country on the basis of the Royal Government's strong social redistributive policies and investments made over the plan. As a result, Bhutan made significant progress to achieve the MDGs and remains committed to realize its long-term Vision 2020 social goals and the Sustainable Development Goals (SDGs).

3. In order to achieve national objectives of "Self-Reliance and Inclusive Green Socio-Economic Development", the Eleventh FYP has adopted the Results Based Planning (RBP) framework that articulates clear outcomes and outputs to be achieved during the plan period.

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Sixteen National Key Result Areas (NKRAs) are identified and more than 300 Sector Key Result Areas (SKRAs) and *Dzongkhag* or District Key Results Areas (DKRAs) are identified that support the achievement of the 16 NKRAs. The 16 NKRAs are identified based on the pillars of the Gross National Happiness principle. Continuing the effort on poverty reduction, the 11th FYP plans to bring down income poverty rate from 12 percent to 5 percent by the end of the plan period.

4. The Royal Government requests continuing Bank support through the proposed second DPC of the programmatic series to support institutional strengthening measures in some key areas, building on the momentum and lessons learnt from the past DPFs, including the usefulness of the instrument in facilitating development in Bhutan. The Royal Government requests selective support for the goals and strategies under the 11th FYP, and is committed to implementing the institutional and policy reforms described in the Policy Program Matrix as part of its effort to foster development and achieve its objectives of Self Reliance and Inclusive Green Socio-Economic Development. The following three broad thematic areas are being addressed under this DPC series: (A) strengthening fiscal sustainability and self-reliance; (B) fostering financial sector development to increase access to finance; and (C) developing the private sector to improve investment climate and increase domestic and foreign investment.

(A) Strengthening Fiscal Sustainability and Self-Reliance

5. Strengthening fiscal sustainability and self-reliance is one of the overarching objectives of the Eleventh FYP. Despite sustained economic growth, Bhutan was exposed to macroeconomic vulnerabilities during the last several years. In March 2012, the Royal Government had to impose several administrative measures that included a ban on imports of vehicles and restrictions on access to foreign exchange, in particular for personal and construction loans. These restrictions were lifted in September 2014 with the introduction of new taxes on vehicles and fuel.

6. While the country is expected to generate additional revenue in the long-run, it faces large macroeconomic imbalances in the short to medium term. Our current account deficit remains constantly high, and it is largely financed through external grants. The Royal Government is taking important steps towards strengthening fiscal sustainability and self-reliance. Since the start of the Eleventh FYP, the Royal Government has embarked on various reforms to address the country's economic challenges.

7. In order to enhance public financial management (PFM), a web based tax module of Revenue Administration Management Information System (RAMIS) was operationalized in January 2015. This module now provides the option for online and real time tax payers' services, in particular tax filings. The Royal Government has also initiated the development of e-procurement as part of reforms aimed at boosting performance. The World Bank has recently approved the use of "*Alternate Procurement Arrangement*" for all the World Bank funded projects under Thimphu Municipality. The Public Expenditure and Financial Accountability (PEFA) assessment for Bhutan was carried out using PEFA Framework 2016.

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The final draft report has been reviewed by the PEFA Secretariat to ensure that the assessment is in conformity with quality assurance processes and a process quality endorsement known as the '*PEFA CHECK*' was issued in September 2016. Bhutan is also one of the few countries that have completed the PEFA assessment using the latest PEFA Framework 2016.

8. To improve fiscal responsibility and supplement efforts to smooth consumption, the Royal Government has taken additional measures to manage public debt. A public debt policy was approved by the cabinet in August 2016. As a key implementation step for the revised Economic Development Policy, tax rationalization measures to improve efficiency and broaden the tax base were approved by the cabinet in October 2016. With these measures, agencies of the Royal Government are mandated to improve their efficiency and effectiveness in utilizing the available resources. The Royal Government is initiating efforts to improve tax administration and rationalize tax exemptions and holidays. Given the country's situation, while tax exemptions and holidays carry some benefits in encouraging investments in productive sectors, their contribution to economic development and private sector development were objectively reviewed to formulate the tax rationalization measures.

9. At the end of the Eleventh FYP, the Royal Government has committed to more than 85 percent of the total expenditure to be financed by domestic revenue. This entails improving revenue generation and the balance of payment situation.

(B) Fostering Financial Sector Development to Increase Access to Finance

10. Private sector access to finance remains a serious constraint. The narrow economic base and geo-topographical situation limit the financial institutions' ability to improve access to finance, especially for the Small and Medium Enterprises (SMEs), Cottage and Small Industries (CSIs) and individual entrepreneurs. The Royal Government has committed to improve access to finance. Laws and procedural mechanisms will be simplified in consultation with relevant authorities such as the Royal Monetary Authority (RMA) of Bhutan, the central bank.

11. The Eleventh FYP has ambitious targets to improve and simplify the procedures for business start-ups, prevent business malpractice, ensure fair competition in the market, and promote international best practices in the business environment. The 11th FYP envisions to promote SMEs, CSIs and individual entrepreneurs through the following objectives:

i. Strengthened policy environment and institutional framework
ii. Strengthened legislative framework and enterprise environment
iii. Improved access to finance and incentives
iv. Enhanced competitiveness and innovation
v. Enhanced employment and culture of entrepreneurship
vi. Improved market access

12. For example, the Royal Government approved a new Insolvency Bill in September 2016 that introduced a new restructuring and insolvency system that is aligned with international best practices, with specific provisions for MSMEs.

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As the regime gradually becomes more effective, creditors should be more likely to lend, including to borrowers with whom they have not had a long-standing relationship. In addition, Bhutan's Credit Information Bureau (CIB) upgraded its systems in October 2016 to enable the sharing of credit information from utility companies. This upgrade is expected to increase the availability of credit information, and thus reduce financial institutions' risk and cost of lending.

13. In collaboration with the RMA, the Royal Government also approved a Financial Sector Strategy and Action Plan in September 2016. This plan articulates a vision for an integrated and sound financial sector, in addition to providing the concrete actions that need to be undertaken for its implementation.

(C) Developing the Private Sector to Improve Investment Climate and Increase Domestic and Foreign Investment

14. The Royal Government continues to play a key role in economic development, and the private sector remains small and underdeveloped. In order to boost the role of the private sector, one of the strategic thrust areas under the Eleventh FYP, the section on Green Accelerated Economic Development, places greater emphasis on economic diversification with a focus on the development of the non-hydropower sectors and fostering growth of a dynamic private sector that catalyzes a transition to a green economy. Key attributes of a green economy include low carbon emissions, efficient and sustainable resource use, and socially inclusive economic growth and investments, which are closely aligned with our development planning framework.

15. The main programs under this thrust area include: (i) economic stimulus program (ii) Rapid Investment in Selected Enterprise (RISE) program under which focus has been given to the tourism sector, agro-processing industries, construction sector, small and cottage industries (including cultural industries), and manufacturing and mining sector; (iii) optimizing opportunities of accelerated hydropower development; and (iv) enabling environment which includes improvement and simplification of procedures, enhancing efficiency in reviewing, streamlining and enforcing legislation, policies, rules and regulations; and (v) facilitating infrastructure investments.

16. In order to improve Bhutan's investment climate, the Royal Government enhanced the delivery of two public services in September 2016 that are key for domestic and foreign investors – the registration of new businesses and the transfer of property titles. Specifically, the upgraded platform to transfer property titles makes it easier to transfer titles by strengthening the connection between the National Land Commission and the Thimphu Municipality's Land Records section, in addition to offering an online platform. With the leadership of the Ministry of Economic Affairs, a new online single window for business registration has started to allow the processing of business registration to be performed in the same office through the submission of one application, with the option to register online in October 2016. Finally, in order to scale up Private Public Partnership (PPP) in the strategic infrastructure sector, the Royal Government has adopted the PPP policy in March 2016 that governs institutional arrangements for government facilitation of PPPs followed by its rules and regulations by the Ministry of Finance in September 2016.

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TASHICHHO DZONG

Altogether, these reforms should lead to reduced burdens for businesses and a more predictable and transparent investment climate.

17. To achieve the objectives mentioned above, the Royal Government has committed to enhance the performance of the country for the ease of doing business. Concerted efforts are being made by the entire government machinery to bring improvement on all 10 Doing Business indicators.

Summing up

18. The Royal Government remains highly committed to our reform progress supported by the current programmatic DPC series described above.

19. Finally, we wish to express our appreciation for the support and assistance extended by the World Bank Group to Bhutan's socio-economic development. We look forward to continued support and fruitful collaboration in the years to come.

Yours sincerely,

(Namgay Dorji)
Finance Minister

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INTERNATIONAL MONETARY FUND

COMMUNICATIONS DEPARTMENT

Press Release No. 16/313
FOR IMMEDIATE RELEASE
June 29, 2016

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2016 Article IV Consultation with Bhutan

On June 22, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Bhutan.

Bhutan has made significant economic progress in recent years and the GDP per capita more than doubled during 2004-2014, rising from $1,108 to $2,612. In the aftermath of the rupee shortage episode of 2012-13, GDP growth has slowed to below 4 percent in Fiscal Year (FY) 2012/13 and FY2013/14 (July 1 – June 30). Measures to cool down activity contributed to the slowdown. However, GDP growth is estimated to have picked up to 5.2 percent in FY2014/15 and is projected to reach 6 percent in FY2015/16. Inflation has decelerated rapidly, from 11.3 percent in Q4 2013 to below 3 percent in Q1 2016, though it is projected to return to about 5 percent. Following the slowdown in the wake of the rupee shortage crisis, growth in credit to the private sector has picked up. The fiscal balance switched from a deficit of 4.2 percent in FY 2012/13 to a surplus of 3.8 percent in FY2013/14, and 1.5 percent of GDP in FY2014/15, reflecting mainly lower capital spending in the early years of the 11th Five Year Plan (2013/14 – 2017/18). The current account deficit has been approaching record high levels in recent years, reflecting hydropower investment. These deficits were financed by robust aid inflows, and the overall balance of payments remained generally positive, allowing further accumulation of international reserves.

Growth is projected to accelerate further in the coming years, to 6.4 percent in FY2016/17 and to over 11 percent in FY2017/18, supported by hydropower construction and the commissioning of new hydropower plants, as well as solid growth in domestic services. The increase in hydropower generation capacity will boost electricity exports, and as a result, the current account deficit will decline rapidly, from over 30 percent in FY2016/17 to around 5 percent in FY2020/21. Reflecting accelerated capital spending in the final years of the 11th Five-Year Plan, fiscal balance is projected to turn to a moderate deficit in FY2016/17.

Risks are linked mainly to the high public external debt and the need to manage projected large hydropower-related revenues. If not properly managed, the large pickup in hydropower exports

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

and the projected increase in export earnings and budget revenues could undermine macroeconomic stability and the competitiveness of the economy, resulting in overheating and external imbalances akin to those seen during 2012-13. In addition, Bhutan's growth could be adversely affected by a growth slowdown in India triggered by delays in structural reforms. Also, as illustrated by the slowdown in tourist arrivals in the wake of Nepal's earthquake, the Bhutanese tourism industry is susceptible to adverse regional developments.

Executive Board Assessment[2]

Executive Directors welcomed the improvement in Bhutan's macroeconomic performance and commended the authorities for the significant economic and social gains of recent years. Directors also considered that the outlook was favorable going forward. However, the current account deficit and external public debt remain high, mainly reflecting developments in the hydropower sector. Accordingly, Directors cautioned that while hydropower development brings opportunities, it also creates macroeconomic challenges that need to be managed carefully to avoid overheating and imbalances. Moreover, strong efforts are required to increase employment opportunities, especially for the youth, through enhanced skills and training, and economic diversification.

Directors noted that the favorable fiscal outcomes in recent years reflected slower-than-projected implementation of investment projects. They recommended balancing acceleration of capital spending with maintaining sound fiscal balances and macroeconomic stability. Directors underscored the need to improve tax revenue collection and limit exemptions, especially given the expected gradual phasing out of donor assistance and the need for higher social spending. They welcomed plans to introduce a modern goods and service tax and encouraged the authorities to ensure timely implementation by 2018.

Directors considered the current monetary policy stance to be broadly appropriate and commended the authorities for the recent tightening. Directors recommended close monitoring of liquidity, credit and inflation, and encouraged the authorities to stand ready to adjust monetary policy as needed. They also recommended further improvement of the liquidity management system.

Given close economic ties with India, Directors agreed that the exchange rate peg to the Indian rupee has served Bhutan well and remains an appropriate nominal anchor, even as the ngultrum is moderately overvalued. They emphasized that macroeconomic stability and improvements in the business climate and competitiveness are essential to support the peg.

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Directors welcomed the authorities' plans to strengthen reserve management. They noted that while the level of international reserves remains adequate, there is room for improvement in the composition of reserves to better align it with the structure of external debt and trade flows. Directors noted the Royal Monetary Authority's recent efforts to strengthen macroprudential regulation and supervision and welcomed the introduction of additional tools. They emphasized the need to fill remaining regulatory gaps, including in the regulation of nonbank financial institutions.

Directors encouraged elimination of exchange rate restrictions as soon as macroeconomic conditions allow.

Bhutan: Selected Economic Indicators, 2012/13–2017/18 1/

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
			Est.		Proj.	
Real sector						
Real GDP at market prices (percent change)	3.6	3.8	5.2	6.0	6.4	11.3
Consumer prices (percent change, period average)	11.3	10.0	6.4	4.4	4.6	5.1
General government			(In percent of GDP)			
Total revenue and grants	30.2	33.6	28.9	31.5	27.2	27.3
Tax revenue	15.2	14.4	14.7	13.2	13.2	12.6
Non-tax revenue	5.6	6.3	5.4	5.7	5.0	4.5
Foreign grants	9.4	12.7	8.0	12.3	9.0	10.2
Total expenditure and net lending	34.4	29.8	27.4	30.9	28.4	26.6
Current expenditure	17.8	16.0	16.8	17.3	16.8	16.0
Capital expenditure	18.2	14.8	12.3	14.9	12.9	11.8
Current balance (excluding grants)	3.0	4.7	3.3	1.6	1.4	1.1
Overall balance	-4.2	3.8	1.5	0.6	-1.2	0.7
Public sector debt 2/	99.9	96.4	96.5	105.5	113.6	112.7
Monetary sector			(Percent change, unless otherwise indicated)			
Broad money	18.6	6.6	7.8	...	...	...
Credit to private sector	6.2	5.1	11.0	...	...	...
Interest rates (end of period, in percent)						
Term Deposit Rates	5.0-9	5.0-8.7	4.0-10	...	...	...
Lending	11.5-16	10.0-16	11.7-17	...	...	...
RMA bills (91-days)	3	2.3	0.13	...	...	...
External sector			(In millions of dollars, unless otherwise indicated)			
Current account balance	-470	-483	-581	-579	-708	-528
(In percent of GDP)	-25.4	-26.4	-28.8	-27.8	-31.5	-20.7
Trade balance	-377	-393	-419	-550	-630	-474
Exports (goods)	546	535	578	556	579	751
(Percent change)	-11.5	-2.0	8.2	-3.9	4.0	29.8
Of which: Electricity	188	167	181	192	180	315
Imports (goods)	-923	-928	-998	-1,107	-1,177	-1,174
(Percent change)	-8.8	0.5	7.5	11.0	6.2	-0.2
Grants (current transfer)	86	63	77	111	88	113
Capital and financial account balance	557	638	633	762	724	787
Loans (net)	244	355	374	339	346	343
Errors and omissions	80	-85	-60	0	0	0
Overall balance	168	70	-9	183	16	259
(In percent of GDP)	9.1	3.8	-0.4	8.8	0.7	10.2
Gross official reserves	917	982	958	1,141	1,157	1,417
(In months of goods and services imports)	11.9	11.8	10.4	11.3	11.3	13.1
External debt (in percent of GDP)	94.1	93.6	94.5	105.8	113.0	110.7
Ngultrum per U.S. dollar (period average)	54.9	61.5	62.1	...	...	...
Memorandum items:						
GDP at market prices (in millions of U.S. dollars)	1848.7	1829.6	2017.1	2084.8	2251.1	2549.5
Electricity exports (in percent of total goods exports)	34.5	31.2	31.4	34.6	31.2	42.0
Unemployment rate (in percent) 3/	2.1	2.9	2.6	...	...	...

Sources: Bhutanese authorities; and IMF staff estimates and projections.

1/ Fiscal year begins July 1.

2/ Public and publicly guaranteed debt, including loans for hydropower projects.

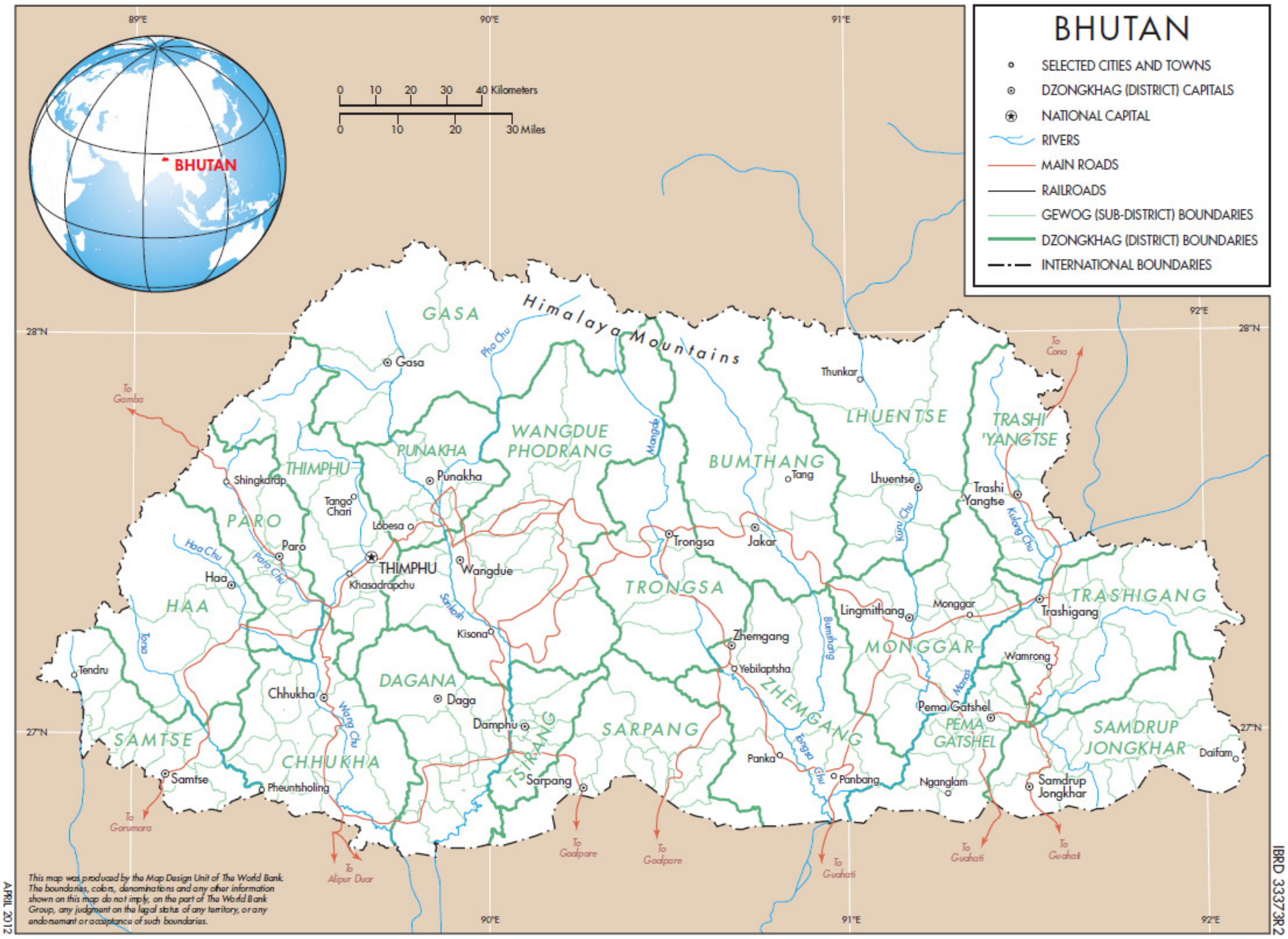
3/ On a calendar year basis (e.g., the entry for 2012/13 is for 2012).

ANNEX 4: ENVIRONEMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior actions	Significant positive or negative environment effects (yes/no/to be determined)	Significant poverty, social or distributional effects positive or negative (yes/no/to be determined)
Pillar 1: Strengthening Fiscal Sustainability and Self-Reliance		
Prior action 1: The Recipient, through its Cabinet, has approved a debt policy setting debt limits to improve fiscal sustainability.	Associated environmental risks are negligible.	While no significant impact is expected in the short-run, a policy setting debt limits to improve fiscal sustainability should contribute to sustainable economic growth, which in turn improves the livelihoods of the poor and those less well-off in the long run.
Prior action 2: The Recipient, through its Ministry of Finance, has approved the revised rules and regulations on fiscal incentives in order to broaden the tax base and align with the Economic Development Policy.	Associated environmental risks are negligible.	The direct impact on the poor or the vulnerable should be limited since the tax rationalization measures focus on tax measures related to enterprises (e.g., sector specific incentives) rather than individuals. An increased tax base will boost the government's capacity to address poverty and vulnerability.
Pillar 2: Increasing Access to Finance		
Prior action 3: The Recipient, through its Cabinet, has approved for submission to its Parliament the Insolvency Bill to provide a framework for businesses to resolve insolvency and to strengthen the rights of secured creditors.	Associated environmental risks are negligible.	The Bankruptcy Act is likely to contribute to an improved business environment, which should reduce risks among potential entrepreneurs and existing businesses. The effects are likely to be indirect, through the impact on growth.
Prior action 4: The Recipient: (a) through the BICMA and BEA, has issued a directive for utility companies to share credit information with the CIB; and (b) through a letter from the CIB dated October 25, 2016, has certified the completion of the upgrades of its system to enable the sharing of credit information from utility companies.	Associated environmental risks are negligible.	Improved access to finance will support private-sector development and job creation, with likely positive benefits in the medium term.
Prior action 5: The Recipient, through its Cabinet, has approved the Financial Sector Development Action Plan.	Associated environmental risks are negligible.	The Financial Sector Development Action Plan is expected to positively impact poverty reduction and shared prosperity in the long run by increasing and deepening access to finance for a larger number of people, including those who are more vulnerable or poor. In addition, it could increase the access to finance of women as well as of those in the agriculture sector.
Pillar 3: Improving the Investment Climate and Increasing Domestic and Foreign Investment		
Prior action 6: The Recipient, through a letter from its National Land Commission dated October 25, 2016, has certified the establishment of an online property and land registration system in Thimphu.	The program will enable governments to deliver better public services. However, the program may generate e-waste through the disposal of ICT equipment. This impact can be mitigated through e-	An electronic property and land registration system should enhance the ease of doing business, which in the medium term promotes private sector development and job creation.

	waste minimization techniques and safe disposal of e-waste.	
Prior action 7: The Recipient, through a letter from its MoEA dated October 26, 2016, has certified the introduction of a single window for online business registration.	The program may generate e-waste through the disposal of ICT equipment. This impact can be mitigated through e-waste minimization techniques and safe disposal of e-waste.	Streamlining the business registration process should lessen the burden for business owners, especially owners of MSMEs, which should in turn expand the number of MSMEs established and increase job creation.
Prior action 8: The Recipient: (a) through its Cabinet, has approved a PPP Policy; and (b) through the MoF, approved PPP rules and regulations at its 54th policy planning and coordination meeting in 2016.	Associated environmental risks are negligible. PPP policy states that all PPP projects will be subject to all existing laws and regulations including those related to the environment.	The direct impact on poverty should be limited. It may have an indirect positive impact in the long run, as effective PPPs for infrastructure development can contribute to economic growth.

ANNEX 5: MAP


BHUTAN
SELECTED CITIES AND TOWNS
DZONGKHAG (DISTRICT) CAPITALS
NATIONAL CAPITAL
RIVERS
MAIN ROADS
RAILROADS
GEWOG (SUB-DISTRICT) BOUNDARIES
DZONGKHAG (DISTRICT) BOUNDARIES
INTERNATIONAL BOUNDARIES
0 10 20 30 40 Kilometers
0 10 20 30 Miles
Himalaya Mountains
GASA
WANGDUE PHODRANG
PUNAKHA
THIMPHU
PARO
HAA
SAMTSE
CHHUKHA
DAGANA
TSIRANG
SARPANG
TRONGSA
BUMTHANG
ZHEMGANG
LHUENTSE
MONGGAR
TRASHI 'YANGTSE
TRASHIGANG
PEMA GATSHEL
SAMDRUP JONGKHAR
THIMPHU
Gasa
Punakha
Shingkarap
Tango Chari
Lobesa
Paro
Haa
Khasadrapchu
Wangdue
Kisona
Tendru
Chhukha
Daga
Damphu
Samtse
Pheuntsholing
Sarpang
Trongsa
Jakar
Tang
Thunkar
Lhuentse
Trashi Yangtse
Zhemgang
Yebilaptsha
Panka
Panbang
Lingmithang
Monggar
Trashigang
Wamrong
Pema Gatshel
Nganglam
Samdrup Jongkhar
Daifam
To Gamba
To Cona
To Gorumara
To Alipur Duar
To Goalpara
To Guahati
APRIL 2012
IBRD 33373R2
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