1. Key development issues and rationale for Bank involvement

1.1 Bhutan has been making rapid socioeconomic progress. Social services and infrastructure have been expanded greatly, as well as decentralized governance. The economy has been growing at about 6.5 percent on average during the past decade, led by secondary and tertiary sectors which now contribute about 80% of GDP. The economic transition is fueling rapid urbanization. Since 2000, the urban population in Bhutan is estimated to have grown by about 4.7 percent per year. Starting from a low base, the urban population now accounts for about a third of total population, and is expected to reach 50% of the total population by 2020.

1.2 The rapid urban growth is generating a host of major challenges for this hilly country of scattered small settlements. Meeting the challenges of urban development, management and finance has become a key developmental agenda for the Royal Government of Bhutan (RGOB) and international donors. In recent years RGOB has been developing an initial institutional framework for urban management, including the National Housing Policy, Municipal Act, Land Act, Thimphu and Phuentsholing City Corporations, as well as the National Housing Development Corporation (NHDC). A significant part of foreign financial assistance has been directed to the development of urban housing and infrastructure. These institutions are expected to evolve significantly and the urban investments to continue at high levels, as the country goes through the major democratic transition from 2008 as well as continued rapid urban growth.

1.3 Thimphu, the country’s capital and by far the largest city with about 80,000 residents, provides the largest stage for the new urban challenges and urban management systems. The nation’s first comprehensive Structural Plan was established in 2002 for the greater Thimphu region, and the City Corporation was established in 2003. While the Plan provides a good long-term framework and the City Corporation provides services competently with adequate cost recovery (in terms of water and sewerage), the city has been struggling to manage the urban expansion. Its population has been growing rapidly, recently at a rate of about 3.6% a year, and the city area was expanded in 1997 and 2002. The newly annexed areas remain undeveloped or informal settlements without systematic urban infrastructure.
1.4 The lack of development in these areas is partly due to the development freeze in effect, which has been imposed with the intention and promise to provide the necessary plan and infrastructure. Detailed Local Area Plans (LAPs) have been prepared for these areas - five in the North and five in the South – since 2003, but the infrastructure is yet to be built mainly for lack of financing. In order to avoid the legal and financial burden of land acquisition, the government has been trying to implement the land pooling scheme in these areas. The consultation for land pooling has progressed slowly as the legal framework, procedures, and the staff skills needed to be developed through experience. There now are final LAPs and land pooling agreements in several of the areas. RGOb approached IDA and ADB for financing infrastructure development in those areas - ADB in the south and IDA in the north. ADB approved its loan of $25 million (Urban Infrastructure Development Project) more than one year ago, but the construction activities have not started yet.

1.5 The experience with the Thimphu LAPs illustrates the need to develop new approaches, institutions and capacities for urban management. The development freeze and the initial plan for the government provision of high-standard infrastructure are consistent with the government-led development approach which has yielded Bhutan’s rapid social as well as economic advances. The rapid urban growth, however, is likely to generate heavy investment and management requirements that cannot be met solely by the government. The land pooling is a significant innovation to share the burden of urban development with landowners, but it needs to be refined for higher efficiency and flexibility. Further, the overall urban management and finance systems need reorientation to enable the market and enhance efficiency and equity.

1.6 IDA started supporting Bhutan’s urban development with the Bhutan Urban Development Project (1999-2006) which helped to develop urban water supply in ten small and medium-sized towns as well as serviced sites in two of the towns. It also helped strengthen local government’s project management and cost recovery for water supply. The government has shown strong interest and appreciation of the Bank’s policy advice, through this project as well as the recent TA to prepare the national urban strategy and Thimphu city development strategy. Given the need to accommodate the increasing urban population and the need to develop Bhutan’s policy and institutions to facilitate and manage the urban growth, the proposed project could make significant contribution to the equitable and sustainable expansion of urban services, an essential element of the first pillar of the Bank’s current Country Assistance Strategy (CAS) for Bhutan (2005), and would also contribute to the private sector development, the second pillar of the CAS.

2. Proposed project development objectives (PDOs)

2.1 The proposed project development objectives are to: (i) support Bhutan’s municipal reform program to achieve a more decentralized and accountable urban local government system, starting from Thimphu; and (ii) improve infrastructure services in northern Thimphu. The first objective is about helping RGOb and TCC implement the recently-passed Bhutan Municipal Act of 2007 through a series of technical assistance, training programs, policy dialogue, and research/studies and if needed funding of an effective intergovernmental fiscal system. The second objective addresses an urgent need for serviced urban land, given the already substantial and increasing migrant population settling in the peripheries of Thimphu. The process of attaining these objectives would help develop models and capacity for broader urban management in Bhutan.

3. Preliminary project description
3.1 The project is proposed as a specific investment loan with a technical assistance and an investment component, each designed to address the two objectives. However, the team proposes to take a two-track approach in terms of project design at the moment, with a different primary focus under each track. Track One will be focusing more on the municipal reform process with a limited physical component for improving service delivery in northern Thimphu. Track Two will be primarily focusing on improving service delivery in northern Thimphu while incrementally supporting municipal reform/capacity building at TCC. Track One is a more comprehensive fiscal and institutional approach that subsumes service delivery priorities within a vision of strengthening decentralized municipal government. Track Two is a more incremental approach on the institutional agenda with greater emphasis on service delivery outcomes in the short to medium term and as an entry point on the institutional agenda. The team proposes to hold a dialogue with RGOB and TCC on these approaches as soon as the new government is formed and a new Thimphu mayor is elected. The final project design will be decided, based on the dialogue and a better assessment of the political economy factors that will guide the overall urban municipal reform. In any case, the project will likely include the following two components. The extent and depth of each component and their linkages will depend on which of the two tracks are acceptable to Government.

3.2 Municipal Reform/Institutional Development: The project proposes to help RGOB and TCC to implement the municipal reform program and also improve their urban management and finance systems. This would include a focus on the intergovernmental fiscal system, the regulatory framework that would guide this system, and urban local government system of financing, budgeting and planning. The project would also facilitate the modification of the framework of development control (and permit) system to better calibrate infrastructure development and land pooling to the growth of population and land demand, to facilitate private initiatives and investments, and to increase the fiscal revenues. To this end, the project will provide technical assistance to improve the municipal finance systems and inter-governmental relations, including infrastructure service charges and the reclassification of land for tax purposes. The project will also improve the planning and urban designs, conservation, regulation, and land pooling frameworks. In addition, the project will finance the establishment of a land registry office for Thimphu, in accordance with the recently adopted land and municipal legislation, which will underpin development activities in the LAP areas included under the project, as well as provide services for remaining portions of the city. The project will also provide TA for project implementation, monitoring and evaluation at the central and local government levels.

3.3 Northern Area Development: The project will finance infrastructure improvement and development in the northern LAP areas. The options are: (i) developing full basic infrastructure (roads, water supply and sewerage) in all five areas, which would cost over $25 million; (ii) developing full basic infrastructure in two areas where land pooling arrangements have been progressing, which would cost $10-12 million; (iii) developing infrastructure to varying levels in all five areas depending upon the existing developments and imminent prospects, at a cost of about $15-20 million. RGOB favors option (i) or (ii) for various reasons, including the parity with the planned development of the southern LAP areas financed by ADB and the equity among the landowners within the same LAP areas.
4. **Safeguard policies that might apply**

4.1 Overall, the project is expected to have positive environmental and social impacts by supporting sustainable urban growth and improving environmental services. Potential negative environmental impacts associated with construction of new infrastructure systems such as water supply and urban drainage will be addressed through: (1) site-specific environmental analysis; (2) incorporation of environmental monitoring into O&M systems; and (3) institutional strengthening of concerned agencies in urban environmental management.

4.2 Social analysis and stakeholder consultations will be ensured during the project preparation to mitigate any negative social impacts. Special attention will be paid to issues related to land pooling and involuntary resettlement.

5. **Tentative financing**

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6. **Contact point**

Contact: Toshiaki Keicho  
Title: Senior Urban Environment Specialist  
Tel: 94-11-5561345  
Fax: 94-11-2440357  
Email: tkeicho@worldbank.org