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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT FOR A PROPOSED

DEVELOPMENT POLICY CREDIT

IN THE AMOUNT OF SDR 20.6 MILLION (US\$30 MILLION EQUIVALENT)

TO

THE KINGDOM OF BHUTAN

FOR THE FIRST PROGRAMMATIC

STRENGTHENING FISCAL MANAGEMENT AND PRIVATE SECTOR EMPLOYMENT OPPORTUNITIES
DEVELOPMENT POLICY CREDIT

March 2018

Macroeconomics, Trade and Investment Global Practice
South Asia Region

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

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of Feb 12, 2018)

Currency Unit Bhutanese ngultrum
US\$1.00 = BTN 64.0

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
BoP	Balance of Payments
BTN	Bhutanese ngultrum
CIB	Credit Information Bureau
CRST	Central Registry Secured Transaction
DPC	Development Policy Credit
EDP	Economic Development Policy
FDI	Foreign Direct Investment
FY	Fiscal Year
FYP	Five-Year Plan
GDP	Gross Domestic Product
GNH	Gross National Happiness
GNHC	Gross National Happiness Commission
GOI	Government of India
GRS	Grievance Redress Service
GST	Goods and Services Tax
ICT	Information and Communication Technology
IMF	International Monetary Fund
INR	Indian rupee
LDP	Letter of Development Policy
MDF	Multi-Donor Fund
MIPA	Moveable and Immovable Property Act
MoF	Ministry of Finance
MSME	Micro, Small and Medium Enterprises
MW	Mega Watts
NKRA	National Key Result Area
NPL	Non-Performing Loan
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
RBI	Reserve Bank of India
RGoB	Royal Government of Bhutan
RNR	Renewable Natural Resources
RMA	Royal Monetary Authority (Central Bank)
SDR	Special Drawing Rights
WB	World Bank
WBG	World Bank Group

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KINGDOM OF BHUTAN
THE FIRST PROGRAMMATIC DEVELOPMENT POLICY CREDIT FOR
STRENGTHENING FISCAL MANAGEMENT AND PRIVATE SECTOR EMPLOYMENT OPPORTUNITIES

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SUMMARY OF PROPOSED CREDIT AND PROGRAM
THE KINGDOM OF BHUTAN
STRENGTHENING FISCAL MANAGEMENT AND PRIVATE SECTOR EMPLOYMENT OPPORTUNITIES

Borrower	The Kingdom of Bhutan
Implementation Agency	Ministry of Finance
Financing Data	International Development Association (IDA) Credit. Terms: IDA Regular for small state economies. Amount: SDR 20.6 million (US\$30 million equivalent).
Operation Type	Programmatic. First of three operations.
Pillars of the Operation and Program Development Objective(s)	Pillar 1: Strengthening the policy framework to improve fiscal management Pillar 2: Enhancing policies to promote private sector employment opportunities
Result Indicators	<p>Pillar 1:</p> <ul style="list-style-type: none"> Stabilization Fund operational and members of the Governing Board of the Stabilization Fund have been appointed. Baseline (2016): 0; Target (2021): All. GST Law adopted and revenues collected. Baseline (2016): BTN 0; Target (2021): BTN 4,000 million Number of PFM systems interconnected. Baseline (2016): 0; Target (2021): 5 <p>Pillar 2:</p> <ul style="list-style-type: none"> Number of CSIs under incubation: Baseline (2016): 7 in total, of which 0 female-owned; Target (2021): 30 in total, of which 5 female-owned. Number of entities reporting to CIB. Baseline (2016): 988; Target (2021): 1,087 Percentage of Teachers meeting new Teachers' Standards. Baseline (2016): 0 percent; Target (2021): 15 percent. Energy Efficiency Policy reducing energy consumption in tons of oil equivalent (TOE): <ul style="list-style-type: none"> i) Building & appliance sectors: Baseline 2014: 270,356 TOE; Target 2021: 8,000 TOE reduction ii) Industry Sector: Baseline 2014: 241,972 TOE; Target 2021: 15,000 TOE reduction iii) Transport Sector: Baseline 2014: 121,218 TOE; Target 2021: 7,000 TOE reduction
Overall risk rating	Moderate
Climate and disaster risks	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	P164290

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

1. INTRODUCTION AND COUNTRY CONTEXT

1. The proposed Development Policy Credit (DPC) of US\$30 million is the first in a programmatic series of three operations that aim to strengthen policy framework to improve fiscal management and enhance policies to promote private sector employment opportunities in Bhutan. Bhutan is one of the smallest but fastest-growing economies in the world with an annual average growth rate of 7.6 percent over the past three decades. This stellar growth performance has helped improve living standards and has contributed to poverty reduction. However, further welfare improvements will require a dynamic job-creating private sector. The current hydropower driven growth model has created some macroeconomic imbalances and coupled with a large and dominant public sector, impeded the development of a vibrant private sector. As a result, the economy has witnessed considerable volatility, and limited job creation. This DPC series will help the government address some of these challenges by supporting reforms aimed at improving the management of macroeconomic volatility, strengthening domestic resource mobilization, and promoting employment opportunities in the private sector. The DPC series is also consistent with Bhutan's 11th (2013-18) and 12th Five-Year Plans (FYP) (2018-23).

2. Bhutan's natural endowments historically have constrained development, but, in more recent periods have also provided opportunities for rapid growth and advancement. Bhutan's mountainous topography has endowed it with substantial wealth in hydropower generation. In 1988, Bhutan opened its first major hydroelectric facility at Chhukha and began exporting surplus electricity to India. Since then, a number of hydropower plants have been completed, boosting exports, public revenue, and construction. In addition, Bhutan's topography, cultural assets, and historical isolation also make it a coveted destination for international tourists, who have demonstrated a willingness to pay substantial premiums to visit the country. Completely closed to tourists until 1974, tourism has grown rapidly in recent years. Bhutan attracted only 7,158 tourists as recently as 1999, but welcomed 210,000 tourists in 2016.

3. As Bhutan has opened itself to the world, its economy has been transformed by the growth in hydropower and tourism, resulting in rapid economic growth and declines in poverty. Between 2000 and 2016, Bhutan's per capita gross domestic product (GDP) almost doubled to US\$2,800. Bhutan has almost eliminated extreme poverty, with estimates indicating that just 2 percent of the population live on less than US\$1.90 a day, which is the second lowest level of poverty in South Asia and substantially lower than the regional average of 19 percent. Similarly, the national poverty rate has declined from 12 percent in 2012 to 8 percent in 2017. Bhutan's economy has also shared the benefits of increasing prosperity. Between 2000 and 2015, the average income and expenditure of the bottom 40 percent of the distribution grew at the same rate as the overall average.

4. At the same time, significant challenges remain. The small size of the country's population and land area, its landlocked geography, and its mountainous topography present constraints that inhibit the exploitation of economies of scale and gains from merchandise trade. Bhutan's history of isolation—borne of the country's geography and topography—has also inhibited the incorporation of local producers into global value chains and resulted in minimal flows of foreign investment. Given the capital-intensive nature of the country's primary growth driver (the hydropower sector employs only 0.8 percent of the labor force), and extensive use of foreign labor in hydropower construction, the structure of employment in Bhutan remains overwhelmingly agrarian accounting for 70 percent of the jobs in the private sector. This is also reflected in lack of job opportunities for the youth, for which unemployment rate reached 11 percent in 2017. Though unemployment rate is low at 2 percent (Bhutan Living Standards Survey 2017), this low number masks pockets of unemployment and inequality. Higher percent of female members of the workforce are

unemployed compared to male (2.2 vs. 1.8 percent). Unemployment rate is highest among the youth, with female youth unemployment being higher than male (11.7 vs. 10.4 percent).

5. Furthermore, the current growth model also brings sustainability and macroeconomic challenges. The massive scale of hydropower generation projects relative to the size of the Bhutanese economy generates large fluctuations in aggregate demand, both during the construction phase and when the projects are commissioned. Taken together, the three hydropower projects currently under construction have a cost amounting to 190 percent of the country's GDP. Further, tax collection is low by international standards and has been on a declining trend relative to GDP. This is largely explained by the fact that hydropower, especially during construction, does not contribute to tax revenues. In the near-term, Bhutan will have to manage revenue pressures arising from the withdrawal of excise duty rebate from India due to the introduction of India's Goods and Services Tax (GST) as well as the delays in the commissioning of the three hydropower projects.

6. To support the government of Bhutan address these challenges, the proposed series aims to strengthen the policy framework to improve fiscal management and enhance policies to promote private sector employment opportunities in Bhutan. The proposed operations are structured around two pillars. The first pillar focuses on actions that strengthen macroeconomic management, domestic resource mobilization and public financial management. This will also contribute to a more stable financial sector that is better able to achieve the objective of the second pillar, which seeks to increase access to finance, for MSMEs. In addition, the second pillar is also targeting to: (a) help unlock employment opportunities in the tourism, agriculture and MSMEs ('cottage and small industries'); and (b) seek to create a more efficient education sector which will help to develop the skills that Bhutan's private sector is seeking. This operation also incorporates the government's efforts to ensure a sustainable economic growth model by supporting gender equality policies and climate change initiatives.

7. Current political environment is stable, and overall risks to the operation are moderate. Since the political transition in 2008, Bhutan has held two free and fair general elections and the third one is scheduled in 2018, which puts it between first and second operations of the programmatic series. The government also engages in participatory processes that include members of the opposition party in formulating development strategies, such as the ongoing preparation of the 12th FYP. While political will at the highest level is strong, reform momentum could potentially falter in the run-up to the elections as the government's decision-making process will likely become more risk-averse, with major reforms getting delayed.

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

8. Economic performance has remained robust over the last three years. Following its deceleration in the aftermath of the "rupee shortage crisis"¹ in FY2012/13 and FY2013/14, growth has picked up and remained robust averaging nearly 7 percent. In FY2016/17 real GDP growth is estimated at 7.4 percent driven largely by construction, transport and communication. Strong performance in the tourism sector has helped to maintain momentum in the services sector. In contrast, agricultural performance in FY2016/17 slowed down after a bumper growth in the previous year, though it remains above recent trends. On the demand side, growth was primarily driven by increased investment in fixed capital and sustained growth in government consumption.

¹ Although Bhutan's currency is pegged to the Indian rupee (INR) and its international trade are predominantly with India, the share of INR denominated assets in Bhutan's external reserves has been historically low. During 2010-13, overheating pressures led to a shortage of rupee reserves, with rupee-imports coverage ratio falling to less than 1 month, while convertibility of hard currency reserves was hindered. To ease rupee liquidity the Royal Monetary Authority (RMA) borrowed large INR amounts at costly terms from select Indian commercial banks and tapped its currency swap arrangement with the Reserve Bank of India (RBI).

Table 1: Key Economic Indicators

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	(actual)	(actual)	(actual)	(estimate)	(forecast)	(forecast)	(forecast)
Real Sector	Annual percentage change, unless otherwise indicated						
Real GDP	4.0	6.2	7.3	7.4	5.8	5.4	6.0
GDP per capita (in US\$)	2,495.9	2,720.9	2,797.0	3,129.3	3,517.4	3,899.9	4,271.4
Agriculture	3.7	5.4	6.7	6.0	5.2	4.0	3.0
Industry	3.8	6.0	7.5	6.5	5.4	5.0	4.8
electricity	3.6	2.2	4.9	2.5	2.7	8.9	10.5
construction	2.1	8.6	12.0	10.1	3.9	(3.9)	(7.7)
Services	5.0	8.3	9.2	9.1	9.0	9.0	8.8
Unemployment (ILO definition)	2.6	2.5					
CPI, average	9.3	6.7	3.3	4.9	6.1	6.0	5.5
GDP deflator	7.1	6.0	3.9	6.4	8.7	7.4	5.3
Fiscal Accounts	Percent of GDP, unless otherwise indicated						
Revenue and grants	33.6	28.8	29.9	26.7	28.2	20.5	25.6
Expenditure	30.8	29.0	31.8	31.3	31.7	21.2	26.4
Fiscal balance	3.8	1.5	(1.1)	(3.3)	(2.4)	(0.7)	(0.9)
Primary balance	5.7	3.1	0.4	(2.1)	(1.2)	0.1	0.7
Selected Monetary Accounts	Annual percentage change, unless otherwise indicated						
Credit to the private sector	10.5	17.9	11.4	15.4	17.8	18.2	17.7
Balance of Payments	Percent of GDP, unless otherwise indicated						
Current account balance	(26.4)	(28.3)	(29.8)	(22.7)	(21.7)	(17.5)	(11.9)
Merchandise exports (percent change, y/y)	9.8	9.4	(8.9)	12.5	0.2	17.0	12.2
hydropower exports	(0.7)	10.3	(6.4)	22.4	2.5	28.2	19.0
non-hydropower exports	15.4	9.1	(10.0)	7.7	(1.0)	10.8	7.7
Merchandise imports (percent change, y/y)	12.7	9.8	9.0	(0.4)	(2.7)	(0.4)	1.6
Foreign direct investment	1.6	0.5	0.4	(2.0)	0.6	0.6	0.9
Gross reserves (months of imports)	12.4	11.2	13.3	14.1	16.8	17.2	18.7
Total public debt	96.4	96.0	114.4	106.6	94.7	92.3	88.9
External public debt	93.8	94.3	111.1	100.3	94.7	92.3	88.8
hydro debt	61.1	67.6	81.0	77.6	76.2	74.6	72.0
non-hydro debt	32.7	26.7	30.0	22.7	18.5	17.7	16.8
Domestic public debt	2.6	1.7	3.3	6.3	0.0	0.0	0.0
Memorandum items							
Nominal GDP, US\$ Million	1,829.5	2,027.6	2,116.7	2,404.6	2,727.1	3,077.5	3,424.6
Exchange Rate (Nu/USD), FY average	61.5	62.1	66.3	66.4			

Source: MFCTC, RMA and WB staff estimates.

9. Bhutan's inflation is strongly correlated with India. With 75 percent of Bhutan's imports coming from India and an exchange rate pegged to the Indian rupee, Bhutan's consumer price index (CPI) is closely linked to India's. CPI in Bhutan has slowed to 3.3 percent (y/y) in December 2017, down from a peak of 11.8 percent (y/y) in December 2013. This decline was mainly driven by inflation easing in India. However, flash floods in early 2017 led to an increase in food prices which pushed the CPI up to 5.3 percent in July 2017.

10. The current account deficit remains high at 22.7 percent of GDP at the end of FY2016/17, but continues to be financed by large aid flows and investments by India². The current account deficit had reached record high levels in FY2015/16 of nearly 30 percent of GDP, following a surge in imports related to the on-going construction of hydropower projects. The following year, exports grew moderately in nominal terms, but the decline in imports particularly related to hydropower construction helped to improve the current account deficit. The current account deficit was mostly financed by capital flows from India for the hydropower projects through a combination of grants and loans. These financial flows exceed the current account deficit, resulting in international reserves to increase by nearly 4 percent in FY2016/17. Foreign exchange reserves remain comfortable at nearly US\$ 1,162 million providing a cover of nearly 11 months of imports of goods and services. The real effective exchange rate of the Bhutanese ngultrum has been stable in the past few

² India covers financial and construction risks for all hydropower projects, allowing Bhutan to treat hydropower loans from India like FDI, on exceptional basis.

years, which is consistent with Bhutan's exchange policy of pegging to the Indian rupee, India's large share in Bhutan's international trade, and convergence of inflation rates between Bhutan and India.

11. Bhutan's financial sector is dominated by banks and remains sound. Private credit growth has rebounded following the easing of restrictions that were put in place in response to the "rupee shortage crisis" in 2012. Credit growth to the private sector has accelerated to about 13-15 percent over the last three years following a deceleration to below 10 percent between 2012-2014. The Banks' capital adequacy ratio has remained high, at 16 percent in September 2017, above the 12.75 percent required minimum. As credit growth has picked up in the last few years, asset quality in the financial sector has also deteriorated slightly. Gross NPL ratio of the financial sector increased to 12.9 percent as of September 2017 from 9.1 percent in 2016.

12. Fiscal performance has reflected the expenditure dynamics of Bhutan's five-year plans. Specifically, capital expenditure tends to increase over the course of the plan period, as projects get underway. This has been reflected in a deterioration of the fiscal balance as the plan progresses. A surplus of 3.8 percent of GDP was recorded in FY2013/14, the first year of the 11th FYP, compared to the deficit of 3.3 percent of GDP at the end of FY2016/17, the fourth year of the FYP because of capital spending which grew by 16.8 percent in FY2016/17. Current spending increased by 5.5 percent in FY2016/17, moderating significantly since FY2014/15 when it grew by nearly 18 percent to accommodate a civil service pay rise. While expenditures have grown in the final years of the plan, revenue mobilization outcomes have not kept up pace. Tax revenues as a percentage of GDP has fallen from 14.4 percent in FY2013/14 to 13.3 percent in FY2016/17. The widespread use of tax incentives has resulted in a loss of nearly 2 percent of GDP (IMF Article IV 2016). To streamline tax incentives, the Rules on Fiscal Incentive Act of Bhutan 2017 were enacted (the ministry level approval was one of the prior actions of the previous operation). Non-tax revenue has remained constant around 6 percent of GDP.

Table 2: Selected Fiscal Indicators (in percent of GDP)

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	(actual)	(actual)	(actual)	(estimate)	(forecast)	(forecast)	(forecast)
Resources	33.3	27.9	30.6	26.7	28.2	20.5	25.6
Taxes	14.4	14.6	13.9	13.3	13.4	11.8	11.4
Direct taxes	9.9	9.2	8.6	7.8	8.0	8.5	8.6
Indirect taxes	4.5	5.4	5.4	5.5	5.4	3.3	2.7
Non-tax revenues	6.3	5.4	5.7	5.3	5.6	5.6	8.7
Grants	12.7	7.9	10.6	8.1	9.2	3.1	5.5
Expenditure	30.8	29.0	31.8	31.3	31.7	21.2	26.4
Current expenditure	16.0	16.7	16.3	15.1	15.6	15.6	16.4
of which, interest payments	1.9	1.6	1.5	1.3	1.1	0.8	1.5
Capital spending	14.8	12.3	15.5	16.2	16.1	5.6	10.0
Fiscal balance	3.8	1.5	(1.1)	(3.3)	(2.4)	(0.7)	(0.9)
Financing (net)	(3.8)	(1.5)	1.1	3.3	2.4	0.8	0.9
External borrowing (net)	0.7	0.9	0.9	1.6	5.4	1.8	1.4
Domestic borrowing (net)	(4.5)	(2.4)	0.2	1.8	(3.0)	(1.0)	(0.5)
Memorandum items							
Off-budget grants	8.3	7.7	8.0	6.8	6.0	3.9	1.6
Debt service to exports (ratio)	26.7	19.3	14.7	25.2	38.2	7.1	12.3

Source: MFCTC, MoF and WB staff estimates.

13. Bhutan's external public debt stands at 100.3 percent of GDP in FY2016/17, but about 78 percent comes from self-sustaining export-oriented hydropower projects. These hydropower projects carry their own creditworthiness as they are expected to generate substantial earnings after covering their debt obligations, thus with very limited risks for the Government of Bhutan. The Government of India is the main financier and buyer of the electricity generated by these projects—in Indian rupees (and therefore, without exchange rate risk). As a result, a large portion of external debt—75.4 percent—is denominated in Indian rupees. External debt outside hydropower projects stands at a low 22.7 percent of GDP and comes from concessional loans

from multilateral financial institutions and bilateral donors (Austria, Denmark and Japan). Domestic public debt is a low 0.01 percent of GDP. Bhutan's external debt service to exports ratio remains manageable at 25.2 percent and is projected to spike to 38.2 percent in FY2017/18 as a large repayment to the Government of India (GoI) comes due in the current fiscal year, and then to drop off substantially. Due to Bhutan's unique mitigating measures, the updated World Bank Debt Sustainability Analysis of 2018 categorized Bhutan as being under the moderate risk of debt distress.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

14. Bhutan's macroeconomic outlook is expected to remain stable over the medium term. Growth is expected to decelerate to around 5.7 percent a year over the 2018-2020 period, mainly due to delays in the commissioning of two large hydropower projects. Geological complications limited the construction of these two hydropower projects in FY2017 and FY2018, so the anticipated positive impact was not fully realized. India's GST, implemented in July 2017, may have an adverse impact on the Bhutanese economy in FY2017 through trade and revenue channels. Imports will likely increase as Indian exports are zero rated under the GST, making Bhutan's imports cheaper, while exports to India will be subject to GST, removing Bhutan's previous competitive edge over Indian producers.

15. Bhutan's rate of inflation is expected to accelerate to 6.1 percent in FY2017/18 and broadly remain at that level. Structural drivers of inflation in India, including rising food prices and projected increase in commodity and fuel prices are expected to persist. Given Bhutan's strong economic and financial linkages with India, these developments will reflect on prices in Bhutan as well.

16. The current account deficit is expected to decrease rapidly over the projection period and will continue to be financed by capital flows from India. The current account deficit is projected to peak at 21.7 percent of GDP in FY2017/18 and then fall quickly in FY2018/19 and eventually reaching 11.9 percent of GDP in FY2019/20. Export earnings are expected to increase, starting by the end of 2017 with the commissioning of the Mangdichu hydropower project. At the same time, with the construction of Puna-I and II ending, import payments are also expected to taper during the latter half of the projection period. The surplus in the overall balance of payments (BoP) is expected to continue during the projection period and is expected to result in a marginal increase in the total foreign exchange reserves taking it to US\$1.6 billion. The reserve position should adequately cover 18 months of imports.

Table 3: BoP Financing Requirements and Sources (in USD millions)

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	(actual)	(actual)	(actual)	(estimate)	(forecast)	(forecast)	(forecast)
Financing Requirements	603.0	649.7	667.8	671.5	811.9	547.1	441.0
Current account deficit	482.9	574.4	630.6	546.8	591.8	537.1	408.4
Loan repayments	120.1	75.3	37.2	124.7	220.0	10.0	32.6
Financing Sources	603.0	649.7	667.8	671.5	811.9	547.1	441.0
Capital Transfer	275.0	225.3	191.0	186.5	359.9	197.9	220.5
Foreign Direct Investment	29.1	10.6	8.0	(48.2)	15.7	19.9	30.5
Loan borrowings	331.9	425.0	683.3	515.4	627.5	358.4	332.0
Change in Reserves (+ decrease)	(69.6)	9.2	(196.8)	(65.4)	(191.2)	(29.0)	(141.9)
Net Errors & Omissions	36.65	(20.39)	(17.81)	83.16	-	-	-

Source: MFCTC and WB staff estimates.

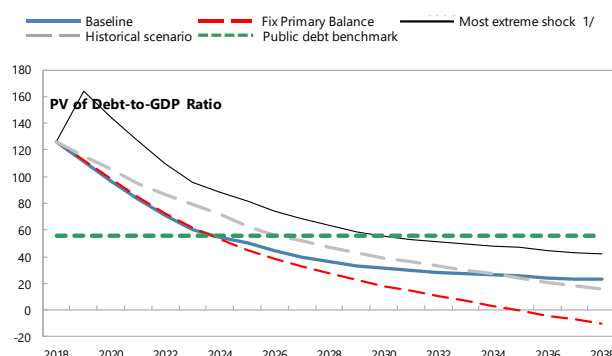
17. The fiscal deficit is projected to decline to 0.9 percent of GDP in FY2019/20 from 2.4 percent of GDP in FY2017/18. Fiscal policy is expected to remain prudent over the medium-term, with the Government generally containing expenditures to keep the fiscal balance from deteriorating. As it has been historically observed, capital spending is expected to remain subdued during the first couple of years of the new five-year plan period (FY2018/19 represents the first year of the 12th FYP). Consequently, the sharp drop in expenditures expected in FY2018/19 is a result of capital expenditure slowdown in the first year of the new FYP. It is important to note that all hydro-related capex is off-budget and this slowdown pertains to the non-

hydro capital expenditures. Recurrent expenditure is expected to remain stable at around 15-16 percent of GDP throughout the forecast period.

18. Fiscal revenues are expected to moderately recover, supported by the Government's measures to introduce a modern GST law and higher non-tax revenue from the hydropower sector. With the introduction of GST in India, there will be a phasing of excise duty rebates that Bhutan used to receive from India as these have been subsumed within the GST system. This will result in a loss of revenue starting from FY2018/19 when the tax revenue is expected to decline to 11.8 percent of GDP from 13.4 percent. Structural reforms such as the introduction of Bhutan's own GST system (supported through this DPC operation) will help to prevent the slide of the tax revenues. At the same time, the commissioning of new hydropower project will also lead to an increase in the non-tax revenue through greater royalties and dividend transfer from the state-owned power companies. Nevertheless, continued widespread tax exemptions, informality, low rates and narrow bases will continue to hinder the effectiveness of fiscal policy.

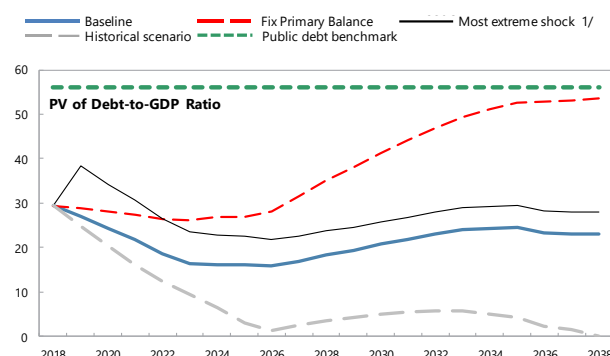
19. The risk of debt distress has not changed compared to the June 2016 assessment, and Bhutan remains at moderate risk of external debt distress. Under the baseline, all five debt burden indicators exhibit prolonged and large breaches of the indicative thresholds. These breaches result from significant investments in hydropower production, especially since 2011. The GOI accounts for the largest share of this financing, with outstanding debt at end-2017 amounting to US\$1.9 billion (or 71½ percent of total external public debt). That said, GOI purchases the surplus electricity output, and covers both financial and construction risks of the hydropower projects. This reduces the risk of debt distress. Therefore, while breaches under the debt burden indicators seem to suggest a high risk of debt distress, the risk assessment improves to moderate once GOI's insurances are considered.

Figure 1: Public Debt Sustainability Analysis



Source: WB DSA 2018.

Figure 2: Public Debt Sustainability Analysis without hydro-related financing



20. Bhutan's macroeconomic policy framework is adequate for the proposed DPC; however, downside risks persist. On the external side, while the current account deficit is projected to decline, this relies exclusively on the completion and commissioning of on-going hydropower projects. Given the size of the hydropower sector relative to the economy, any further delay could adversely impact this positive outlook. Furthermore, with the introduction of the GST in India, non-essential imports from India such as vehicles can become cheaper, which could increase imports substantially and negatively impact the BoP. On the fiscal front, improving revenue collection and increasing reliance on domestic revenues in covering budgetary spending poses a big challenge. Further delays in commissioning of the on-going hydropower projects or the implementation of Bhutan's own GST law could negatively impact the fiscal space needed to implement the 12th FYP. However, the 12th FYP aims to finish on-going capital project and not start new ones, and as such its future trajectory is fairly certain. In the medium term, fiscal rules be it through the stabilization fund or separately through amendments to the Public Finance Act needs to be implemented to ensure that the

projected increase in hydropower related revenues are carefully managed. The expected boost in economic activity could risk a resumption of overheating and macro imbalances as the one experienced during the 2012-2013 ‘rupee shortage crisis’.

2.3 IMF RELATIONS

21. Bhutan is on a two-year Article IV cycle. The last review took place in early 2016 with a joint Debt Sustainability Assessment presented to the IMF Board in July 2016. In addition, the IMF provides technical assistance, which focuses on macro-fiscal, budget, cash management, and e-payments. The proposed DPC operation is consistent with and reinforces the IMF Article IV recommendations on the fiscal side and on financial deepening. It also complements the macro-fiscal support provided by the IMF, and brings additional depth to key structural efforts over the medium term in investment climate and private sector development.

3. THE GOVERNMENT’S PROGRAM

22. “Self-reliance and inclusive green socio-economic development” are the overarching objectives of Bhutan’s 11th FYP.³ A notable paradigm shift of the 11th FYP is the adoption of a results-based planning framework that articulates clear outcomes and outputs to realize the objectives. The government has identified 16 National Key Result Areas (NKRAs), national outcomes and outputs, to be achieved over the next five years, which are: (a) Sustainable and Equitable Socio-economic Development; (b) Preservation and Promotion of Culture; (c) Conservation and Sustainable Utilization and Management of the Environment; and (d) Promotion of good Governance.

23. Bhutan’s 12th FYP is expected to be prepared by mid-2018. The Gross National Happiness Commission (GNHC), the government’s planning agency, has already commenced the preparation of the 12th FYP. Initial guidelines prepared by GNHC suggests that the Royal Government of Bhutan (RGoB) will continue to invest in infrastructure projects. However, the bulk of these investments will be done to complete on-going projects and not start new ones. There is an increased awareness within the RGoB of the need to diversify the economy. In addition, the RGoB wants to ensure that there is a strong private non-hydropower sector that will be able to absorb Bhutan’s growing population.

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

24. The proposed Operation supports the sustainable and equitable socioeconomic development pillar of the 11th FYP. It also supports RGoB initiatives on macroeconomic management and promoting private sector jobs. It supports the macro-fiscal and private sector development components of the government’s program, which are focused on: (a) macroeconomic sustainability and fiscal management; (b) domestic resource mobilization; (c) access to finance; and (d) priority areas identified for economic diversification. The DPCs’ support to reforms to help create private sector jobs in priority sectors such as agriculture, tourism and cottage and small industries is also fully aligned with the government’s long-term development objectives.

25. The design of this Operation includes country-specific lessons from past operations. The 2017 Performance and Learning Review notes that: “Programmatic development policy lending, combined with relevant analytical work and technical assistance, has been effective in supporting government policy reforms. DPCs have enabled the WBG to better respond to the government’s demands to support key policy reforms to address the structural constraints in public finance and private sector development. They have

³ The 11th FYP is the second five-year plan to be implemented since the introduction of 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 through 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 the society. Green Development means ensuring carbon neutral development at all times.

provided a platform for bringing together analytical work, technical assistance and policy dialogue. The DPCs have been complemented with analytical work and technical assistance, and as a package this has also contributed to strengthening government capacity. Furthermore, DPCs have provided an important platform for the WBG to collaborate across Global Practices as well as between the Bank and IFC.” The Operation also benefits from the on-going technical assistance and analytical works that the World Bank is providing on Public Financial Management, Agriculture, Jobs Platform and the recently completed Investment Climate Assessment. In addition, Bhutan has a good track record of eventual parliamentary approval and implementation of previous bills supported by DPCs.

4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar 1: Strengthening the policy framework to improve fiscal management

Measures to improve macroeconomic management

Prior Action DPC1:	Trigger DPC2:	Trigger DPC 3:
Prior Action 1: Parliament approves the establishment of a stabilization fund.	<u>Trigger 1:</u> Cabinet approves the governance framework of the stabilization fund.	<u>Trigger 1:</u> Cabinet approves the fiscal rules that define conditions for inflow and outflow of funds to and from the stabilization fund.

26. Large lumpy investments in hydro power have defined Bhutan’s economy in the past and will continue to do so in the medium term. Bhutan earned around 20 percent of total revenues from hydropower in 2016. The Public Finance Act (2007) stipulates that the cost of recurrent expenditure must be met from the internal resources of the country. However, this rule does not constrain recurrent spending when there is a spike in revenues. These spikes happen every time a large hydropower project is on stream leading to pro-cyclical fiscal policy and fluctuations in aggregate demand. Consequently, adequate tools to manage aggregate demand are critical. In the near-term, Bhutan will continue to import significant amounts of goods and services related to on-going construction of new hydropower projects. However, following the end of construction and commissioning of these hydropower projects, they are expected to generate significant cashflows for the government. Therefore, an appropriate framework to manage these flows is critical to ensure proper macroeconomic management. With the objective of effectively managing these cash flows, the government has authorized the creation of a stabilization fund and the FY2017/18 budget set aside Nu 100 million (US\$1.4 million) to kick-start the fund.

27. The objective of the stabilization fund is to establish a fiscal rule which will ensure macroeconomic stability. Subsequent policies necessary for operationalization and implementation of the stabilization fund (governance structure, fiscal rules) will be established through second and third operations. The World Bank has, in the past, advised the RGoB of the need for alternative rules that delink fiscal policy from volatility of hydro revenues, proposing the adoption of a medium-term balanced budget rule with excess resources placed in a separate account that has clear rules on its use and a strong governance mechanism to prevent the financing of recurrent expenditure. A high-level RGoB Committee was tasked in 2012 to prepare a proposal for the establishment of a stabilization fund. The Committee recommended that a Stabilization Fund be established that is tied to the adoption of a fiscal rule, covering the entire budget, which would transfer revenue into the Fund during revenue spikes as well as outflows from the Fund during severe business cycle downturns to stabilize expenditure and ensure a smooth fiscal path. This reform is expected to result in lower volatility of government spending, thereby contributing to greater macroeconomic stability. Currently, the World Bank has an on-going technical assistance that is supporting RGoB in establishing the appropriate governance framework for the fund as well as definition of the necessary fiscal rule.

Domestic revenue mobilization measures

Prior Action DPC1:	Trigger DPC2:	Trigger DPC 3:
Prior Action 2: Cabinet approves the introduction of GST.	<u>Trigger 2:</u> Cabinet approves the draft GST bill and submits to Parliament.	<u>Trigger 2:</u> Parliament approves the GST Bill.
Prior Action 3: MoF issues administrative measures to minimize impact on revenues in response to India's GST introduction.	<u>Trigger 3:</u> Parliament approves fiscal tax rationalization measures to minimize impact on revenues in response to India's GST introduction.	

28. Domestic revenues as a share of GDP have been declining. Bhutan's domestic revenue mobilization represents about 19 percent of GDP. Tax revenues comprising of income taxes, indirect taxes and duties constitute 71 percent of the total domestic revenues (13.3 percent of GDP) and the remaining comes from non-tax revenues including dividends, interest on loans, and others. Domestic revenues finance the entire current expenditure and around 24 percent of capital expenditure of the government. The country's domestic revenue mobilization efforts face two main challenges in the foreseeable future. The first is the coming to close of GOI's reimbursement of excise on imported Indian goods equivalent to nearly 2 percent of the GDP due to the introduction of India's GST, and the second is the delay in hydropower projects that also could represent lost revenues of another 2 percent of GDP.

29. This operation will support the RGoB in its efforts to increase domestic revenues to minimize the impact of India's GST reforms. In the first year, this Operation will support the Ministry of Finance (MoF)'s administrative measure to issue a new rule on the valuation, collection and deposit of sales tax on vehicles. A change in valuation of a vehicle from point of entry to point of sales, will increase the value of the vehicle, which will result in higher revenues.

30. The second and third operations of the series will support the implementation of Bhutan's own modern GST Law. GST law will replace the existing sales tax and not only improve efficiency of tax collection, but also lead to significant increases in collection of domestic revenue. The second operation will also support Parliamentary approval of fiscal tax rationalization measures that will streamline tax rates and tax exemptions that have led to underperformance of domestic revenue mobilization. These measures are expected to increase revenue collection, which will help mitigate the revenue loss from the implementation of GST in India until Bhutan implements its own GST law.

Public financial management measures

Prior Action DPC1:	Trigger DPC2:	Trigger DPC 3:
	<u>Trigger 4:</u> MoF approves amended Public Procurement Rules.	<u>Trigger 3:</u> Cabinet approves and submits to Parliament new Public Procurement bill.
	<u>Trigger 5:</u> MoF issues a Budget Call Notification incorporating recognition of gender and climate change initiatives in FY2018-19.	<u>Trigger 4:</u> MoF adopts an order establishing interconnectivity of new/existing PFM information systems for automated exchange of data.

31. Bhutan was the fifth country in the world to receive the Public Expenditure and Financial Accountability (PEFA) CHECK⁴ but further improvements in the country's PFM systems are needed. According to the 2016 PEFA report, the three areas which could be strengthened include transparency; predictability and control in budget administration; and accounting and reporting. The government updated its Public Financial Management (PFM) strategy based on the PEFA results. In addition, enhanced use of Information and Communication Technology (ICT) is a cross cutting theme that can further help the government to bring efficiency and improvements in PFM as the present procurement system is largely paper-based. The government currently uses many stand-alone systems to cover various aspects of PFM. Given the limitations

⁴ PEFA CHECK is a mechanism instituted by PEFA Secretariat for confirming the adequacy of the quality assurance processes used in planning and implementing a PEFA assessment. The objective is to increase users' confidence in the findings of a given PEFA assessment and confirm that the assessment contributes to a pool of reliable information on PFM system performance.

in some of these systems and that they are not integrated, the government has not been able to achieve an integrated financial management system.

32. The proposed DPC series will support the RGoB in the areas of strengthening transparency, budget reporting and more extensive use of ICT. The proposed triggers for the second and third operations will complement the government’s newly adopted PFM Reform Strategy. In line with Bhutan’s development objectives, it will support the approval of new public procurement law which will help to provide the legal framework for the implementation of the new e-procurement system. At present, public procurement is regulated by a set of rules and regulations and not a full-fledged law. Furthermore, it will also support the implementation of a new budget reporting format that incorporates gender and climate change budgeting. This information will be useful to parliamentarians and the public and shall enhance transparency and improve budget reporting. Lastly, the operation will also support activities which will include the integration of the various PFM systems which will underpin the introduction of e-procurement system and result in greater efficiency and transparency and ultimately result in improved quality of spending.

Pillar 2: Strengthening private sector employment opportunities

Economic diversification measures

Prior Action DPC1:	Trigger DPC2:	Trigger DPC 3:
<u>Prior Action 4:</u> Ministry of Economic Affairs (MoEA) approves Guidelines for Operationalization of Business Incubation Center for Cottage and Small Industries (CSI).	<u>Trigger 6:</u> Cabinet approves the revised Foreign Direct Investment (FDI) Policy, amended to ease and harmonize equity restrictions.	<u>Trigger 5:</u> Cabinet approves Rules and Regulations defining procedures for land acquisition and leasing for FDI projects under the Land Act.
<u>Prior Action 5:</u> Cabinet approves the Renewable Natural Resources (RNR) Marketing Policy for agricultural products.	<u>Trigger 7:</u> Cabinet approves the revised Cottage and Small Industries (CSI) Policy.	

33. While hydropower has transformed Bhutan’s economy, employment remains concentrated in agriculture and the public sector. Since the commissioning of the Chhukha hydropower plant in 1988, Bhutan’s economy has been transformed by hydropower, which currently accounts for over a third of exports, while employing 0.8 percent of the labor force. However, while the hydropower sector has grown rapidly over the past three decades, the more labor-intensive sectors of manufacturing and services have remained stagnant (employing 6.5 and 15.5 percent of labor force respectively). Consequently, agricultural farming continues to account for more than 58 percent of total labor force (70 percent of jobs in the private sector).

34. Economic diversification will be key to unlocking private sector employment opportunities. While the hydropower sector has served Bhutan well, it cannot create enough employment opportunities to capture the large volume of youth coming into the labor market. The main impediments faced by the private sector include small domestic market and adverse geography. Agriculture has experienced low productivity over recent decades and now constitutes around 15 percent of GDP only. Exports of a limited number of niche agricultural products are increasing, however, and new marketing initiatives can potentially extract a greater premium for Bhutanese products abroad. Given the labor intensity of agriculture, Bhutan’s ability to develop these markets, master agribusiness value chains, develop associated MSMEs (‘cottage and small industries’), and attract investment could have a significant bearing on growth in rural household incomes in the coming years.

35. To address these challenges, the RGoB has approved new guidelines for Business Incubation Centers for MSMEs and approved a new Renewable Natural Resources (RNR) Marketing Policy for agricultural products. The Incubation Centers will provide aspiring entrepreneurs with necessary training in business

operations (including financing, sales and marketing) while the RNR Marketing Policy will provide incentives to farmers to ensure commercialization of crops, enhance fair pricing of agriculture products and improve market access to increase Bhutan's agriculture exports. Most producers grow cereal crops for subsistence. However, due to the expansion of feeder roads that enable producers better access to markets in India, exports of several high-value horticultural crops – and the proportion of firms cultivating such crops – have recently increased. Most farmers and traders sell to Bangladeshi or Indian merchants operating within Bhutan or at border markets, rather than at the end market of the destination countries. This limits their exposure to innovation in product types, trade finance, product quality and other requirements of end markets, marketing, and distribution. Further, uncertainty and risks are defining features of any agricultural sector, including that in Bhutan. The sources of risks are numerous and diverse. From events related to climate-change and weather conditions to fluctuations of prices for products or inputs. One additional objective of RNR policy is to strengthen the system for management of information around these risks and to develop risk management strategies in order to mitigate their impact on Bhutan's agricultural output.

36. In subsequent operations, this program will also help support the implementation of a revised FDI policy. Foreign direct investment is important for Bhutan's economic development as a source of capital, innovation, management expertise, and in enabling access to external markets. However, equity restrictions exist and differ for various nonpriority sectors. The 2010 FDI policy has used a 'negative list' approach towards entry barriers, which helps improve predictability for foreign investors. However, some equity restrictions might need to be revised to ensure that desirable investments are not inhibited. One example is the minimum investment threshold in the hotel sector. The purpose of the restriction is to attract high-value, low-impact tourism, but investment size is not necessarily the best tool to achieve this objective. The revised FDI policy will look to address issues around the minimum level of investment required and the enabling environment for profit repatriation. Further, secondary legislation under the Land Act will also provide greater clarity and certainty on how FDI investments can obtain land for their projects.

Measures to improve access to finance

Prior Action DPC1:	Trigger DPC2:	Trigger DPC 3:
Prior Action 6: RMA Board approves Amendment to Credit Information Bureau Rules and Regulations 2017 to allow reporting by other entities.	Trigger 8: (i) RMA Board issues regulation for Micro-financial Institutions (MFIs) to start sharing credit information with CIB. (ii) RMA Board adopts CSI Supervision Manual for CIB.	Trigger 6: Parliament approves the amendments to the Movable and Immovable Property Act.
Prior Action 7: RMA Board approves E-money issuer Rules and Regulations 2017.		Trigger 7: Parliament approves the new Insolvency Act.

37. Bhutan's private sector is constrained by the insufficient access to finance. Recent reforms have laid the foundations for the development of Bhutan's financial sector. However, the growth of private sector firms – and the growth of micro-enterprises, in particular – continues to be impeded by inadequate access to finance. Further analysis reveals that access to finance is restricted both by supply-side factors, such as a lack of financial competition; insufficient credit information; and an unpredictable restructuring and insolvency regime, and by demand-side factors, such as an inability to collateralize assets and a lack of financial literacy. As revealed by the recent World Bank Investment Climate Assessment, the top constraint that firms face was and remains access to finance. The procedures for acquiring a loan are complex, collateral requirements are high and the regulations governing their use are restrictive.

38. The proposed Operation supports the RGoB in addressing some of the demand-side factors restricting firms' access to finance. Implementation of the proposed legal reforms described below to improve financial infrastructure (credit information bureau, collateral registry, and e-money) and strengthen the legal rights of creditors and borrowers will go a long way in addressing the access to finance constraints, given that currently, CIB only collects information from banks, which limits the system's utility. Farmers are at a

disadvantage, as fewer than one-in-five have access to bank credit. Mobile banking has potential to extend credit to small enterprises and other clients that cannot be served by traditional banks. In addition, Bhutan's high level of mobile phone penetration would facilitate expansion of financial access through mobile banking. The amendment to the Credit Information Bureau rules will ensure reporting of other entities (utilities, insurance companies, etc.) of the credit information. In addition, E-money issuer rules establish legal regulations for provision of mobile banking and payments services that have not existed before in Bhutan.

39. A new restructuring and insolvency regime aligned with best practices will increase the supply of finance by providing better protections for creditors and borrowers and facilitating efficient debt recovery.

A new Insolvency Bill would replace the current Bankruptcy Act and certain sections of the Companies Act. The new Insolvency Bill, whose preparation was supported through the previous programmatic DPC series, introduces a new restructuring and insolvency system aligned with best practices and which improves both the reorganization and the liquidation of distressed companies and small businesses. The Bill has been approved by the Cabinet and awaits approval through Parliament. This will be an important step to improving access to credit by better pricing creditor risk; preserving jobs and supply chains; promoting entrepreneurship; and improving economic efficiency by reallocating productive assets from insolvent to solvent firms.

40. Further, an increase in the realized demand for finance can be achieved by expanding the scope of collateralizable assets. To this end, the RGoB will aim to adopt amendments to the Moveable and Immovable Property Act (MIPA) and enhance the Central Registry for Secured Transactions (CRST), while pursuing reforms that will enable the use of crops, crop transactions, and land as collateral. The demand for finance may be further increased through efforts to address financial illiteracy and to develop cultures of financial responsibility and inclusion within the private sector.

Measures to improve skills in the labor force

Prior Action DPC1:	Trigger DPC2:	Trigger DPC 3:
Prior Action 8: Ministry of Education approves the International School Guidelines 2017.	<u>Trigger 9:</u> Cabinet approves the Teachers Standards Policy. <u>Trigger 10:</u> Cabinet approves the revised National Human Resource Development Policy.	<u>Trigger 8:</u> Ministry of Education approves the Non-Formal Education Equivalency Framework. <u>Trigger 9:</u> Cabinet approves the amendment of the Labor and Employment Act (2007) and submits to Parliament.

41. Labor-related barriers also impede Bhutan's private sector employment growth. Bhutan's working age population is increasing just as the public sector's absorption capacity is diminishing, making it more important than ever that the private sector create quality jobs. A truly effective employment policy must also address the ability of the private sector to access the workforce it needs for growth. According to the analysis in the Bhutan Enterprise Survey of 2015 (Ministry of Labor and Human Resources and WBG 2016) one of the main labor-related constraints to private sector employment growth is the lack of workers with relevant experience and skills. Implementation of the proposed legal reforms described below will enable future workers to be better skilled through both formal education, non-formal education, work place learning and ensure effective matching of labor supply to the labor demand in the country.

42. While securing equitable access to education has been achieved in Bhutan, continued improvements in the quality of education are needed. With a modest start of about 400 students in 11 schools in 1960s, access to education has grown to about 170,000 students in 600 schools in 2016. Ministry of Education is continuously striving to ensure continued evolution of the education sector to improve the quality of education received by students. To this end, the Guidelines for establishment of international schools in Bhutan aim to provide an alternative for international and Bhutanese students. The proposed Guidelines will establish a legal basis for opening of international schools in Bhutan that should provide for introduction of

best international practice in education. While the direct impact of international schools on the skills in the labor force would be limited, their role could be instrumental in providing a demonstration effect on modern-day instruction and for other schools to emulate.

43. Student outcomes are not satisfactory in Bhutan and can be improved. One of the most critical concerns in Bhutan is the quality of education students receive. The increase in enrolment at the primary education level is now placing enormous pressure at the secondary schools, thus resulting in overcrowded classrooms. The government has realized that the quality of graduates from all levels of education does not meet the needs of the modern-day workforce. Current teaching and learning approaches do not help students develop competencies in the field of critical thinking, creativity, innovation, communication and leadership qualities. For example, when jobs in call centers for international companies were offered to high school graduates, only 3 percent of the students could successfully qualify. Consequently, RGoB has realized that poorly trained teachers are having an impact on student outcomes and has proposed a new Teachers Standards Policy that will not only set the standard for teachers in individual subjects, but it will also provide for necessary training and equipping for them to meet the new policy directives.

44. Alleviating skill constraints facing the private sector will be essential to bolstering economic growth, particularly in the tradable services sector. While Bhutan has made significant strides in increasing school enrolment over the past decade, such improvements address the prevailing skill shortage only gradually. Thus, to limit the negative impact that skill shortages are having on Bhutanese firms, the RGoB should act to ensure a greater availability of skills over the short-term by developing channels for skilled migration while also investing in building the skills of the adult population. This will require changes to the existing Labor and Employment Act.

Measures for sustainable and inclusive development

Prior Action DPC1:	Trigger DPC2:	Trigger DPC 3:
Prior Action 9: Ministry of Economic Affairs approves National Energy Efficiency and Conservation Policy.	<u>Trigger 11:</u> Cabinet approves the Gender Equity Policy. <u>Trigger 12:</u> Cabinet approves: i) National Energy Efficiency and Conservation Policy and ii) National Climate Change Policy.	<u>Trigger 10:</u> Ministry of Economic Affairs approves revised rules and regulations of the Alternative Renewable Energy Policy 2013. <u>Trigger 11:</u> Cabinet approves the National Gender Equity Action Plan.

45. While Bhutan has a robust framework for management of public policy, it is still in the early phases of implementation and many actions are needed for operationalization of stated objectives. Self-reliance and inclusive, green socio-economic development are the overarching objectives of the 11th FYP. However, this FYP is only the second five-year plan to be implemented since the introduction of democratic constitutional monarchy in 2008. Similarly, the 12th FYP anticipates policies that promote gender equality, maintain a healthy eco-system and foster carbon-neutral and climate-resilient development. Consequently, much work remains to be done in translating these stated objectives into public policy and this DPC aims to reinforce these policy priorities. In addition to a robust framework, Bhutan has an equally solid track-record of implementing policies, especially those related to the environment.

46. Promoting sustainable and inclusive development will be crucial to meet Bhutan's long-term development goals. While Bhutan's policy planning process naturally incorporates climate change impact, the Economic Development Policy (2016) emphasizes that energy efficiency and conservation measures need to be institutionalized and promoted. The Ministerial approval of the National Energy and Conservation Policy paves the way for the adoption and implementation of this policy, which aims to encourage general improvements in the energy performance standards of the major economic sectors. The overall economy will be improved by energy efficiency and conservation measures through reduced energy intensity, avoided

greenhouse gas emissions and higher revenue earning due to additional export of electricity. In parallel, the RGoB has advanced preparation of the National Climate Change Policy which aims to put in place measures to help Bhutan anticipate and mitigate effects of climate change.

47. Bhutan has made tremendous progress in female labor force participation, but the quality of jobs for women is still an issue. Although women’s participation in the labor force has increased, it has not translated into improvements in employment quality. The Labor Force Survey shows that Bhutanese women work in lower quality jobs than men—women who earn income from work outside the home, their earnings are only 75 percent of men’s earnings. Improving job quality and productivity for women would not only enhance gender equality, but it would also contribute to economic growth. Unemployment, particularly among educated youth – higher among females, remains a key concern of the Government of Bhutan. In this regard, it is important to ensure women become competitive in the labor force along with men. Measures to improve skills in labor force needs to be made gender responsive. To achieve these goals, the Government is planning to adopt a Gender Equity Policy in the second operation and the corresponding Action Plan in the third operation.

48. This Operation is underpinned by extensive analytical work. The prior actions of this Operation are supported by analytical work prepared by the WBG, and are complemented by additional work undertaken by the RGoB and other development partners. Several pieces are especially salient in informing the DPCs, including the Public Finance Think Piece (2016), the semiannual Bhutan Economic Updates, Debt sustainability analysis (2018), and the Investment climate assessment (2017). The RGoB proactively draws upon the WBG’s analytical work and technical assistance to formulate the key reform programs.

Table 4: Analytical Underpinnings

Prior Actions	Analytical Underpinnings
<i>Pillar 1: Strengthening the policy framework to improve fiscal management</i>	
<u>Prior Action 1:</u> Parliament approves the establishment of a stabilization fund.	Bhutan: Boosting Public Savings, Considerations and Options Policy Note; Bhutan Public Finance Think Piece; on-going TA on establishment of a Stabilization Fund.
<u>Prior Action 2:</u> Cabinet approves the introduction of GST.	Bhutan Tax Rationalization Technical Assistance. PFM Multi-Donor Fund (MDF)).
<u>Prior Action 3:</u> MoF issues administrative measures to minimize impact on revenues in response to India’s introduction of GST.	Bhutan Tax Rationalization Technical Assistance. PFM MDF.
<i>Pillar 2: Strengthening private sector employment opportunities</i>	
<u>Prior Action 4:</u> Ministry of Economic Affairs (MoEA) approves Guidelines for Operationalization of Business Incubation Center for Cottage and Small Industries (CSI).	Bhutan Competitiveness Policy Note; Investment Climate Assessment.
<u>Prior Action 5:</u> Cabinet approves the Renewable Natural Resources (RNR) Marketing Policy for agricultural products.	Bhutan Competitiveness Policy Note. Investment Climate Assessment.
<u>Prior Action 6:</u> RMA Board approves Amendment to Credit Information Bureau Rules and Regulations 2017.	Bhutan Financial Sector Reform Policy Note; Bhutan Competitiveness Policy Note.
<u>Prior Action 7:</u> RMA Board approves e-money issuer Rules and Regulations 2017.	Bhutan Financial Sector Reform Policy Note; Bhutan Competitiveness Policy Note.
<u>Prior Action 8:</u> Ministry of Education approves and operationalizes the International School Guidelines 2017	Bhutan Labor Market Study.
<u>Prior Action 9:</u> Ministry of Economic Affairs approves National Energy Efficiency and Conservation Policy	Bhutan Gender Policy Note. Bhutan Competitiveness Policy Note.

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

49. This DPC series underpins all three objectives of the Country Partnership Strategy (FY2015-19): (a) improving fiscal and spending efficiency; (b) increasing private sector and competitiveness; and (c) supporting green development. The DPC is designed to have a strong impact on economic growth through a renewed focus on private sector development by creating the enabling environment to generate more jobs. While on the fiscal front, this operation supports measures to create fiscal space through greater revenue enhancing policies and ensure quality of spending through PFM system reforms.

50. This Operation fully supports progress towards the WBG's twin goals in Bhutan. This operation seeks to help Bhutan increase its competitiveness which will enable Bhutan to absorb its growing population into the workplace. By supporting policies which help to create more and better jobs while still protecting Bhutan's national assets, this operation will not only continue to support Bhutan's recent gains in poverty reduction, but also help WBG meet its commitment to climate change and gender equality. Further, the reforms supported under this programmatic series are expected to strengthen the enabling environment that promotes private sector investments, including the partnership with the public sector (PPPs).

51. Other Bank operations/activities complementing the proposed DPC series include: (a) an investment climate assessment, and implementation of the plan; (b) general policy dialogue on macro-fiscal and the preparation of a public finance think piece as an input to a fiscal strategy; (c) support to the MoF through the PFM MDF; (d) financial sector technical assistance; and (e) technical assistance on the assessment of Bhutan's Labor Market.

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

52. Bhutan's policy making process is broadly consultative and inclusive. Bhutan generally follows an extremely consultative policymaking process with policies going through extensive rounds of public scrutiny. The country has developed a comprehensive system for management of public policies founded on the principles of GNH. Government strategies are rooted in the constitution and the GNHC serves a central role in ensuring compliance of the public policies and processes with principles of GNH. The four principles of GNH are: (a) good governance; (b) sustainable socio-economic development; (c) preservation and promotion of culture; and (d) environmental conservation. Every policy is screened for compliance with these principles and extensive public consultations with relevant government stakeholders are carried out prior to their adoption. Therefore, the reforms supported by this operation have gone through the GNH screening tool which includes broad and extensive consultations.

53. Coordination with development partners. Collaboration between the IMF and the World Bank staff is effective with regular consultations on macroeconomic, debt management, and financial issues. Other development partners engaged in macro-fiscal technical assistance dialogue include the Asian Development Bank (ADB) and the United Nations. The World Bank and the ADB coordinate in the areas of financial sector development and private sector development, with the ADB providing a variety of technical assistance services. As part of the preparation of this programmatic series the task team also consulted extensively with the ADB in Bhutan. The ADB recently completed its own programmatic budget support operation.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

54. The majority of prior actions will have either neutral or a long-term positive impact. Establishment of the stabilization fund (Prior Action 1) should not have direct effect on poverty but may have indirect but positive effects in the future with stabilized macroeconomic conditions and improved transparency and accountability. Supporting Business Incubation Center for CSI (Prior Action 4) and RNR Marketing Policy for agricultural products (Prior Action 5) should help RGOB to create an enabling environment for small

enterprises and potential entrepreneurs to grow, and likely contribute to job creation in the long run. Support to CIB rules and regulations amendment (Prior Action 6) and E-money issuer rules and regulations (Prior Action 7) intend to mitigate insufficient access to finance. These reforms should contribute to positive effects on poverty reduction to the extent that they contribute to job creation for those otherwise unemployed and poor. The introduction of International School Guidelines (Prior Action 8) should have no effect on poverty as public education is already free and international schools when introduced will target wealthier households.

55. However, some prior actions could potentially have effects on the poor and the bottom 40 percent.

The introduction of GST bill under Prior Action 2 is likely to have a significant short to medium term effect on the consumption patterns of the poor and the bottom 40 percent. The magnitude of the effect is unknown at this point as it will depend on how the overall GST scheme and key elements are designed, including but not limited to eligible items and tax rates. A Poverty and Social Impact Analysis will be conducted as RGoB designs the fine detail of the GST scheme for operations 2 and 3.

56. Policies supported under this operation are expected to have positive effects on gender equality.

The new budget reporting format will initiate the process of accounting of activities that directly support gender equality. Review and analysis of development policies, programs and their budgets from the gender perspective will result to institutionalization of gender accountability of programs/projects for gender-responsible outcomes. The strengthening of private sector employment opportunities (Pillar 2) will help ensure a better environment for entrepreneurship, access to finance and improvement in labor force skills and sustainable and inclusive development. Therefore, these reforms are expected to have positive distributional effects. The CSI Policy is expected to have concrete provisions for the promotion of women entrepreneurship. In addition, the policies, acts and framework are expected to be gender friendly. Better access to finance, is further expected to promote women entrepreneurship. The Gender Equity Policy and national action plan is expected to result in increased political representation of female and female literacy, resulting into increased female labor force participation, overall reducing the gender gap in the human development index.

5.2 ENVIRONMENTAL ASPECTS

57. Policies supported by this operation are not expected to have significant negative environmental effects on the country's environment, forests and other natural resources. There could be minor negative environmental effects pertaining to the policies / guidelines related to facilitating CSIs, promoting RNR-based agricultural products and establishing international schools (see annex 4). However, these minor effects, if any, are expected to be mitigated thanks to the RGoB's country environmental system.⁵

58. In terms of RGoB's country environmental system, the National Environment Protection Act 2007 is the overarching umbrella legislation that governs the use of land, water, forests, minerals and other natural resources. This provides for an effective system for conservation and protection through NEC and other specified authorities / committees to independently regulate and promote sustainable development in an equitable manner. Other relevant regulations include the Environmental Assessment Act 2000 and its clearance regulation amended till 2016, Waste Prevention and Management Act 2009 and its Regulations amended till 2016, Water Act 2011 and its Regulation amended till 2014 and the Listed and Exempted Activities 2016. Together these legislations and regulations and the relevant institutions constitute the country's environmental systems. These existing systems would be able to address the above mentioned

⁵ Bhutan is the only carbon negative country in the world. Nestled in the eastern Himalayas between China and India, Bhutan's terrain comprises steep mountains crisscrossed by snow-fed rivers with considerable hydropower generation potential, which meets its entire electricity needs from this source. About half of the land is protected area to help preserve biodiversity. Forest coverage is more than 70 percent of the total land and nearly 2/3 of the population is still engaged in agriculture. Together with industry that is centered on hydropower production, these make Bhutan the only carbon negative country in the world.

minor distributional environmental effects, particularly considering that the likelihood and its severity are low. There are no gaps or shortcomings in the country systems that are required to address these effects.

59. Potential positive effects pertain to the National Energy Efficiency and Conservation Policy. The policy implementation would result in the energy demand being reduced. Several local environmental effects associated with hydropower development will be proportionately reduced and energy savings could lead to a potential increase in the export of power to India. This will contribute towards a reduction in the GHG emissions as India has a high-carbon, coal-based grid.

60. Climate Co-Benefits assessed from this operation (DPC1) are US\$3.33 million or 11.1 percent. The project has potential for increasing climate co-benefits. Climate co-benefits calculated for each of the prior action of DPC1 are zero, with exception to Prior Action 9, where co-benefits are estimated at US\$ 3.33 million or 11.1 percent. Prior Action 5 is assessed as having potential for increasing climate co-benefits if the policy will lead to climate change mitigation, or mainstreaming of climate action.

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

61. The overall fiduciary risk from Bhutan's PFM system and the use of budget resources is moderate. While challenges remain, the core elements of an adequate public financial management system are in place, including publication of the budget. The positive trajectory of improvements in financial management 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, and (d) 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. These positive steps, as well as the government's demonstrated focus on results and strong commitment for continued PFM reforms, provide a satisfactory basis for proceeding with the proposed operation. The recently published PEFA update 2016 confirms that Bhutan has good fiscal discipline through comprehensive coverage of the budget, orderly execution, good control over expenditure commitments and fiscal risks, timely and reliable financial reporting, and improved audit and legislative scrutiny. The World Bank also provides technical assistance on PFM issues through a recently launched Bhutan PFM-MDF.

62. The MoF discloses the National Budget to be discussed and approved by parliament during the June session. The budget document is comprehensive: it includes an analysis of the previous year's financial statements, the budget for the coming year by economic and administrative classification, tax measures, a macro-fiscal economic outlook, a report on state-owned enterprises and government share-holdings, on the RMA and the pension fund. Quarterly and monthly execution reports are produced, but not disclosed, to date. Financial statements of the previous year are disclosed after being audited.

63. In external audit, Bhutan has a reasonably well-functioning public financial accountability. The Royal Audit Authority conducts financial audits at two tiers, one at the national level, the consolidated annual financial statements of the Royal Government, and the other 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. Consequently, the last audited fiscal year is 2015/16. The report contains the result of the audit of the annual financial statements of the government, the overall financial condition and recommendations to improve the economy, efficiency and effectiveness of the government. Besides, the Royal Audit Authority also conducts the financial audits of the donor assisted projects and performance audits.

64. The foreign exchange control environment of the central bank is satisfactory. The annual audit reports are published on the RMA website and are annually audited by external auditors. The auditors have issued an unqualified report for FY2016/17. 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 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.

65. Once the credit is approved by the Board and becomes effective, the government will submit to IDA an application for withdrawal of the proceeds, if IDA is satisfied with the progress achieved by the government in carrying out the Program and with the adequacy of the country's macroeconomic policy. IDA will disburse the US dollar proceeds of the credit in one tranche to the Government Consolidated Fund Account maintained in 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 of the country (including the date of receipt, exchange rate applied to convert the Credit proceeds into Bhutanese ngultrum and name/number of the government's bank account and the budget management system in which the funds have been deposited).

66. Disbursement of the credit proceeds will not be linked to specific purchases. However, the government will 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.

67. Reporting, auditing and closing date. The closing date of the proposed operation will be February 28, 2019.

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

68. The MoF leads the effort in coordinating the overall implementation of the DPC. MoF has experience and is conversant with World Bank policies and procedures through lending and TA operations. Given the history of budget lending operations in Bhutan, some institutional capacity has been built up on data requirements and overall monitoring arrangements. Bhutan is one of the first countries in the Asia and Pacific Region to implement the recommendations of the Enhanced General Data Dissemination System (e-GDDS). The National Summary Data Page utilizing the Statistical Data and Meta Data Exchange is available on the National Statistics Bureau's website. In addition, data is generally available through the MoF and the central bank's website. The World Bank team will continue to provide support to the government in monitoring the reform progress and results.

69. The Prime Minister's office, MoF, Ministry of Economic Affairs, GNHC, RMA and other relevant ministries monitor and assess the reform progress and impacts during the operation. The MoF monitors progress of fiscal indicators both through their annual budget report and their performance agreement signed with the Prime Minister.

70. Grievance redressal. Communities and individuals who believe that they are adversely affected by specific country policies supported by 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 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, because 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 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

71. The overall risk rating for this operation is moderate. Among the listed categories, (a) political and governance, (b) macroeconomic, (c) sector strategies and policies, (d) fiduciary, and (e) 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 2018 which puts it between first and second operations of the programmatic series. The RGoB also engages in participatory processes that include members of the opposition party in formulating development strategies, such as the ongoing preparation of the 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.

72. Technical design risks are substantial. Some of the critical reforms supported by the Operation are new and technically challenging for the RGoB. Introduction of Goods and Services Tax is a prime example. The WBG has provided policy advice in the past. To mitigate related risk, the WBG will continue to provide analytical support and will lead the implementation of PFM-MDF that specifically focuses on PFM and tax issues. This operation supports many activities which require Parliamentary or Cabinet or GNHC approval. There could be potential delays in the passage of identified policies and bills. Their procedures can be lengthy. In addition, the third general elections are scheduled for 2018. These risks are somewhat mitigated by program design which back-loads some of the more challenging actions.

73. Risks related to institutional capacity for implementation and sustainability, are substantial. 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. 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). In addition, there will be close supervision of this Operation to help address emerging challenges related to institutional capacity.

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	N/A
Overall	M

ANNEXES

ANNEX 1: POLICY AND RESULTS MATRIX

Prior Actions (DPC1)	Triggers (DPC2)	Triggers (DPC3)	Expected Results
<i>Pillar 1: Strengthening the policy framework to improve fiscal management</i>			
<i>Measures to improve macroeconomic management</i>			
<u>Prior Action 1:</u> Parliament approves the establishment of a stabilization fund.	<u>Trigger 1:</u> Cabinet approves the governance framework of the stabilization fund.	<u>Trigger 1:</u> Cabinet approves the fiscal rules that define conditions for inflow and outflow of funds to and from of the stabilization fund.	Stabilization Fund is established as evidenced by appointment of all members of the Governing Board. Baseline (2016): 0 Target (2021): All
<i>Domestic revenue mobilization measures</i>			
<u>Prior Action 2:</u> Cabinet approves the introduction of GST. <u>Prior Action 3:</u> MoF issues administrative measures to minimize impact on revenues in response to India's GST introduction.	<u>Trigger 2:</u> Cabinet approves the draft GST bill and submits to Parliament. <u>Trigger 3:</u> Parliament approves fiscal tax rationalization measures to minimize impact on revenues in response to India's GST introduction.	<u>Trigger 2:</u> Parliament approves the GST Bill.	Revenues collected under GST Baseline (2016): BTN 0 Target (2021): BTN 4,000 million
<i>Public financial management measures</i>			
	<u>Trigger 4:</u> MoF approves amendments to existing Public Procurement Rules. <u>Trigger 5:</u> MoF issues a Budget Call Notification incorporating recognition of gender and climate change initiatives in FY2018-19.	<u>Trigger 3:</u> Cabinet approves new Public Procurement bill. <u>Trigger 4:</u> MoF adopts an order establishing interconnectivity of new/existing PFM information systems for automated exchange of data.	Number of PFM systems interconnected Baseline (2016): 0 Target (2021): 5
<i>Pillar 2: Enhancing policies to promote private sector employment opportunities</i>			

<i>Economic diversification measures</i>			
<p><u>Prior Action 4:</u> Ministry of Economic Affairs (MoEA) approves Guidelines for Operationalization of Business Incubation Center for Cottage and Small Industries (CSI).</p> <p><u>Prior Action 5:</u> Cabinet approves the Renewable Natural Resources (RNR) Marketing Policy for agricultural products.</p>	<p><u>Trigger 6:</u> Cabinet approves the revised Foreign Direct Investment (FDI) Policy amended to ease and harmonize equity restrictions.</p> <p><u>Trigger 7:</u> Cabinet approves the revised Cottage and Small Industries (CSI) Policy.</p>	<p><u>Trigger 5:</u> Cabinet approves Rules and Regulations defining procedures for land acquisition and leasing for FDI projects under the Land Act.</p>	<p>Number of CSIs under incubation</p> <p>Baseline (2016): 7 total, o/w female-owned 0. Target (2021): 30 total, o/w female-owned 5.</p>
<i>Measures for improving access to finance</i>			
<p><u>Prior Action 6:</u> RMA Board approves Amendment to Credit Information Bureau (CIB) Rules and Regulations 2017 to allow reporting by other entities.</p> <p><u>Prior Action 7:</u> RMA Board approves E-money issuer Rules and Regulations 2017.</p>	<p><u>Trigger 8:</u> (i) RMA Board issues regulation for Micro-finance Institutions (MFIs) to start sharing credit information with CIB. (ii) RMA Board approves CIB Supervision Manual.</p>	<p><u>Trigger 6:</u> Parliament approves the amendments to the Movable and Immovable Property Act.</p> <p><u>Trigger 7:</u> Parliament approves the new Insolvency Act.</p>	<p>Number of entities reporting to CIB</p> <p>Baseline (2016): 988 Target (2021): 1,087</p>
<i>Measures to improve skills in the labor force</i>			
<p><u>Prior Action 8:</u> Ministry of Education approves the International School Guidelines 2017.</p>	<p><u>Trigger 9:</u> Cabinet approves the Teachers Standards Policy.</p> <p><u>Trigger 10:</u> Cabinet approves the revised National Human Resource Development Policy.</p>	<p><u>Trigger 8:</u> Ministry of Education approves the Non-Formal Education Equivalency Framework.</p> <p><u>Trigger 9:</u> Cabinet approves the amendment of the Labor and Employment Act (2007) and submits to Parliament.</p>	<p>Percentage of Teachers meeting new Teachers' Standards</p> <p>Baseline (2016): 0 percent. Target (2021): 15 percent.</p>
<i>Measures for sustainable and inclusive development</i>			
<p><u>Prior Action 9:</u> Ministry of Economic Affairs approves National Energy Efficiency and Conservation Policy.</p>	<p><u>Trigger 11:</u> Cabinet approves the Gender Equity Policy.</p>	<p><u>Trigger 10:</u> Ministry of Economic Affairs approves revised rules and regulations of the</p>	<p>Energy consumption tons of oil equivalent (TOE):</p>

	<p><u>Trigger 12:</u> Cabinet approves: i) National Climate Change Policy and ii) National Energy Efficiency and Conservation Policy</p>	<p>Alternative Renewable Energy Policy 2013.</p> <p><u>Trigger 11:</u> Cabinet approves the National Gender Equity Action Plan.</p>	<p>i) Building & appliance sectors: Baseline 2014: 270,356 TOE Target 2021: 8,000 TOE reduction</p> <p>ii) Industry Sector: Baseline 2014: 241,972 TOE Target 2021: 15,000 TOE reduction</p> <p>iii) Transport Sector: Baseline 2014: 121,218 TOE Target 2021: 7,000 TOE reduction</p>
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ANNEX 2: LETTER OF DEVELOPMENT POLICY



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**ROYAL GOVERNMENT OF BHUTAN
MINISTRY OF FINANCE
TASHICHHO DZONG**



DMEA/WB-DPC/2018/ 106

February 27, 2018

Dr. Jim Yong Kim
President
The World Bank Group
Washington DC 20433
USA

Dear Dr. Kim,

1. This letter of Development Policy lays out the key elements of the Royal Government of Bhutan's (RGoB) proposed Policy and Institutional Reform Program over the next three years. The RGoB requests the assistance of the World Bank Group in the form of the Development Policy Financing (DPF) instrument for US\$ 30 million. This financing will be used to support the reform areas articulated in the 11th Five Year Plan as well as the first two years of the 12th Five Year Plan. The main objective of the 11th Five Year Plan is green socio-economic development and self-reliance. The assistance from the World Bank Group is needed to especially support the RGoB's efforts to improve fiscal sustainability and to strengthen private sector employment opportunities in the country.
2. The Royal Government of Bhutan would like to thank the International Development Association for providing extensive support through the DPF instrument in the past. Starting with a Development Policy Grant in FY 2006, Bhutan has benefited from the use of the DPF instrument in FY 2007, FY 2009, FY 2012 and FY 2016. All these operations have helped to deepen Policy and Institutional Reforms in the country and were deeply embedded in our respective Five-Year Plans as well. As a result, Bhutan made significant progress to achieve the MDGs and reduce poverty from 12 percent in 2012 to 8 percent in 2017. The Royal Government of Bhutan also remains committed to realize its long-term Vision 2020 social goals as well as the medium term Sustainable Development Goals (SDGs) by 2030.
3. The Royal Government of Bhutan requests continuing World Bank support through the proposed programmatic Development Policy Credit (DPC) to support institutional strengthening in some key areas. Building on the momentum and the lessons learned from the past DPF operations, the RGoB believes that the instrument is highly useful in facilitating development in Bhutan and to enable the World Bank Group in achieving its own twin goals of reducing poverty and boosting shared prosperity across its member states. The RGoB requests selective support for the goals and strategies under the 11th Five Year Plan and is committed to implement the institutional and policy reforms described in the policy and results matrix. The following two broad thematic areas are being addressed in this DPC series: (A) Improving Fiscal Sustainability and (B) Strengthening Private Sector Employment Opportunities.



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(A) Improving Fiscal Sustainability

4. Improving fiscal sustainability is one of the overarching objectives of the 11th Five Year Plan and is expected to remain there as part of the 12th Year Plan as well. Despite sustained economic growth, Bhutan was exposed to macroeconomic vulnerabilities during the last several years. In order to address these vulnerabilities and to smoothen consumption, the RGoB will look to establish a Stabilization Fund. Furthermore, to improve fiscal responsibility and supplement efforts to increase self-reliance the RGoB also will take steps to introduce new tax measures including the establishment of a new Goods and Services Tax (GST) under this Program.
5. The Royal Government of Bhutan also believes that improved Public Financial Management (PFM) systems will help to improve the quality of public spending in the country. With that in mind, the RGoB has recently approved its new PFM Reform Strategy. To complement the objectives of the new PFM Reform Strategy, the RGoB through this operation will also look to improve public procurement systems and introduce gender and climate change budgeting.

(B) Strengthening Private Sector Employment Opportunities

6. The Royal Government of Bhutan continues to play a key role in the economic development of the country as the private sector still remains relatively small and underdeveloped. In order to boost the role of the private sector, the 11th Five Year Plan placed great emphasis on economic diversification, skill development, access to finance and sustainable and inclusive development. All these areas form part of the Green Accelerated Economic Development section of the 11th Five Year Plan which greatly emphasis on the development of the non-hydropower sectors and fostering growth of a dynamic private sector that catalyzes a transition to a green economy. As you might be aware that as the only carbon negative country in the World, Bhutan incorporates climate change initiatives within our development planning framework.
7. Through this operation, the Royal Government of Bhutan will provide a direct support to reform its thrust sectors of Agriculture, Tourism and Cottage and Small Industries. The RGoB has approved new guidelines for Business Incubation Centers for CSIs and approved a new Renewable Natural Resources (RNR) Marketing Policy for agricultural products. The Incubation Centers will provide aspiring entrepreneurs with necessary training in business operations (including financing, sales and marketing) while the RNR Marketing Policy will provide incentives to farmers to ensure commercialization of crops, enhance fair pricing of agriculture products and improve market access to increase Bhutanese's agriculture exports.
8. The Royal Government of Bhutan will also take steps to improve bottlenecks such as access to finance and use the DPC operation to improve skills development in the country. Implementation of the proposed legal reforms to improve financial infrastructure (Credit



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Information Bureau, collateral registry, and e-money) and strengthen the legal rights of creditors and borrowers will go a long way in addressing the access to finance constraints.

9. As highlighted above, the Royal Government of Bhutan strongly believes in an economic growth trajectory that is sustainable and inclusive. While Bhutan's policy planning process naturally incorporates climate change impact, the Economic Development Policy (2016) emphasizes that energy efficiency and conservation measures are institutionalized and promoted. Through this operation, we will support efforts to implement a new energy efficiency program.

Conclusion

10. The Royal Government of Bhutan remains highly committed to our reform progress supported by the proposed programmatic DPC series. We would like to express our appreciation for the support and the 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)

ANNEX 3: ENVIRONMENT 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)
Operation Pillar 1: Strengthening the policy framework to improve fiscal management		
<u>Prior action 1:</u> Parliament approves the establishment of a stabilization fund.	No significant environmental effects. However, a more stable financial management will lead to reducing ad hoc development decisions. This implies could lead to positive environmental effects. Any unplanned development decisions could result in environmental effects on being fully identified or not being managed in a timely manner.	No significant poverty effect in the short run is expected.
<u>Prior action 2:</u> Cabinet approves the introduction of GST.	No significant environmental effects.	The introduction of GST may have a significant effect on the consumption pattern of the poor and the bottom 40 percent. The magnitude will depend on the specifics of the GST scheme. A poverty and social impact analysis is required.
<u>Prior action 3:</u> MoF issues administrative measures to minimize impact on revenues in response to India's GST introduction.	No significant environmental effects.	No significant poverty effects in the short run is expected.
Operation Pillar 2: Enhancing policies to promote private sector employment opportunities		
<u>Prior action 4:</u> Ministry of Economic Affairs (MoEA) approves Guidelines for Operationalization of Business Incubation Center for Cottage and Small Industries (CSI).	No significant environmental effects. However, there could be minor effects, which can be mitigated by the existing country environment system.	A positive effect expected in the long run to the extent that this prior action creates an enabling environment for small enterprises and potential entrepreneurs to grow and create jobs.
<u>Prior Action 5:</u> Cabinet approves the Renewable Natural Resources (RNR) Marketing Policy for agricultural products.	No significant environmental effects. However, there could be minor effects, which can be mitigated by the existing country environment system.	A positive effect expected in the long run to the extent that this prior action creates an enabling environment for small enterprises and potential entrepreneurs to grow and create jobs.

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)
<u>Prior Action 6:</u> Amendment to Credit Information Bureau Rules and Regulations 2017 approved by RMA Board.	No significant environmental effects.	Indirect but potentially positive poverty effects in the long run if this prior action can mitigate insufficient access to finance and contribute to job creation.
<u>Prior Action 7:</u> E-money issuer Rules and Regulations 2017 approved by RMA Board.	No significant environmental effects.	Indirect but potentially positive poverty effects in the long run if this prior action can mitigate insufficient access to finance and contribute to job creation.
<u>Prior Action 8:</u> Ministry of Education approves and operationalizes the International School Guidelines 2017.	No significant environmental effects. However, there could be minor effects, which can be mitigated by the existing country environment system.	No significant poverty effects.
<u>Prior Action 9:</u> Ministry of Economic Affairs approves National Energy Efficiency and Conservation Policy.	Significant positive environmental effects. The policy implementation will result in the energy demand being reduced and need for new hydropower plants commensurately deferred or avoided. Local environmental effects will be proportionately reduced. The potential increase in export of power to India – which has a coal-based grid – will result in reduced GHG emissions as well. The policy implementation will result in expanded awareness of the population. This is particularly relevant in Bhutan, which has a natural-resource based economy.	Poverty effects will depend on the scope of energy efficiency and conservation measures. There may be a negative poverty effect if opportunity cost of compliance is higher for less successful enterprises.