



The World Bank

Strengthening Fiscal Management and Private Sector Employment Opportunities Development Policy Credit
(P171780)

Program Information Document (PID)

Concept Stage | Date Prepared/Updated: 27-Sep-2019 | Report No: PIDC27885

BASIC INFORMATION

A. Basic Project Data

Country Bhutan	Project ID P171780	Project Name Strengthening Fiscal Management and Private Sector Employment Opportunities Development Policy Credit (P171780)	Parent Project ID (if any) P164290
Region SOUTH ASIA	Estimated Board Date Mar 31, 2020	Practice Area (Lead) Macroeconomics, Trade and Investment	Financing Instrument Development Policy Financing
Borrower(s) The Kingdom of Bhutan	Implementing Agency Ministry of Finance		

Proposed Development Objective(s)

This Development Policy Credit will support the government in its efforts to strengthen the policy framework to improve fiscal management and enhance policies to promote private sector employment opportunities.

Financing (in US\$, Millions)

SUMMARY

Total Financing	30.00
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DETAILS

Total World Bank Group Financing	30.00
World Bank Lending	30.00

Decision

The review did authorize the preparation to continue



B. Introduction and Context

Country Context

Large-scale hydropower development has contributed to growth and prosperity in Bhutan but has also exposed fiscal and macroeconomic vulnerabilities. Bhutan's state-led hydropower sector currently accounts for 25 percent of Gross Domestic Product (GDP), 20 percent of fiscal revenues and 30 percent of exports. Fiscal revenues from hydropower have helped finance investments in physical and human capital and raised living standards, allowing Bhutan to reduce the official poverty headcount from 23.2 percent in 2007 to 8.2 percent in 2017. However, the revenue flows from hydropower are volatile, as the commissioning of new projects every few years generates significant fiscal windfalls. These windfalls pass through to expenditure, leading to a highly procyclical fiscal policy stance. At the same time, domestic tax revenue has remained relatively constant in recent years, averaging between 14 and 15 percent of GDP, and the public debt burden is high at around 110 percent of GDP in FY2019. The private sector in Bhutan is still at a nascent stage and the hydro sector, given its capital-intensive nature and the extensive use of foreign labor in construction, only employs 1 percent of the labor force. As a result, employment remains overwhelmingly agrarian and the unemployment rate, especially for the younger generation, is high. As such, reducing the procyclicality of fiscal policies and creating job opportunities in the private sector are key policy priorities in Bhutan.

The proposed operation is the last in a programmatic series of three operations focused on strengthening the policy framework to improve fiscal management and promote private sector employment opportunities in Bhutan. The proposed Development Policy Credit (DPC) supports the government's efforts in addressing Bhutan's pressing macroeconomic challenges. In doing so, this DPC builds on the progress achieved by the government's economic reform agenda, supported through the first two operations in this series. Past reforms to improve fiscal management involved the establishment and operationalization of a stabilization fund to improve fiscal management, cabinet approval for the introduction of a new Goods and Services Tax (GST), reforms to public financial management through the roll out of an electronic public expenditure management system (e-PEMS) and amendments to the procurement rules and regulations. Private sector development was supported through business incubation centers for cottage and small industries and improved access to finance and payment settlements through a strengthened supervision framework for the credit information bureau and the introduction of a Global Interchange for Financial Transactions. Past reforms to improve human capital development included the passing of International School Guidelines, the waiving of the cut-off points for admission into class XI, the adoption of a Non-Formal Education Equivalency Framework and the adoption of a maternal and child health program.

Relationship to CPF

This DPC series underpins all three objectives of the existing Country Partnership Strategy (FY2015-19). They include: (a) improving fiscal and spending efficiency; (b) increasing private sector and competitiveness; and (c) supporting green development. The operation is designed to improve spending efficiencies through the adoption of fiscal stabilization measures, a strengthened PFM system and a modernization of the tax system through the introduction of the GST. It will also support private sector development through improved access to finance, human capital development and greater macroeconomic stability. Green development will be supported through the national energy efficiency and conservation, and the national climate change policy.

C. Proposed Development Objective(s)

This Development Policy Credit will support the government in its efforts to strengthen the policy framework to improve fiscal management and enhance policies to promote private sector employment opportunities.



Key Results

The proposed operation supports policy measures that aim at improving fiscal management and enhancing employment opportunities in the private sector. Results intended to improve fiscal management aim at (i) improvements to *domestic resource mobilization* through the introduction of a GST and (ii) *reducing the procyclicality of fiscal policy* and improving the efficiency with which budgets are executed through the adoption of fiscal stabilization measures and public financial management reforms. To improve private sector employment opportunities, this DPC aims at three key results. First, the operations aims to enhance *access to finance and capital* for firms through Foreign Direct Investment (FDI) reforms and improved payment system supervision. Second, the operation will *improve human capital formation* through reforms to the education and health system. Finally, the policy measures supported by this operation will enhance *environmental sustainability and gender inclusiveness*.

D. Concept Description

The proposed operation aims to achieve its policy objectives through two pillars, the first of which aims to strengthen the policy framework to improve fiscal management. This will be achieved through three complementary measures. First, it will support the adoption of fiscal stabilization measures to manage lumpy hydropower windfalls. Second, to enhance domestic revenue collection, DPC3 supports the adoption of the GST bills, which will replace the existing sales tax system and are expected to widen the tax net and reduce distortions in the tax system. Third, Public Financial Management (PFM) reforms will focus on interlinking all PFM systems, integrating e-PEMS (supported under DPC2) into a wider network, allowing for automated data exchange and ultimately improving the implementation of fiscal policy.

The second pillar of the operation aims to enhance policies to promote private sector employment opportunities. Reforms under this pillar follow a two-pronged strategy. This consists, first, of facilitating credit and technology transfer for the private sector through a new FDI policy and mitigating payments risks through improved oversight. Second, labor market supply side reforms will focus on the education sector by supporting improved learning through new teacher standards and a National Education Policy which aims at improving access, quality and equity in the system. Labor market supply side reforms will also focus on the health sector through the operationalization of the Accelerating Maternal and Child Health Program. To enhance the inclusiveness and sustainability of private sector development, this operation also supports a new National Energy Efficiency and Conservation Policy, a new National Climate Change Policy and a new National Gender Equality Policy.

The proposed operation is aligned with the government's program outlined in the 12th Five-Year Plan (FYP). The 12th FYP for 2018-23 was finalized in January 2019 and focuses on four key areas: (i) A just society, which aims at poverty reduction, human capital investments and institutional stability; (ii) A harmonious society, focusing efforts on preserving and promoting culture, maintaining climate resilience, promoting a caring society, and ensuring happy human settlements; (iii) A sustainable society, aimed at macroeconomic stability, service delivery and environmental sustainability; and (iv) Decentralization, which would require empowering local governments and other sub-national bodies. In building a just society, the proposed operation supports improvements in the education and health sectors, and the development of a private sector which will help create jobs and contribute to sustainable poverty reduction. With regards to a harmonious society, the operation promotes inclusiveness the National Gender Equality and Policy and addresses climate change through the National Climate Change Policy. Towards a sustainable society, the proposed operation supports macroeconomic stability and environmental sustainability.



E. Poverty and Social Impacts and Environmental Aspects

Poverty and Social Impacts

The prior actions supported under this DPC operation are expected to have a positive poverty, social and gender effect in the medium to long run. Preliminary analysis suggests that the poverty impact of the introduction of the GST is likely to be negative in the short run, as it is expected to lead to rising consumer prices which will negatively affect poor households. The adoption of fiscal stabilization measures will have positive impacts, by helping to constrain discretionary spending, promoting fiscal discipline and building fiscal space which can mitigate the adverse impact of aggregate shocks and sustain social spending. The reforms in the education and health sector are also expected to have positive impacts by enhancing learning through better access and higher quality education and improving maternal, neonatal and child health. The National Gender Equality Policy aims to provide equal opportunities for women and men in the areas of education and employment and promote women's empowerment, with positive impacts expected. Similarly, the Climate Change Policy will help reduce vulnerability and build resilience to climate change. The remaining prior actions are expected to have neutral impacts.

Environmental Impacts

The proposed operation is likely to have an overall positive effect on the environment. While it is possible that there could be minor negative environmental effects pertaining to the policies/guidelines related to facilitating FDI, the FDI policy has a basic principle of promoting a green and sustainable economy, and documents requirement of environmental clearance and compliance. Therefore, these effects, if any, are expected to be managed with the government's existing country environmental system. Significant benefits are expected from implementation of the National Energy Efficiency and Conservation (EE&C) Policy and the National Climate Change Policy. EE&C measures are likely to lower the intensity of energy use, thereby reducing the reliance on hydro power. It will also improve the competitiveness of industries and create new jobs. All other prior actions supported by this operation will have no significant effects on the environment.

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APPROVAL

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