PROJECT PERFORMANCE ASSESSMENT REPORT

BHUTAN

Fiscal Sustainability and Investment Climate Development Policy Credit Series

Report No. 168982
NOVEMBER 1, 2022

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WHAT WORKS

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Fiscal Sustainability and Investment Climate Development Policy Credit Series (IDA-56470, IDA-59230)

November 1, 2022

Human Development and Economic Management

Independent Evaluation Group

Abbreviations

ADB	Asian Development Bank
ASA	advisory services and analytics
CIB	Credit Information Bureau
CRST	Central Registry for Secured Transactions
DBRM	*Doing Business* Reform Memorandum
DPC	development policy credit
FDI	foreign direct investment
FSDAP	Financial Sector Development Action Plan
FY	fiscal year
GDP	gross domestic product
IMF	International Monetary Fund
MIPA	Movable and Immovable Property Act
MLR	minimum lending rate
MSME	micro, small, and medium enterprises
PPP	public-private partnership
RMA	Royal Monetary Authority
SCD	Systematic Country Diagnostic
SOE	state-owned enterprise

All dollar amounts are US dollars unless otherwise indicated.

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Note: IEG = Independent Evaluation Group; PPAR = Project Performance Assessment Report.

Contents

Box

Table

Appendixes

Data

This is a Project Performance Assessment Report by the Independent Evaluation Group of the World Bank Group on the Bhutan First and Second Development Policy Credits for Fiscal Sustainability and Investment Climate (P147806 and P157469). Following standard Independent Evaluation Group procedure, the draft Project Performance Assessment Report was shared with relevant government officials for their review. The government had no comments.

Fiscal Sustainability and Investment Climate Development Policy Credit Series (P147806 and P157469)

Basic Data

Country	Bhutan	World Bank financing commitment	$20.00 million and $24.00 million
Global Practice	Macroeconomics and Fiscal Management and Trade and Competitiveness Global Practices, South Asia Region	Actual project cost	$20.07 million and $23.83 million
Project name	Fiscal Sustainability and Investment Climate Development Policy Credit	Expected project total cost	$20.00 million and $24 million
Project ID	P147806 and P157469	Actual amount disbursed	$20.07 million and $23.83 million
Financing instrument	development policy credit	Environmental assessment category	C
Financing source	International Development Association		

Dates

Event	Original Date	Actual Date
Approval	17 Jun 2015 and 21 Dec 2016	17 Jun 2015 and 21 Dec 2016
Effectiveness	not known and 24 Mar 2017	not known and 24 Mar 2017
Closing	31 Mar 2016 and 30 Jun 2018	31 Mar 2016 and 30 Jun 2018

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Summary

Background and Description

This Project Performance Assessment Report evaluates a development policy credit (DPC) series for Bhutan consisting of the First and Second Fiscal Sustainability and Investment Climate Development Policy Credits. The program development objective was to promote fiscal discipline, improve access to finance for enterprises,[1] and improve the climate for business entry and investment in Bhutan. The first operation was approved on June 17, 2015, in the amount of $20 million. The second operation was approved on December 21, 2016, in the amount of $24 million. Both operations closed on schedule. The purpose of this Project Performance Assessment Report is to examine what worked, what didn't, and why, considering sustainability of results and drawing on a broad body of evidence, and provide lessons that are operationally relevant.

The DPC series was designed and implemented with fiscal discipline and private sector–led job creation as important country priorities. The country was emerging from the Indian rupee crisis, which had revealed financial sector and fiscal vulnerabilities. In addition, after decades of successful state-led development, the limitations of this model were emerging and unemployment was rising. As Bhutan had only recently and gradually opened its economy to private sector activity, it was facing challenges of low capacity in the private sector, a nascent regulatory framework and supporting institutions for the private sector, restrictions on enterprise access to finance, and a restrictive environment for foreign direct investment (FDI).

The fiscal sustainability pillar of the series was well designed. It supported removal of restrictions on imports and credit that had been put in place to address the rupee crisis. It also supported measures to increase tax revenue and broaden the tax base through adjustments in fiscal incentives and import duties, and to limit public debt. These were important to safeguard long-term fiscal sustainability. This pillar of the series had strong ownership from the government, mostly because of the desire to address weaknesses exposed during the rupee crisis. It was well supported by World Bank technical assistance that had identified underlying problems and proposed solutions, with the World Bank working with the government authorities and the International Monetary Fund. This pillar contributed to reducing non-hydropower debt and plausibly contributed to increasing tax revenue, although it is not possible to directly attribute the increase in tax revenue to the DPC-supported prior action.

The series was unsuccessful in improving access to finance for enterprises. It had sought to address collateral constraints that were considered an important barrier to access to finance and support development of a regulatory framework for the financial sector. But it did not address other key constraints on access to finance, including controls on interest rates, heavy state control of the sector that directed lending to specific sectors and limited competition and the supply of financial products and services (World Bank 2020c), and the weak capacity of firms to prepare bankable projects. The Financial Sector Development Action Plan was adopted and is being implemented, strengthening the regulatory framework for nonbank financial institutions and payment systems, and detailing a way to improve access to bank finance for small and medium enterprises. But key reforms to address collateral constraints were not enacted because of legal complexities and capacity constraints. The Central Registry of Secured Transactions was enhanced, and information from utility companies was integrated into the Credit Information Bureau. However, mainly because of weaknesses in the results framework, there is no evidence that enterprise access to finance increased.

The series addressed some constraints on FDI, but overall was not effective in improving the climate for business entry and investment. The design of the investment climate pillar focused on one critical constraint—removing some restrictions on FDI. It did support progress in addressing some restrictions on FDI; however, other restrictions remained, per the government of Bhutan's gradual approach to opening to FDI. The design of the DPC series did not address the state's dominant role in the economy and shortcomings in enterprise management and technical capacity. Although reforms supported by the DPC were designed to make some procedures involved in doing business easier—for example, business registration, land titling, and filing and paying taxes—much more needed to be done to effectively transform the business environment to one that facilitates private sector growth.

The electronic tax filing and payments system and the online property and land registry were improved. The time required to pay taxes decreased substantially.[2] The online property and land registry is now being used throughout the country, building on the scope of the DPC prior action. Some restrictions on FDI were relaxed—for example, minimum size of investments, equity percentage of investments, repatriation of profits in foreign currency, domestic borrowing, and visas for executives and workers. However, the expected impact on increasing FDI inflows was not achieved. The reforms intended to simplify business registration (Enterprise Registration Bill) and licensing (Licensing Policy) were not enacted. The amendments to the Companies Act to strengthen protections for minority shareholders were enacted, but there is no evidence of a positive impact.

The areas in which the DPC series performed well had the following features in common: government ownership, straightforward legislative changes, and complementary support from the World Bank Group or other development partners (International Monetary Fund, Asian Development Bank). The areas in which it performed poorly lacked a robust analytical foundation and had weak prioritization of business environment constraints. The series relied heavily on the *Doing Business* indicators, which proved inadequate to guide meaningful reform to the business environment.

The experience with this DPC series suggests several lessons for Bhutan that may also be relevant to countries in similar situations:

1. DPCs should be more selective, focusing on fewer and better-sequenced reforms. Selectivity filters should include reforms that address critical constraints to economic growth and stability, those that have government and parliamentary support, and those for which complementary implementation support—including to address concerns of Parliament—is available.

2. DPCs in Bhutan should have more thorough assessments of technical capacity and implementation risks and pay more attention to risk mitigation. Future DPCs should be accompanied by plans to provide support to implementation. The existence of complementary support was key in each of the policy areas that worked well in this DPC. Capacity constraints limited the implementation of several reforms. The World Bank correctly identified capacity as a risk in Program Documents, but mitigating measures were insufficient and did not cover all aspects that required them, did not extend long enough beyond the time frame of the operation to ensure sustained implementation, or both.

3. Greater attention is needed to foster coordination across ministries and agencies. For this purpose, investment project financing with results-based (disbursement-linked) indicators or Programs-for-Results may be more efficacious instruments to support the achievement of objectives. These can more easily incorporate support for knowledge sharing, capacity building, and institutional strengthening over a longer period than can development policy financing. Other development partners can also be encouraged to provide such complementary support, as was the case in this series with the International Monetary Fund (on fiscal issues) and Asian Development Bank (on the electronic tax filing and payment system).

4. DPCs in Bhutan that aim to address economic growth should be informed by a more rigorous assessment of major constraints to private sector development. The analytics used to inform investment climate prior actions of this DPC series focused on *Doing Business* indicators, which precluded identification and prioritization of major constraints to private sector development. These would have included the state's role in the economy and the incipient nature of the

institutions supporting the business environment. The 2020 Systematic Country Diagnostic provided such a broader picture of constraints to private sector growth (World Bank 2020c); however, the assessment of the regulatory environment was limited by its reliance on aspects measured by *Doing Business*.

5. Bank Group management should consider what steps are feasible when legislation supported by development policy financing prior actions is not enacted. The programmatic approach in this case was insufficient to guarantee that prior actions requiring submission of bills to Parliament or their approval by Cabinet would lead to adoption and implementation of the DPC-supported legislation. The implications for future DPCs and other engagements with the government should be considered.

These lessons have particular importance given the role of DPCs in World Bank lending to Bhutan. During the fiscal year (FY)15–19 Country Partnership Strategy period, the Fiscal Sustainability and Investment Climate DPC series represented two out of the World Bank's four new lending operations in Bhutan and 42 percent of total lending by value. The additional two operations were also a DPC series (Strengthening Fiscal Management and Private Sector Employment Opportunities DPC series, approved in FY18 and FY19). The weak results in enterprise access to finance and the investment climate from the Fiscal Sustainability and Investment Climate DPC series reduced the overall effectiveness of the World Bank–supported program in the country. Although it is understood that the authorities did not request other forms of World Bank lending, reliance on the development policy operation instrument alone proved inadequate to make meaningful progress toward development objectives.

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[1] The first development policy credit had a slightly different formulation of this component of the objective: "contribute to enhancing access to finance to enterprises"

[2] From 85 hours according to *Doing Business* 2016 to 52 hours in *Doing Business* 2019 and 2020.

1. Background, Context, and Design

Background and Context

1.1 This Project Performance Assessment Report covers the Fiscal Sustainability and Investment Climate Development Policy Credit (DPC) series for Bhutan. The series comprised two operations: the First Fiscal Sustainability and Investment Climate DPC for $20 million (approved on May 15, 2015), and the Second Fiscal Sustainability and Investment Climate DPC for $24 million (approved November 28, 2016).

1.2 In the 10 years leading up to the DPC series, Bhutan experienced strong economic growth that sharply reduced poverty. From 2006 to 2015, gross domestic product (GDP) grew at an average annual rate of 7.6 percent. By 2012 (latest data available), extreme poverty had been reduced to 2.2 percent of the population, from 17.8 percent in 2003.[1] Over the same period, Bhutan had transitioned smoothly from an absolute to a constitutional monarchy by 2008. By 2015, the country had held two successful rounds of parliamentary elections.

1.3 Despite this progress, Bhutan faced challenges, notably related to external imbalances. Bhutan's economy is highly dependent on hydropower and on India as a trading partner and transit country. India accounts for 80–90 percent of Bhutan's exports and about four-fifths of its imports (World Bank 2020c; Bhutan 2013, 2016b, 2018b, 2020b).[2] Bhutan's current account balance deteriorated from −5.3 percent of GDP in 2009 to −28.8 percent in 2016, before improving to −15.8 percent in 2020.[3] The current account deficit in Bhutan is of a structural nature, mainly arising from high imports of machinery and equipment for hydropower projects. Bhutan pegs its currency, the ngultrum (Nu), to the Indian rupee, thus linking Bhutan's consumer inflation closely with that of India. The 2012–14 shortfall in Indian rupee reserves (referred to as the rupee crisis) was driven by current account imbalances and the peg to the rupee (see box 1.1).

1.4 Hydropower, agriculture, and forestry provide the main livelihood for more than half of the country's population, although the government remains an important employer. The public sector, the largest formal employer, employs approximately 20 percent of the workforce. In 2019, hydropower directly accounted for 12 percent of GDP (with another 14 percent indirectly through construction and ancillary activities), 28 percent of exports earnings, and 22 percent of government revenue. At the same time, it employed less than 1 percent of the workforce (World Bank 2020c). Agriculture accounted for 13 percent of GDP and 54 percent of employment.

1.5 Hydropower is a critical source of economic activity but also makes the economy vulnerable and has limited spillover to the domestic private sector. A heavy reliance on hydropower created short-term macroeconomic imbalances, including the rupee crisis. Hydropower also contributed to the rapid buildup of Bhutan's India-financed public debt. Hydropower-led growth also crowds out private sector activity because the real currency appreciation that results from hydropower exports reduces the competitiveness of Bhutan's exports (World Bank 2002).

Box 1.1. The Rupee Crisis

There was a shortage of Indian rupees in Bhutan from 2012 until October 2014, driven by the country's dependency on hydropower projects and on trade with India. Between 2009 and 2012, Bhutan's exports to India, of mainly hydropower, minerals, and mineral-based commodities, grew sluggishly—at 3.2 percent per year, on average—whereas imports grew rapidly at an annual rate of about 17 percent. The growth in imports was fueled by excessive domestic credit and resulted in financial instability and ultimately a shortage of Indian rupees. The government responded by introducing credit controls on housing construction (since construction materials were mostly imported from India) and vehicle import loans to control the current account deficit. The Bhutanese authorities realized that over the medium term, monetary and fiscal consolidation were needed to contain domestic demand and avoid a renewed rupee shortage.

Source: Ura 2015.

1.6 The government has been the primary source of employment for educated Bhutanese, but its capacity to absorb a growing workforce is eroding, and there is a growing need for the private sector to create jobs. A growing number of educated Bhutanese are seeking urban employment opportunities, and youth unemployment is relatively high. In 2018, 24.4 percent of urban youth (and 15.7 percent of total youth) were unemployed. Notably, most unemployed people have middle or higher secondary education. Although previously most school graduates were absorbed into the civil service (the preferred employer because of its generous compensation packages), these opportunities are now limited because government employment has reached a saturation point.

1.7 Bhutan's private sector plays a limited role in the economy. The size of the private sector in 2015 was approximately 30,000 formal businesses, of which 99 percent were micro and small businesses (World Bank 2016a). There are currently approximately 350 limited liability companies and a handful of joint-stock companies and partnerships, only about 100 of which are active (Bhutan 2015). Of those, approximately one-quarter are either wholly or partially owned by the government of Bhutan, and these are the largest companies in terms of assets, turnover, employment, and contribution to taxes (Bhutan 2015 and World Bank 2016c). The 11th Five-Year Plan created 12 new state-owned enterprises (SOEs), taking the total to 38 social and commercial SOEs (*The Bhutanese* 2018). They are overseen either by the Ministry of Finance or by Druk Holding and Investments, which is 100 percent government owned. One large private conglomerate comprises over 40 companies and 3,000 employees, with activities in the airline, telecommunications, chemical, beverage, hotel, and other industries. Bhutan's stock exchange has a total market capitalization of about $650 million in 20 companies, many of which are controlled by the government, and only three are actively traded. The remaining businesses are de facto sole proprietorships, with or without employees, and mostly in services and trade (World Bank 2020c).

1.8 Growth of Bhutan's private sector is limited by country characteristics and policy. Bhutan has pursued a state-driven approach to industrial development. The country's economy opened to the world only relatively recently. The government's policy for industrial development was to create commercially oriented SOEs that currently operate in the manufacturing, energy, financial, and other sectors. Managerial and technical skills and experience required by the private sector are in short supply. The domestic market is small, and opportunities for firms to compete are dampened by SOE and incumbent participation in competitive markets; the 2020 Systematic Country Diagnostic (SCD) states that "the continued creation of SOEs in commercial sectors has crowded out private sector activities" (World Bank 2020c). Remoteness and weak connectivity leave firms with limited access to foreign markets. Smaller firms have limited access to finance because of restrictive regulations, complex procedures, and high collateral requirements. The business environment suffers from lack of transparency and predictability (World Bank 2020c).

1.9 At the time of the DPC, foundational elements of private sector growth were yet to be put in place. These included an insolvency framework, addressing tariff and nontariff barriers to export, and developing a financial sector geared toward meeting the needs of micro, small, and medium enterprises (MSMEs). Private sector growth was further limited by low entrepreneurial skills and a mismatch between the demand for and supply of skills in the labor market. Firms noted additional difficulties arising from restrictive labor regulations.[4] Additionally, there are many limitations on foreign direct investment (FDI), including unequal treatment of foreign and domestic investors.[5]

1.10 Recognizing the need to promote more diversified growth and employment creation, the government adopted the Economic Development Policy in 2016. The policy supported the development of sectors that were expected to help the country meet its ambitious objectives of (i) achieving a minimum average annual economic growth rate of 10 percent and (ii) becoming a middle-income nation by 2020. The policy recognized the need to improve the business-enabling environment. The core growth areas of the economy were identified as hydropower, agriculture, cottage and small industries, tourism, and mining.

Objective, Design, and Financing

1.11 To support the reform agenda of the government of Bhutan, the World Bank prepared a programmatic series of two DPCs. The objective of the series was to promote fiscal discipline, contribute to enhancing access to finance to enterprises, and improve the climate for business entry and investment. A list of prior actions is included in table A.2 in appendix A, and they are summarized here.

1.12 Pillar 1 supported fiscal sustainability and self-reliance. DPC1 supported actions to (i) replace the blanket administrative restrictions on imports of vehicles with the introduction of taxes on imported vehicles; (ii) eliminate the restrictions on loans for housing and vehicles; and (iii) raise taxes and customs duties on selected products. The restrictions on lending and vehicle imports had been put in place to limit the demand for rupees during the rupee crisis. DPC2 supported (i) measures to reduce tax exemptions and broaden the tax base and (ii) adoption of a debt policy to ensure that financing decisions were prudent and that public debt was maintained at a sustainable level. With these actions, the program sought to improve fiscal discipline and sustainability, and thus macroeconomic stability.

1.13 Pillar 2 supported actions to increase access to finance for firms. These included a package of reforms to ease collateral constraints, consisting of (i) amendments to the Movable and Immovable Property Act (MIPA) to facilitate the use of movable assets as collateral, (ii) broader use of the Central Registry for Secured Transactions (CRST), (iii) the submission to Parliament of a new Insolvency Bill, and (iv) steps to strengthen the Credit Information Bureau (CIB). This pillar also supported adoption of the Financial Sector Development Action Plan (FSDAP), which attempted to deepen and strengthen the sector through improvements in the nonbank financial institution regulatory framework, bank lending to small and medium enterprises, and a national payments system strategy and policy.

1.14 Pillar 3 supported reforms to improve the business environment. The proposed reforms included (i) amendment of the Companies Act to improve minority shareholders' rights,[6] (ii) establishment of an online property and land registration system, (iii) simplification of the business registration process, (iv) approval of a Licensing Policy to encourage businesses to participate in the formal economy, (v) and introduction of an electronic tax filing and payment system. DPC1 supported amendments to the FDI policy to revise the minimum threshold of investment and to authorize profit repatriation in foreign currency. DPC2 supported the approval of the public-private partnership (PPP) policy, rules, and regulations.

2. What Worked, What Didn’t Work, and Why?

Design

What Worked

2.1 The design of the DPC series was relevant in addressing fiscal stability, an important precondition for economic development. The World Bank was aware of the issues and understood the government’s objectives and the reforms it was prepared to implement.[7] The DPC prior actions were aligned with the fiscal problems stated in the government’s Economic Development Policies of 2010 and 2016. They addressed vulnerabilities uncovered during the 2012–13 rupee crisis linked to fiscal challenges arising from hydropower development.[8] Some tax exemptions and holidays had narrowed the tax base without clear evidence of contribution to private sector development, and some tax measures were found to be ad hoc and inconsistent. Therefore, the DPC supported measures to raise tax revenues and strengthen public debt management through measures to reduce tax expenditures and broaden the tax base. The DPC also supported adoption of a debt policy to promote prudent financing decisions and to ensure that public debt was maintained at a sustainable level, at predetermined external debt thresholds. In accordance with the debt policy, and based on inputs and support received from the World Bank and International Monetary Fund (IMF), the government also prepared a Medium-Term Debt Management Strategy and regular debt sustainability analyses.

2.2 The measures introduced under this DPC series continue to have relevance as the government of Bhutan navigates the impact on public finances of the COVID-19 pandemic, particularly to safeguard the progress made on improving fiscal and debt sustainability. The COVID-19 shock has had a sizable impact on tax revenue, fiscal deficit, and public debt; the framework developed by this DPC series, if implemented carefully, may help mitigate the adverse shock on the economy and the fiscal position of the government.

2.3 The DPC’s emphasis on access to finance was appropriate because this is a key issue for private sector development. In the 2009 and 2015 International Finance Corporation Enterprise Surveys, Bhutanese firms, especially MSMEs, cited limited access to financial services as the biggest obstacle to doing business. The procedures for acquiring loans were complex, the collateral requirements were high, and regulations governing loan use were restrictive. The seizing of pledged assets by banks was a long, drawn-out judicial procedure that favored the borrowers at the expense of creditors.

This forced banks to rely on collateral rather than cash flows when evaluating prospective borrowers.

2.4 To address these challenges, the DPC series supported prior actions to address the collateral constraints faced by borrowers and resolve insolvency. The prior actions included amendments to the MIPA for the use movable assets as collateral; submission to Parliament of a new Insolvency Bill; recording the usage of movable assets as security by registering them in the CRST; and steps to strengthen the CIB. Work on MIPA, CRST, and CIB aimed to address complementary aspects of collateral constraints. Establishing an insolvency framework addresses the need to recognize that risk taking involves occasional failure and there should be a way to resolve such cases. Thus, the results chain for the reforms and actions under pillar 2 addressed some important constraints to access to finance for MSMEs.

2.5 The FSDAP supported by the DPC addressed important and relevant aspects. A prior action of the second operation supported Cabinet approval of the FSDAP. The FSDAP included more than 170 points aimed at addressing the following areas:

- Improve banking system policy and stability, primarily by addressing competition and innovation, capacity building, and financial soundness
- Improve the framework for nonbank financial institutions, including through a national pension and provident fund policy and improvements in insurance regulation and reporting
- Improve the functioning of financial markets by adopting a new public debt policy that will allow for some public borrowing to meet monetary policy and capital market development purposes and to meet funding needs of the government, relax requirements for initial public offerings, and so on
- Strengthen financial sector infrastructure in crisis management policies and procedures, payments systems, debt recovery environment, and so on
- Expand financial inclusion and financial literacy
- Improve the organization of the Royal Monetary Authority (RMA)—staffing, human resource development, and processes—to better enable it to carry out its responsibilities

2.6 One of the actions in the FSDAP partially addressed one aspect of a structural constraint to lending. It substituted the prevailing uniform systemwide base rate for banks with a system of interest rate ceilings and floors for the banking system as whole and allowed individual banks to set their own interest rates within the band, to encourage interest rate competition. Before this, banks did not price credit; instead, the RMA required them to offer credit at fixed prices, and then ratio credit based on loan-to-value ratios. This action in the FSDAP was partially implemented (see paragraph 2.39).

2.7 The design of the fiscal aspects of the DPC series and specific prior actions were underpinned by strong analytics and technical assistance, including (i) the IMF Article IV Consultation, Joint IMF–World Bank Debt Sustainability Analysis (IMF and World Bank 2016), which covered fiscal policy, tax policy, the hydropower sector's impact on fiscal policy, the financial sector, and debt sustainability; (ii) government analysis of the implications of the rupee crisis; (iii) World Bank semiannual assessments of the country's macroeconomic situation (including fiscal sustainability); (iv) an IMF tax assessment report; (v) a Public Finance Think Piece (produced by the World Bank in 2016, during preparation of the second operation), and (vi) hands-on technical assistance in drafting the tax incentive measures supported by the DPC.[9] The Public Finance Think Piece highlighted (i) the macroeconomic instability resulting from the massive scale of the planned hydropower projects, which generated large fluctuations in aggregate demand and appreciation pressures on the real exchange rate, resulting in inflation for nontradable goods and services and real estate booms; (ii) the limited self-reliance and low tax collection versus the anticipated rise in public expenditures to expand the coverage and quality of social services; and (iii) the limited availability of private sector jobs, because Bhutan's public sector already accounts for a substantial fraction of total employment and further expansion of public sector would increasingly crowd out private sector employment and shrink the country's tax base. The recommendations included adopting a medium-term balanced budget rule among other tools for fiscal management.

2.8 Although the selection of prior actions within the access to finance and investment climate pillars depended on analytics with a narrow scope (as will be discussed in paragraphs 2.12 and 2.13), some of the prior actions of the second operation were supported by analytical underpinnings that went into greater depth. These included an information and communication technology assessment of the land registration system and specifications of functional requirements for the system; developing functional specifications for a one-stop shop for business registration; and technical assistance on drafting a PPP policy and its associated rules and regulations.

2.9 Design of the DPC program was coordinated with and informed by support from other development partners, including the IMF and the Asian Development Bank (ADB). The IMF provided technical assistance on macrofiscal issues, the budget, public financial management, and domestic revenue mobilization. The World Bank team worked jointly with the IMF on tax reform supported by the DPC. The ADB supported implementation of the DPC prior action on the CIB by funding the CIB's interoperability system.

2.10 The prior actions in the investment climate pillar addressed one of the country's major development constraints—restrictions on FDI entry. Other prior actions addressed useful, but not critical, areas. Major development constraints included the following:

1. Regulatory barriers to FDI were critical constraints that were limiting opportunities for private sector–led job creation (World Bank 2020c). These included minimum investment levels by sector, minimum ownership share by a foreign investor, and a difficult authorization process for repatriation of profits in foreign currency. Visa and travel restrictions and the absence of a focal point in government also increased the complexity of foreign investment entry. The DPC supported actions to address this constraint, including reducing threshold limits for FDI; relaxing constraints on repatriation of profits; permitting borrowing from domestic financial institutions; relaxing regulations on the employment of foreigners; and amending the Companies Act to strengthen the protection of minority shareholders, which was not adequately addressed in the existing legal framework (2000 Companies Act).

2. Bhutan's businesses were hindered by the nascent country institutions mandated to regulate business activity, which resulted in a lack of transparency and predictability in the business environment (World Bank 2020c). The DPC contained relevant prior actions to address these aspects, including (i) adoption by Parliament of an Enterprise Registration Bill that eliminated the need for an operating license and replaced it with a single unique business identification number, and established the legal framework for a one-stop shop for registration of new businesses, including online registration; (ii) the approval of a Licensing Policy to improve access to information on requirements for business licenses and permits both in print and online by creating an e-licensing portal; (iii) establishment of an online property and land registration system in Thimphu; and (iv) introduction of an electronic tax filing and payment system.

What Didn't Work

2.11 Although the DPC-supported measures to raise tax revenues and broaden the tax base were successful, fiscal incentives remain costly and are ineffectively targeted. According to interviews with other development partners, many sectors do not require incentives, but incentives are still provided; at the same time, incentives provided at the level of individual firms tend to be too small to make a substantial impact.

2.12 The DPC series was not informed by a broad diagnostic of constraints to private sector development in Bhutan. The design of the access to finance and investment climate pillars depended on analytics with a narrow scope—predominantly, the *Doing Business* Reform Memorandum (DBRM; World Bank 2013; World Bank 2015). The design of these pillars in the first operation, which included triggers for the second, depended almost exclusively on the DBRM. The DBRM identified constraints to improving the investment climate (including access to finance) based on the *Doing Business* indicators. This thus limited the ability of the DPC series to address critical constraints to access to finance and the investment climate that fall outside of the scope of the *Doing Business* indicators. A 2010 Investment Climate Assessment presented a broader assessment of the business-enabling environment in Bhutan (World Bank 2010b); however, (i) it was not used as an analytical underpinning for the design of the first operation and the indicative triggers for the second; and (ii) although it was cited generally as an analytical underpinning in the second operation, it did not have a direct impact on any of the prior actions (World Bank 2016b, 19, table 4); and (iii) it was still somewhat limited in scope because it is based on the Enterprise Survey's established methodology. The second operation also cited other analytical underpinnings (semiannual Bhutan Economic Updates, the poverty assessment, and financial sector stocktaking), but they likewise had no impact on the prior actions.[10] The prior action to approve the FSDAP did have a broader analytical base, including World Bank support for developing a Bhutan Financial Sector Strategy and the FSDAP.

2.13 DPC prior actions omitted key constraints to private sector development, including with respect to access to finance and the investment climate. The World Bank Group focused on the areas with which it is most familiar—credit registries, credit information bureaus, introducing laws for the use of collateral and for an insolvency framework, protection of minority shareholders, and online registries. The analytical underpinnings of the series' design depended almost exclusively on the *Doing Business* indicators. At the same time, deep structural constraints on the demand and supply of finance and the business-enabling environment were left unaddressed. These are the state's role in the economy, access to finance, enterprise capacity, restrictions on FDI entry, and the lack of transparency and predictability of the business environment.

2.14 On demand for finance, Bhutanese firms had limited capacity to prepare bankable projects. The Enterprise Survey for Bhutan in 2015 noted that only 35.8 percent of firms in Bhutan had their annual financial statements reviewed and certified by external auditors (compared with 46.3 percent on average across South Asia; IFC 2015). The 2014–15 *Global Competitiveness Report* scored Bhutan an average of 3.5, and no greater than a 3.8 out of 7 on the nine measures of business sophistication (Schwab 2014). On all but three indicators, Bhutan ranks 110th in the world or worse (out of 144 economies). This points to a lack of capacity among private firms at the time the DPC series was designed.[11] Table 2.1 presents regional comparators.

Table 2.1. Bhutan and Comparator Scores on Measures of Firm Capacity

	Firms with Annual Financial Statement Reviewed by External Auditors (%)	Business Sophistication Average Score	Business Sophistication Score Range (lowest to highest)
Bhutan	35.8 (2015)	3.6	3.1–3.8
South Asia average	46.3	3.8	3.2–4.4
Bangladesh	37.2 (2013)	3.5	2.1–4.7
India	69.9 (2014)	4.2	3.9–4.6
Nepal	70.7 (2013)	3.3	2.9–4.2
Pakistan	37.5 (2013)	3.9	3.2–4.7
Sri Lanka	60.3 (2011)	4.4	3.7–5.3

Sources: First column: International Finance Corporation Enterprise Surveys for the indicated years; Second and third columns: Schwab 2014.

2.15 On the supply of finance, several major structural constraints to expanding access to finance were unaddressed by the DPCs. The procedures for a business acquiring a loan in Bhutan are complex, collateral requirements are high, and the value of the loan is determined by the value of the immovable asset offered as collateral security. Banks cannot seize collateral in a timely manner, and the foreclosure process can take years because of an "inefficient judicial system that favors the borrowers at the expense of creditors" and the inability to publish lists of delinquent borrowers (Ura 2015, 16). The public sector controls 90 percent of financial sector assets and directs lending to priority sectors. This limits competition, the supply of financial products and services, and financial innovation (World Bank 2020c). Also, the policy or regulatory guidelines for financial institutions and banks to finance important sectors that are important for Bhutan's development and for meeting its Sustainable Development Goals, including those related to climate change, are minimal. For instance, the highest share of credit by a wide margin goes first to construction and then to tourism, again driven by civil construction projects. Furthermore, there is no formal system of microfinance in Bhutan, although some informal intermediaries provide limited financial services. Informal intermediaries can be broadly categorized as moneylenders and "family and friends."

2.16 The DPC series omitted several major development constraints related to private sector investment, most notably the crowding out of private sector activity by SOEs. The large presence of SOEs in the economy crowds out private sector activity (see paragraph 1.8). Although SOE reform is politically sensitive, curtailing SOEs' activities in competitive markets is critical for increasing private sector investment, which is part of the project development objective of this DPC series.

2.17 Labor regulations also pose a significant challenge to firms in Bhutan. All sizes of enterprises in Bhutan—large firms most of all—perceive labor regulations to be one of the three biggest obstacles to operations. According to the Bhutan Enterprise Survey 2015 (IFC 2015), close to 20 percent of all firms cited labor regulations as the main obstacle to their operations—making labor regulations the second-most pressing obstacle to firms' operations after access to finance. A 2016 World Bank report on Bhutan's labor market highlights obstacles from restrictive or opaque regulations on hiring non-Bhutanese workers and some social protection programs that are biased toward the public sector, formal employment, and urban areas (World Bank 2016c).

2.18 Firms have limited connections with markets, skills, and technology, which limits their ability to invest and grow. According to the 2020 SCD, "a comprehensive suite of services beyond regulatory reforms is needed to support the growth of MSMEs and also improve labor market outcomes for women, who are more likely to be self-employed. Small enterprises often lack support in such areas as training on basic skills to help them grow or use new technologies, formulate business plans, cultivating market links, and applying good business practices" (World Bank 2020c, 29).

2.19 Last, the regulatory framework to enable a competitive private sector to emerge and grow is nascent, and this creates a lack of transparency and predictability in the business environment (World Bank 2020c). The country has taken a gradual approach to enabling private sector growth, and it does not have a fully developed institutional framework for supporting growth. Some requirements are restrictive; for instance, officials from the Office of the Registrar of Companies are expected to conduct on-site inspections to review and monitor the status of each company and its compliance with the Companies Act, such as whether it conducted board meetings, held shareholder meetings, had a designated CEO, occupied the registered office, and submitted its annual returns to the government. There are few opportunities for policy dialogue between the government and the private sector (World Bank 2020c). The SCD states that "private sector development has been a priority for more than a decade, as expressed in past Five-Year Plans and Economic Development Plans, but these initiatives have not been effective" (World Bank 2020c, 30). Neither the DPC nor its analytical foundations explore what additional improvements in the institutional framework—beyond the *Doing Business* indicators—would be needed to better enable private sector growth.

2.20 One reason the DPC series omitted such constraints was that a diagnostic and prioritization of the many investment climate constraints was missing. The Bank Group had no overarching diagnostic in place at the time the DPC was designed to identify and prioritize the constraints in such an environment and to focus the DPC series on the policy areas that were most critical for private sector–led job creation. Although the analytical underpinnings of the DPC series included a DBRM and an investment climate assessment (World Bank 2010b, 2013), the scope of these assessments was limited primarily to aspects covered in the *Doing Business* report,[12] which assesses only limited aspects of the business environment.

2.21 There was a mismatch between the increase in FDI targeted by the DPC series and the government's preferences. Although the DPC addressed some constraints to FDI and relaxed the regulations on the employment of foreigners, the DPC did not address the overarching issue. Restrictions exist with respect to requiring a local partner, types of contractual arrangements foreign partners may enter into (for example, marketing or franchising collaboration), a minimum period between the start of commercial operations and a foreigner being permitted to divest the equity and repatriate the received amount, restrictions on the import of raw materials or purchase of capital equipment, and so on.

2.22 The DPC series supported prior actions related to the development of PPPs; however, it is not clear that this was a priority for the country, and key aspects that would make PPPs effective were overlooked. The DPC was limited to adopting a policy and preparing a pipeline but omitted a full range of necessary aspects to successfully implement PPPs. The lack of capacity and understanding on PPPs within government agencies meant that the proposal for the adoption of PPPs was superficial. Insufficient attention was paid to solving potential implementation problems arising from the lack of strong supporting institutions, including independent regulators and capacity in the legal and judicial sector. The 11th Five-Year Plan (2013–18) referred to the possibility of PPPs in specific areas (industrial parks; roads; affordable housing; and meeting, incentive, conference, and exhibition facilities). However, the plan did not state that PPPs would be among the government's policy priorities, and these mentions of PPPs were minor within the broad scope of the 293-page plan. A major challenge in Bhutan is inadequate implementation capacity to carry forward policies, acts, and laws. The Bank Group was aware of this deficiency; it was mentioned in both the Program Documents of the DPC series and in the Country Partnership Strategy (World Bank 2014, 2015, 2016b). The design of the DPC did not include complementary support to address these issues.

2.23 Overall, the prior actions required actions by multiple ministries and agencies, and the mechanisms for mitigating capacity and coordination constraints were insufficient. The series comprised 17 prior actions across three pillars, a substantial challenge for a small country with limited capacity. Program Documents noted that the government had limited capacity, rating the risk of institutional capacity for implementation and sustainability as substantial and observing that "limited technical capacity, a complex organizational structure, and weak interagency coordination pose risks to the achievement of the [program's development objective].… The [government of Bhutan] does not have extensive experience collaborating across boundaries" (World Bank 2016b, 25). The Ministry of Finance takes on the responsibility of coordinating with other ministries, but the coordination process is cumbersome. The mitigation mechanisms included (i) reliance on advisory services and analytics (ASA) tasks in various areas supported by the prior actions; (ii) close supervision of the operation; and (iii) the online system for businesses to provide feedback to government on property and business registration was expected to "create an enabling environment to monitor and enhance the implementation of reforms" (World Bank 2016b, 25). These were insufficient. Regarding (i), the Program Document of the first operation did not specify the ASA tasks expected to contribute to the mitigation mechanism; it referred only to "leverag[ing] technical assistance resources" (World Bank 2015, 27). The Program Document of the second operation identified ASA tasks (World Bank 2016b); however, not all prior actions had such support, and given the lengthy processes needed to implement reforms (including legislative processes), some ASA tasks ended before the reforms were implemented. There was no ASA or other support to assist the government in coordination or follow-up on the DPC-supported program as a whole from the World Bank or another development partner. Regarding (ii), "close supervision" is not defined, and there was no Implementation Status and Results Report or other evidence of implementation support in addition to the ASA tasks. Regarding (iii), the scope of the online system cannot be expected to monitor the reform program as a whole.

2.24 The risk that Parliament would not pass reforms because of their complexity was underestimated. Regarding action by Parliament, the ex ante risk assessment in the first operation identified the risk of elections reducing the government's ownership of fiscal reforms, and the risk assessment in the second operation referred to potential delays in approval by Parliament given lengthy procedures. The mitigation measure for the former was to approve the operation well before elections. There was no mitigation mechanism for the latter. In reality, reforms were not passed by Parliament partly because of the complexity of interactions among several pieces of legislation.

2.25 The results framework and its monitoring were weak, particularly related to pillars 2 and 3. Indicators used to measure development outcomes of access to finance and investment climate reforms had low to moderate relevance to the prior actions supported by the operations, and one had a measurement issue. Furthermore, the results framework was overly reliant on *Doing Business* indicators, which are inadequate guides to the prioritization of reforms and may have distracted from other critical issues in the investment climate. Specific shortcomings include the following:

1. On access to finance:

    a. Expansion of the use of the CIB and the share of the population with a bank account measured only individuals, although the intent of the associated reforms was to expand access to finance for enterprises.

    b. The number of MSME loans in the collateral registry was measured only by the number of total loans through 2018; before then, the collateral registry did not differentiate by size of enterprise. Thus, the number reported in the project's Implementation Completion and Results Report was incorrect and there were no data to measure progress on this indicator.

    c. The only results indicator of the access to finance pillar that appropriately measured the outcomes of the reforms supported was the strength of legal rights index of Doing Business. As discussed below (in paragraphs 2.34–2.36, the associated reforms were not implemented.

2. On the investment climate:

    a. Although FDI inflows are one indicator for the reform agenda supported by the DPC, they reflect global economic activity beyond the control of policy makers, and reforms likely require time for the government to build credibility. They should have been complemented by other evidence more closely linked to the prior actions supported by the DPC.

    b. The results framework did not contain any indicators to measure the outcomes of increased protection of minority shareholders, although these do exist in the *Doing Business* index.

    c. The results indicator introduction of online tax filing and payment was the number of payments per year. However, the reform did not target the number of payments; it only introduced an electronic process of filing and paying taxes, the impact of which is more appropriately measured by the time it takes to pay taxes.

Implementation and Supervision

Objective 1: Fiscal Discipline

What Worked

2.26 The DPC series helped Bhutan improve fiscal discipline by establishing limits on government debt and plausibly contributing to an increase in tax revenues. The 2018 IMF Staff Report on the Article IV Consultation for Bhutan (latest available) noted that welcome progress had been made over the previous two years on structural reforms, including on the mobilization of domestic revenues (IMF 2018). It noted that at its highest level, the present value of non-hydropower debt to GDP is projected to be 21 percent of GDP, well below Bhutan's threshold for a high-risk rating (40 percent of GDP).

2.27 To improve fiscal sustainability, the DPC series supported the introduction of a public debt policy that limited government debt. The reforms supported by the series helped better monitor government expenditure. The target of the series was to reduce public non-hydropower debt from 27 percent of GDP in fiscal year (FY)14/15 to 25 percent or less in FY17/18. The ratio of non-hydropower debt to GDP fell to 23.5 percent by 2017/18 (Bhutan 2020c, 47). However, in recent years, non-hydropower debt to GDP has increased because of slowdowns in hydropower and tourism before the pandemic and a 10 percent decline in GDP in 2020. As of June 30, 2020 (FY19/20), non-hydropower debt was 30.3 percent of GDP (Bhutan 2020c, 47), and as of June 30, 2021, it was projected to have increased further to 31.6 percent of GDP (Bhutan 2021b).[13] This remains within the 35 percent threshold prescribed by the public debt policy but is higher than the target of 25 percent set in the DPC series.

2.28 The program plausibly contributed to an increase in tax revenues. The program's expected result was to increase tax revenues from a baseline of Nu 18.4 billion in FY14–15 to Nu 23.2 billion in FY17–18. In fact, tax revenue reached Nu 27.1 billion in FY17–18 and Nu 26.5 billion in FY18–19, exceeding the program's target. However, because of reduced revenue due to delays in hydropower projects (IMF 2018), followed by the COVID-19 pandemic, this result could not be sustained into the next year, when the tax revenues for FY19–20 fell to Nu 22.8 billion (Bhutan 2020a). Tax revenue dropped even further to Nu 20.6 billion in FY20–21 (in the context of a 10.1 percent contraction in GDP in 2020; Bhutan 2021a).

2.29 However, weaknesses in the structure of tax incentives remain and it is difficult to attribute the increase in tax revenues solely to the revisions on tax incentives that was supported by the DPC. Fiscal incentives remain costly and are poorly targeted (see paragraph 2.11). Tax holidays and tax exemptions have generated significant tax expenditures equivalent to 2.6 percent of GDP annually between FY14/15 and FY18/19 (World Bank 2020c).

2.30 Prior actions in the financial stability pillar contributed to results in access to finance. The elimination of restrictions on credit plausibly contributed to increasing the private sector's access to finance. Growth in credit to the private sector, which had accelerated from 2000 through 2011, stagnated in 2012–14. With the change in policy, credit to the private sector increased through 2020.[14] Likewise, the implementation of the FSDAP contributed to fiscal stability by enhancing the stability of the financial sector through policies that would help avoid another episode of rupee shortage in the financial system (see discussion under Objective 2: Access to Finance).

2.31 The success of fiscal sustainability reforms was due to the government's commitment to addressing underlying issues. Within this supportive policy environment, the success of the fiscal sustainability reforms can also be attributed to the significant World Bank technical advisory work provided to the government of Bhutan, which recommended a more flexible adjustment process in response to the need to smooth consumption (linked to demand for Indian rupees) that was brought on by the rupee crisis. According to interviews and the team's analysis, the collaboration with the IMF on the dialogue with the government and on the design of specific reforms, particularly on tax expenditures (incentives) and debt policy, were also key to success.

Objective 2: Access to Finance

What Worked

2.32 Important aspects of the FSDAP were implemented, and include the following:

1. Steps to maintain financial sector stability, whereby the RMA has strengthened prudential regulations and stress-testing exercises and adjusted risk weights and capital requirements

2. The introduction of limits to consumption credit and incentives for lending to the productive sector

3. The change in the regulations for the banking accounts for citizens, the cottage industry, and for small and medium enterprises to conduct foreign currency transactions for imports and exports, within limits, designating the Indian rupee as a foreign currency and specifying that all payments and transfers within Bhutan are to be made in ngultrum

4. Development of the financial sector deepening strategy

5. Replacement of the base rate mechanism with a minimum lending rate system[15]

6. Amendments by the Royal Stock Exchange of Bhutan Limited of its listing rules to promote market transparency and improve corporate governance standards

7. Launch by the Royal Securities Exchange of Bhutan of a separate market board allowing small and medium enterprises and start-ups to raise long-term capital from the market

2.33 Demand from the government and the quality of the World Bank's support were key success factors for the FSDAP. As the rupee crisis unfolded, the World Bank prepared a crisis response paper and shared it with the government in April 2014. The report contains a good explanation of the drivers of the crisis and gaps in the financial sector. Based on the report, the government of Bhutan, including the Ministry of Finance and the RMA, wanted the World Bank to support a wider reform. With grant assistance from the Financial Sector Reform and Strengthening Initiative, the World Bank worked with the Ministry of Finance and RMA to prepare the FSDAP. The World Bank team also supported wide consultations on the FSDAP, which contributed to smooth implementation of the FSDAP reform agenda. The consultations included supporting the formation and work of FSDAP Implementation Committees to address seven key themes in the strategy and action plan. Technical assistance from the World Bank provided after the DPC series supported its implementation (Implementation of Financial Sector Development Action Plan [P161711], FY17–18). This enabled close and continued engagement with RMA after the action plan was finalized, including with its senior management, and assistance to develop some of the regulatory mechanisms in the action plan in more detail. Deliverables of this technical assistance included a policy paper on regulatory aspects of pensions and insurance, a policy paper and strategy to enhance national payment systems, draft regulations for financial institutions and non–deposit taking microfinance institutions or nongovernmental organizations, and a brief on support to cottage and small industry.

What Didn't Work

2.34 The MIPA and the Insolvency Bill were two critical components of improving enterprise access to finance but have not been approved by Parliament as of late 2021. The Bank Group expected that the combination of an improved legal framework for using movable assets as collateral (through the MIPA), a CRST, the introduction of a legal framework for resolving insolvency and for banks to seize pledged collateral (through the Insolvency Bill), and broader coverage in the CIB would overcome constraints in the financial system that had a near-exclusive reliance on property as collateral. This was intended to reduce the risk to banks of lending to MSMEs (and any enterprise that did not have enough property to support the requested loan size), and thereby unlock a critical constraint to such enterprises accessing finance. For the CRST to function according to international good practices requires amendments to MIPA and the new Insolvency Bill, which are not yet in place. MIPA and the Insolvency Bill were approved by Cabinet in September 2016 and are expected to be submitted to Parliament in 2022, but there is no confirmation on the date.

2.35 There are several reasons for the delay in parliamentary submission and approval of these key pieces of legislation. World Bank staff reported that Parliament has a concern about MIPA and the Insolvency Bill: the separate pieces of legislation affect the same group, including small businesses, but the interrelationships between the proposed laws and between them and the Companies Law, which regulates similar matters, are unclear. Ministries and Parliament are therefore reluctant to support the reforms. The Bank Group's advisory work was narrowly focused on the content of the two laws and did not take into account the interrelationships with other laws such as the Companies Law. This indicates a need for better legal capacity and a broader perspective in reviewing the implications of the different pieces of legislation. The delays indicate that the amendments and the new bill were more complicated than the DPC had expected in 2015.

2.36 Further, to resolve insolvency and use movable assets as collateral also requires capacity within the judiciary to resolve commercial disputes. Although the DPC series was accompanied by technical assistance from the Bank Group, this was intended to help the government draft laws rather than to train the judiciary on how to implement them. Assistance was not provided to support the legal capacity of the government indicated by the limited progress on the MIPA and the Insolvency Bill, among others.

2.37 The DPC series supported steps toward improving financial sector infrastructure, but they have not yet had an impact.

- The CRST was upgraded from a registry primarily focused on recording new collateral, mainly land, to a system that provides data on movable and immovable goods to all financial institutions. The improvements in the CRST enable lenders to see if an asset proposed to be used as collateral is unencumbered or has a lien. However, there is no evidence that the number of loans to MSMEs in the collateral registry has increased. As of December 31, 2014, there were 348 loans in the collateral registry, and they could not be disaggregated by size of borrower (World Bank 2019). As of October 29, 2020, there were 335 loans in the CRST, and they were aggregated by size. Of these, 125 were to MSMEs: 32 loans to cottage and small industries (microenterprises), 53 loans to small enterprises, and 67 loans to medium enterprises (data provided by CRST). Thus, the CRST is being used, but there is no evidence that it is helping to increase access to finance.[16] The number of loans in the registry in 2020 is slightly lower than in 2014, and its use by size of enterprise cannot be compared.

- The information in the CIB was expanded to include payments to the television company (Bhutan Info Comm) and Media Authority, to the electricity companies (Bhutan Power Company and Bhutan Electricity Authority), and to the two mobile telephone companies. Before the reform, the CIB only contained information from commercial banks, the pension fund, and insurance companies. Thus, the reform enabled inclusion in the CIB of entities that were not already participating in the formal financial system. However, the information from the utility and the telephone companies is still not fully integrated with the banking system. Although the CIB is an important initiative, it is not at a stage where it can be used by banks and financial institutions to extend credit. It has very limited capacity because of scarcity of human resources (which was not identified as a risk during Bank Group support) and little or no integration with financial sector information systems. Further, the impact of this expansion in information on the private sector's access to finance is unclear. The CIB coverage of individuals increased from 15.9 percent of adults in 2014 to 35.9 percent of adults in 2018, exceeding the target of 30 percent, and further to 37.8 percent by September 30, 2020. The CIB also started covering firms, and by September 30, 2020, reported coverage of 3,842 firms (data provided by CIB). World Bank staff indicated that the increase in coverage of individuals is important for private sector development because most cottage and small industry (micro) firms are sole proprietorships or informal enterprises that access finance through their founder as an individual. However, there are no data available to confirm this hypothesis or link expansion of individuals in the CIB with any expansion in enterprise access to finance. There are also no data to link the inclusion of firms in the CIB with any outcomes on their borrowing.

2.38 The SCD further supports the finding that progress on financial sector infrastructure and addressing collateral constraints has been minimal. The SCD states "a rudimentary Financial Intelligence Unit, credit bureau, central registry, and stock exchange have been established but are not far along, and there is little use of movable collateral and credit information. On average collateral must cover 179 percent of the loan amount, and the prevailing practice is to accept only fixed assets" (World Bank 2020c, 27).

2.39 In addition, the establishment of a minimum lending rate (MLR) to replace the base rate lending system was only partially implemented, and weaknesses in the pricing of credit remain.[17] In August 2016, the RMA began to apply an MLR, a minimum reference rate for lending to be uniformly applied across all the financial institutions. The announcement of the MLR stated that "on the common MLR, each financial institution will competitively add its expected spread to arrive at the final lending rates. The main objective of the MLR is to encourage competition and professionalism among the financial institutions to result in a balanced approach of engaging in financial intermediation" (Royal Monetary Authority 2016). However, in practice, this has not led to substantial improvements. As of 2017, the IMF had begun working with the government on adjusting the framework for lending rates, advising on a Liquidity Forecasting and Management Framework that includes, among other things, a framework for guiding the lending rates of commercial banks (IMF 2019). The World Bank's 2020 SCD refers to the "controlled interest rate regime, restricting competition, the supply of financial products and services, and financial innovation" (World Bank 2020c, 26), and the IMF's 2022 Article IV Consultation report does not mention any progress in this area. Therefore, there is no evidence that the interest rate regime has been substantially improved.

2.40 Although the need for advisory work and implementation support was high in Bhutan, funding for it was scarce. Except for ADB, development partners provided little support to fund technical assistance because of Bhutan's limited engagement with the world. The limited funding available from the Bank Group for advisory work was spread over several priority areas. Moreover, the government has shown little interest in investment project financing, which is an important tool for providing implementation support in more depth and over a longer period than is possible in a DPC series.

2.41 The results under the access to finance pillar show progress on three out of four indicators in the DPC series results framework, but fall short of showing that access to finance for enterprises—the aim of the series—improved. Individuals have more access to bank accounts, the CIB has more credit information about individuals and firms, and the collateral registry is keeping better records on assets offered as security. The level of the strength of legal rights index under *Doing Business*'s Getting Credit indicator did not change, and the target was missed. Although macrolevel data show an increase in credit to the private sector,[18] this does not necessarily represent enterprises accessing finance for the first time, which was the aim of the DPC series. The causal chain from the DPC-supported prior actions to these results is weak. Neither the CRST nor the CIB has had a significant impact, and the MIPA and Insolvency Bill have not been passed. Therefore, there is no basis on which to say that the DPC series contributed to the observed rise in credit to the private sector observed at the macro level.

Objective 3: Investment Climate

What Worked

2.42 The electronic tax filing and payment system was implemented smoothly. The DPC supported the issuance of a notification (legal document) that allows taxes to be filed and paid electronically. The government implemented a custom module in its Revenue Administration and Management Information System to enable the filing of tax returns of personal income tax, business income tax, and corporate income tax at commercial banks or by using an online payment system. Implementation of this system was supported by the ADB; thus, there was complementarity between the World Bank and the ADB in supporting this reform (ADB 2018). The system was being used by 64 percent of taxpayers as of the DPC series Implementation Completion and Results Report (World Bank 2019). The change means that taxes no longer must be filed and paid in person at one of Bhutan's four urban centers.

2.43 There is evidence that the ability to file and pay taxes electronically reduced the burden of paying taxes. The results indicator associated with this prior action was to reduce the number of tax payments per year by businesses from 18 to 6, as measured by *Doing Business*. As of 2020, the number remained at 18. However, this is an inadequate measure of the outcome of this reform. The amount of time it takes to pay taxes is more closely related to the expected outcome of this reform. That was reduced from 85 hours in *Doing Business* 2016 to 52 hours in *Doing Business* 2019 (a level that was sustained in *Doing Business* 2020). *Doing Business* states that the improvement was driven by the implementation of the online platform for filing tax returns.

2.44 The online property and land registry was implemented well. In 2015, all records in the land registry and in the cadastre were paper based, and the two databases were not connected. It could take up to three months to obtain a property title in the Thimphu Municipality. The procedure was time-consuming and susceptible to errors and corruption. The DPC prior action was for the National Land Commission to certify the establishment of an online property and land registration system in Thimphu. An electronic system of land-related information and matching records was implemented across agencies, enabling better accuracy of land information and limiting potential conflicts.

2.45 The World Bank Improving Bhutan Investment Climate technical assistance provided critical support for the implementation of the prior action on the property and land registry. It assessed the existing information and communication technology systems and detailed the software and hardware changes needed to introduce a fully functioning online system, and through it the World Bank signed a Memorandum of Understanding with the National Land Commission that detailed the respective roles and responsibilities for successfully introducing the electronic platform (World Bank 2017).

2.46 The online property and land registry has been rolled out countrywide, beyond the scope of the prior action. It was first rolled out in Thimphu on October 25, 2016, and then made available countrywide. By January 2019, the system was being used in all 20 districts and 4 municipalities, and by end-2019, it had enabled 1,415 transactions and had 1,940 registered users (latest data available from the registry). From a baseline of 92 days to register property as per *Doing Business* 2014, the number of days to register property fell to 77 as of *Doing Business* 2016 and has remained at that level through 2020.

2.47 The two areas that were implemented well and had an impact did not require legislative changes and were supported by complementary assistance to overcome capacity constraints. The prior action on the electronic tax filing and payments system required a notification from the Ministry of Finance and was supported by the ADB. The prior action on the online property and land registration system required a letter from the National Land Commission and was supported by complementary technical assistance from the World Bank. However, although these reforms alleviated some constraints facing businesses, neither of these addressed major constraints in the investment climate, as discussed in the design section.

What Didn't Work

Foreign Direct Investment

2.48 The DPC series supported the government in lifting or relaxing some of the restrictions on FDI; however, restrictive requirements remain, and there has been no substantial increase in FDI. The prior action supported amendments to the 2014 FDI rules and regulations that lifted some restrictions on the minimum size of investments and the floor of the percentage of equity investments; permitted profits to be repatriated in foreign currency; allowed companies with FDI to borrow from financial institutions in Bhutan; and expanded the eligibility for visas to make it easier for companies with FDI to bring in workers from abroad. Although this series supported the government in its gradual opening to FDI and the actions supported by the DPC were important, there are other policy issues limiting FDI that have not been addressed. Even after implementation of the reforms supported by this DPC series, remaining equity restrictions and minimum investment requirements limited FDI in small-scale production and manufacturing and in the information technology sector; investments in infrastructure facilities required the use of a PPP arrangement; and the approval process for FDI was cumbersome, requiring certification by various ministries and agencies, and visas for investors have been cumbersome (World Bank 2020c).

2.49 The expected impact on FDI inflows was not achieved, and Bhutan's share in net global FDI flows fell. The operation targeted an additional $50 million in net FDI inflows from 2014 to 2017. Actual inflows during that period were $25.3 million, only half of the target. Further, the inflows achieved were only one-third of the net inflows over the previous four years (2010–13, $151.2 million).[19] Although FDI inflows are influenced by factors beyond Bhutan's policy environment, including the global economy, examining Bhutan's share in net global FDI flows can shed light on whether it is becoming relatively more attractive to investors. This share (0.028 percent) was much lower in 2014–17 (the period measured by the results framework) than it was in 2010–13 (0.183 percent). The lower share persisted through 2019. This indicates little progress on making Bhutan more attractive for FDI. In addition, the "business impact of rules on FDI" as measured by the World Economic Forum's *Global Competitiveness Report* deteriorated from 4.4 (out of 7) in 2013–14 to 3.7 in 2017–18 (latest data available),[20] situating Bhutan 121st out of 144 economies on this indicator in 2017–18 (Schwab 2014, 2017). In 2020, Bhutan experienced a net outflow of FDI ($2.8 million).

Legislative Reforms

2.50 Areas of the program that required legislative changes faced problems, pointing to the need for deeper stakeholder dialogue and an overestimation of the capacity of the government to drive the process. Apart from the amendments to the Companies Act for minority shareholder protection, the other bills submitted to Parliament, including the Enterprise Registration Bill (DPC1, prior action 6)[21] and the Licensing Policy (DPC1, prior action 7),[22] were later withdrawn. Parliament was concerned that the interactions of the Company Act, MIPA, the Insolvency Bill, the Enterprise Bill, and the Licensing Policy were not fully clear, and thus these bills have been severely delayed and not passed as of early 2022.

2.51 The reforms supporting business entry were not implemented:

- **Business registration.** Prior action 6 of DPC1 required submission of the Enterprise Registration Bill to Parliament. The bill would make business registration easier by establishing an online single window that enables online business registration. The bill was submitted to but then withdrawn from Parliament over concerns unrelated to online business registration (regarding the capacity of small enterprises to meet requirements of the bill on accounting standards).

- **Business licensing.** Prior action 7 of DPC1 required approval of the Licensing Policy by Cabinet. This reform was intended to increase the transparency and predictability of the process of obtaining a license and make the process easier for enterprises in remote areas, by (i) enabling provision of information about the steps and documents required to set up a business and obtain necessary permits through an online portal and printed information sheets; (ii) establishing the legal framework required to allow online issuance of business licenses. The policy was not approved by Parliament. Parliament was concerned about provisions related to environmental clearance (whether they were too onerous for small businesses), the level of accounting knowledge that small business owners would need to get a business license, and the interactions among the Licensing Policy, MIPA, the Insolvency Bill, amendments to the Companies Act, and the Enterprise Bill, which were not fully clear. Additionally, technical and coordination difficulties hindered the implementation of the online portal.

2.52 Reforms related to protection of minority shareholders and PPPs were implemented, but they did not target major constraints and had little impact.

- Amendments to the Companies Act to strengthen the protections for minority shareholders were expected to enhance a company's ability to raise capital and to contribute to improving the enabling environment for FDI when the foreign investor is a minority partner in a business. The amendments were passed in 2016. The DPC series results framework did not establish any indicators to measure the outcomes of the reforms to improve minority shareholders' rights, and other available evidence is weak. *Doing Business* indicators show a slight deterioration in Bhutan's performance on protecting minority shareholders over time.[23] Further, the DPC-supported reform was expected to improve an aspect of foreign investment entry, but as discussed in paragraph 2.49, FDI levels have been modest.

- Per the DPC prior action, the Cabinet approved the PPP policy on March 1, 2016, through the Ministry of Finance approved PPP rules and regulations in 2016, and assembled a list of five potential PPP infrastructure projects. These projects were expected to provide investment opportunities to the private sector, including foreign investment. The list of PPP projects was presented to the PPP Steering Committee in March 2018, later than the deadline date. Its late delivery prevented the committee from reviewing the pipeline of projects by the end of 2017, as had been expected in the DPC program's results framework. One pilot project, for an integrated bus terminal in Thimphu, was selected and a feasibility study was undertaken, but the project did not progress. Only one PPP project began, supported by the International Finance Corporation: the first PPP concession to design, build, and operate parking facilities in Thimphu City (with a private investor from Nepal). However, the investor abandoned the project and withdrew in 2020.

2.53 Other amendments to the Companies Act passed at the same time appear to be designed to increase transparency and predictability in the business environment by making the regulatory framework clearer through the role of the Office of the Registrar of Companies.[24] The amendments also enabled relevant company data to be migrated to the online land and collateral registry systems, making them fully functional, and adjusted other provisions related to the collateral registry, such as secured transactions and insolvency proceedings, associated with the reforms in those areas supported by this DPC series. However, the DPC prior action related to the Companies Act did not focus on these reforms.

2.54 Despite some progress suggested by the results framework, evidence that the business climate in the country has improved is weak. The DPC series did not overcome the major constraints to private sector development in the country (as discussed in the design section). The program underestimated the challenges of supporting an embryonic private sector in a country where SOEs dominate the economy.

2.55 There was also insufficient attention paid to solving potential implementation problems arising from the lack of capacity in the country—a deficiency the Bank Group knew about beforehand, since it was mentioned in both the Program Documents of the DPC series and in the Country Partnership Strategy (World Bank 2010a, 2015, 2016b). The World Bank is not working on capacity development in the country, primarily because of limited International Development Association resources for the country.

3. Lessons

3.1 Overall, this Project Performance Assessment Report suggests that DPCs in Bhutan should be more selective, be sequenced to address critical constraints, have stronger risk assessment and mitigation, be complemented by support to overcome capacity constraints for implementation and coordination, and be informed by broader diagnostics. The DPC-supported reforms that were implemented successfully had complementary implementation support (from the IMF, ADB, or the Bank Group), and did not require complex legislative reform.

- DPCs should be more selective, focusing on fewer and better-sequenced reforms. Selectivity filters should include reforms that address critical constraints to economic growth and stability, those that have government and parliamentary support, and those for which complementary implementation support—including to address concerns of Parliament—is available.

- DPCs in Bhutan should have more thorough assessments of technical capacity and implementation risks and pay more attention to risk mitigation. Future

DPCs should be accompanied by plans to provide support to implementation. The existence of complementary support was key in each of the policy areas that worked well in this DPC. Capacity constraints limited the implementation of several reforms. The World Bank correctly identified capacity as a risk in Program Documents, but mitigating measures were insufficient and did not cover all aspects that required them, did not extend long enough beyond the time frame of the operation to ensure sustained implementation, or both. A more selective set of reforms (as per the lesson above) can also help focus scarce implementation support resources.

- Greater attention is needed to foster coordination across ministries and agencies. For this purpose, investment project financing with results-based (disbursement-linked) indicators or Programs-for-Results may be more efficacious instruments to support the achievement of objectives. These can more easily incorporate support for knowledge sharing, capacity building, and institutional strengthening over a longer period than can development policy financing. Other development partners can also be encouraged to provide such complementary support, as was the case in this series with the IMF (on fiscal issues) and ADB (on the electronic tax filing and payment system).

- DPCs in Bhutan that aim to address economic growth should be informed by a more rigorous assessment of major constraints to private sector development. The analytics used to inform investment climate prior actions of this DPC series focused on *Doing Business* indicators, which precluded identification and prioritization of major constraints to private sector development. These would have included the state's role in the economy and the incipient nature of the institutions supporting the business environment. The 2020 SCD provided such a broader picture of constraints to private sector growth (World Bank 2020c); however, the assessment of the regulatory environment was limited by its reliance on aspects measured by *Doing Business*.

- Bank Group management should consider what steps are feasible when legislation supported by development policy financing prior actions is not enacted. The programmatic approach in this case was insufficient to guarantee that prior actions requiring submission of bills to Parliament or their approval by Cabinet would lead to adoption and implementation of the DPC-supported legislation. The implications for future DPCs and other engagements with the government should be considered.

3.2 These lessons have particular importance given the role of DPCs in World Bank lending to Bhutan. During the FY15–19 Country Partnership Strategy period, the Fiscal

Sustainability and Investment Climate DPC series represented two out of the World Bank's four new lending operations in Bhutan and 42 percent of total lending by value. The additional two operations were also a DPC series (Strengthening Fiscal Management and Private Sector Employment Opportunities DPC series, approved in FY18 and FY19). The weak results in enterprise access to finance and the investment climate from the Fiscal Sustainability and Investment Climate DPC series reduced the overall effectiveness of the World Bank–supported program in the country. Although it is understood that the authorities did not request other forms of World Bank lending, reliance on the development policy operation instrument alone proved inadequate to make meaningful progress toward development objectives.

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[1] Extreme poverty is measured at $1.90 per day (2011 purchasing power parity), World Development Indicators.

[2] Since 2016, Bhutan's exports to India in US dollar terms have ranged between 77.7 percent and 90.9 percent of total exports, and imports from India have ranged from 77.1 percent and 83.9 percent of total imports (Bhutan 2013, 2016, 2018b, 2020b).

[3] World Development Indicators, Current account balance (percentage of gross domestic product); https://data.worldbank.org/indicator/BN.CAB.XOKA.GD.ZS?locations=BT.

[4] Access to finance (23.8 percent of respondents) and labor regulations (22.6 percent of respondents) are cited as the top business environment obstacles, per the Enterprise Survey undertaken in 2015 (IFC 2015).

[5] Foreign direct investment was permitted only from 2002, in specific sectors, and there were limits on foreign ownership, a minimum investment size and debt-to-equity ratio, and restrictions on the use of foreign labor.

[6] The amendments also broadened the scope of business arrangements and made the Companies Act consistent with related legislation, although these aspects were not among the development policy credit (DPC) prior actions.

[7] Based on a World Bank Macroeconomic and Public Finance Policy Note for the government of Bhutan in November 2015 and other work (Boyreau and Rama 2015).

[8] Due to their bulky nature and discontinuities associated with their commissioning, hydropower projects can generate large macroeconomic fluctuations with disruptive effects.

[9] In its Bhutan Tax Rationalization technical assistance, the World Bank supported revisions to both general incentives (such as sales tax and customs duty exemptions for imports of plant and machinery) and sector-specific incentives (such as tax holidays).

[10] As per the table of analytical underpinnings mapped to the prior actions in the Program Document (World Bank 2016b).

[11] By 2017–18, in the latest *Global Competitiveness Report* featuring Bhutan, its average score on these indicators had improved to 3.8 and its ranking had improved to 77th out of 137 economies on business sophistication (Schwab 2017).

[12] The scope of the task Improving Bhutan Investment Climate (P153221) was broader, but the work completed in time to inform the DPC series was limited to those areas covered by the *Doing Business* report, as stated in that task's Completion Report (World Bank 2017).

[13] This is similar to the International Monetary Fund's estimate of 33 percent in FY20–21.

[14] World Development Indicators, Domestic Credit to Private Sector (percentage of gross domestic product); https://data.worldbank.org/indicator/FS.AST.PRVT.GD.ZS?locations=BT.

[15] However, see limitations on its implementation, discussed in the What Didn't Work section.

[16] The Implementation Completion and Results Report Review for this DPC noted that the Central Registry for Secured Transactions had played a role in increasing access to finance. However, this was based on assumptions regarding the share of micro, small, and medium enterprises in loans reported in the Central Registry for Secured Transactions because data on the size of borrowers was collected only beginning in 2018.

[17] As of 2017, the International Monetary Fund began working with the government on adjusting the framework for lending rates, advising on a Liquidity Forecasting and Management Framework that includes, among other things, a framework for guiding the lending rates of commercial banks (IMF 2019). However, the World Bank's 2020 Systematic Country Diagnostic refers to the "controlled interest rate regime, restricting competition, the supply of financial products and services, and financial innovation" (World Bank 2020c, 26), and the International Monetary Fund's 2022 Article IV Consultation report does not mention any progress in this area. Therefore, there is no evidence that the interest rate regime has been addressed or improved.

[18] According to the *World Development Indicators*, in 2014, credit to the private sector in Bhutan as a percentage of gross domestic product was 45 percent. By the same measure, credit to the private sector has risen continuously since then, and in 2020, credit to the private sector in Bhutan as a percentage of gross domestic product touched 68.9 percent. However, this does not necessarily represent borrowing by firms that could not previously access financing, which was the aim of the DPC series. This could represent more borrowing by the large incumbent firms. Additional data that could help identify a link to the DPC series include, for instance, individuals in the Credit Information Bureau obtaining loans for business purposes; growth in the number of enterprises accessing finance; growth in loan volumes per enterprise; growth in loan volumes to micro, small, and medium companies; and so on.

[19] World Development Indicators, Foreign direct investment, net inflows (balance of payments, current US$); https://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD?locations=BT

[20] Measured through the World Economic Forum's Executive Opinion Survey: "In your country, how restrictive are rules and regulations on foreign direct investment?" (1 = extremely restrictive; 7 = not restrictive at all).

[21] The prior action required submission to Parliament.

[22] The prior action required only approval by Cabinet, but implementation of the Licensing Policy required parliamentary approval.

[23] Bhutan's score on the strength of minority investor protection index fell from 5.0 (out of 10) in *Doing Business* 2015 to 4.7 (out of 10) in *Doing Business* 2016, without an explanation. In *Doing Business* 2017, the methodology changed, and Bhutan scored 6 (out of 10) on the extent of shareholder rights index. Its performance on this index then deteriorated to 4 (out of 10) in *Doing Business* 2018 and 2019, and 3 (out of 10) in *Doing Business* 2020. The deterioration in 2018 is described as follows: "Bhutan strengthened minority investor protections by clarifying ownership and control structures but weakened minority investor protections by reducing shareholder rights" (*Doing Business*, https://archive.doingbusiness.org/en/reforms/overview/economy/bhutan).

[24] Other amendments to the Companies Act passed at the same time established the Office of the Registrar of Companies (Registrar) as an autonomous authority for the regulation of businesses and clarifying and expanding its functions. The Registrar is now responsible for registration of all businesses; issuing regulations appliable to businesses and capital markets; making provisions for commercial dispute resolution and establishing a dispute resolution body; implementing corporate social responsibility policies; and adopting a Corporate Governance Code, among other roles. (See description of the Registrar's role and its evolution here: https://www.cra.gov.bt/, section "About Us.") It is also responsible for corporate accounting and auditing standards and regulations on mergers and acquisitions.

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Appendix A. Ratings

First and Second Fiscal Sustainability and Investment Climate Development Policy Credits (P147806 and P157469)

Table A.1. ICR, ICR Review, and PPAR Ratings

Indicator	ICR	ICR Review	PPAR
Outcome	Satisfactory	Satisfactory	Moderately unsatisfactory
Bank performance	Satisfactory	Moderately satisfactory	Moderately unsatisfactory

Sources: ICR: World Bank 2019; ICR Review: World Bank 2020b.
Note: The Implementation Completion and Results Report (ICR) is a self-evaluation by the responsible Global Practice. The ICR Review is an intermediate Independent Evaluation Group product that seeks to independently validate the findings of the ICR. PPAR = Project Performance Assessment Report.

The Implementation Completion and Results Report Review (ICRR) recommended that a Project Performance Assessment Report (PPAR) be done to "to examine the contribution of the program to the country's development outcomes, to examine in depth the implementation problems and to evaluate policies in terms of their worth and the likelihood of implementing them" (World Bank 2020b, 13).

The downgrade in the outcome rating versus the ICRR is due to several factors and is discussed in detail in the sections below.

1. The PPAR has enabled this evaluation to analyze more deeply the extent to which the prior actions supported private sector development by addressing the critical constraints in this area.

2. The PPAR is using the new methodology for rating development policy financing, which includes a deeper examination of the relevance of prior actions (see appendix E).

3. This PPAR has uncovered several errors and weaknesses in the results framework that were not identified at the ICRR stage. These include the following:

    a. Low relevance of some of the results indicators to the results chain of the prior actions (particularly when measuring enterprise access to finance)

    b. An error in reporting credit of micro, small, and medium enterprises in the collateral registry (see discussion in paragraph 2.25 in the main text)

    c. A major discrepancy between the foreign direct investment (FDI) numbers used in the Implementation Completion and Results Report and ICRR (the source of which is unknown) and the data available in the World Development Indicators database.

The downgrade in the Bank performance rating is due to this PPAR's more thorough assessment of design, the extent to which the mitigation measures were implemented sufficiently to overcome capacity constraints, and the revealed level of government ownership of the reform agenda.

1. Relevance of the Objectives

Relevance of the Objectives

The program's objectives had strong relevance to the country's challenges. The program development objectives were to promote fiscal discipline, improve access to finance for enterprises,[1] and improve the climate for business entry and investment in Bhutan. These reflected priority issues as Bhutan dealt with the weaknesses that had been exposed by the Indian rupee crisis and the limits of its state-led economic model to provide economic growth and jobs for the growing number of educated youth in the country. They were consistent with government strategies (11th Five-Year Plan 2013–18, Economic Development Policy of 2010 and 2016) and the World Bank Group fiscal years (FY)15–19 Country Partnership Strategy, and scoped appropriately. The causal chain underlying the series was that the diversification of the economy away from hydropower-led growth and its potential for creating jobs would be enhanced by supporting the private sector. This would require providing a stable macroeconomic environment, providing access to finance to small firms, improving the business climate, and increasing foreign and domestic investment.

Relevance of Prior Actions

Based on the ratings described in this section, the relevance of prior actions overall is **moderately satisfactory.** Prior actions are listed in table A.2.

The prior actions of pillar 1 on fiscal discipline were relevant to meaningfully contribute to improving fiscal discipline. They can be considered in three categories:

1. **Measures to remove restrictions that were imposed to address the rupee crisis.** This was important to eliminate any economic distortions from these policies after the rupee crisis eased. They included lifting the ban on housing and vehicle loans and the ban on vehicle imports. (prior action 1—relevance: **satisfactory**)

2. **Measures to increase tax revenue and expand the tax base.** Customs duties, sales taxes, and green taxes on selected goods were raised. Tax exemptions that had been found to be ineffective were revised. These reforms were relevant to

increasing government revenues to improve fiscal stability and were developed with the support of the World Bank and International Monetary Fund. (prior actions 1 and 3—relevance of both: **satisfactory**)

3. **Measures to limit public debt.** A debt policy was adopted to ensure that financing decisions were prudent and that public debt was maintained at a sustainable level. This was important for ensuring fiscal stability, particularly given the level and characteristics of hydropower-related debt. (prior action 2—relevance: **satisfactory**)

The prior actions of pillar 2 on improving access to finance for enterprises were relevant as a package of reforms to address the critical issue of collateral constraints (prior actions 4, 5, 6, 7, and 8), and to contribute to the strengthening of the financial sector's regulatory framework (prior action 9). Thus, the relevance of these prior actions themselves is **satisfactory.** However, the pillar omitted addressing other critical constraints to access to finance on the supply and demand side, as discussed in this PPAR. Therefore, the relevance of the set of prior actions within pillar 2 is rated as **moderately satisfactory.**

Only one prior action of pillar 3 on improving the climate for business entry and investment in Bhutan was relevant to a critical constraint: prior action 13 on relaxing restrictions on FDI. Its relevance is **satisfactory**. Other prior actions aimed to make business-related procedures easier or improve access to information, but did not address critical constraints, as discussed in the main text of this PPAR. Thus, the relevance of prior actions 10, 11, 12, 14, 15, and 16 is rated as **moderately satisfactory.** Prior action 17 on public-private partnership (PPP) policy and rules and regulations was not consistent with the government's cautious approach to opening to private sector participation in the economy, and complementary elements to make PPPs work in the country were missing. Therefore, the relevance of prior action 17 is **moderately unsatisfactory.**

Table A.2. Prior Actions

Prior Actions under DPC1 (approved May 2015)	Prior Actions under DPC2 (approved November 2016)
Pillar 1: Strengthening Fiscal Sustainability and Self-Reliance	
Prior action 1: Lift the policy ban of March 2012 on provision of housing and vehicle loans; instead, raise custom duties, sales taxes, and green taxes on selected goods.	Prior action 2: Government to approve a debt policy setting debt limits to improve fiscal sustainability. Prior action 3: Approve rules and regulations on fiscal incentives to broaden the tax base and align it with the Economic Development Policy.
Pillar 2: Increasing Access to Finance	

Prior Actions under DPC1 (approved May 2015)	Prior Actions under DPC2 (approved November 2016)
Prior action 4: Submit a bill to Parliament to amend the Property Act to allow use of movable assets as collateral.	Prior action 7: Submit to Parliament the Insolvency Bill to provide a framework for businesses to resolve insolvency and to strengthen the rights of secured creditors.
Prior action 5: Issue notification to improve access to credit by SMEs using movable assets as collaterals and registering them in the Central Registry for Secured Transactions.	
Prior action 6: Issue the CIB regulations that obliges data providers to provide credit information of utility companies to the CIB.	Prior action 8: (i) issue a directive for utility companies to share credit information with the CIB; and (ii) certify the completion of the upgrades of its system to enable the sharing of credit information from utility companies.
	Prior action 9: Approve the Financial Sector Development Action Plan.
Pillar 3: Improving the Business Climate	
Prior action 10: Submit to Parliament a bill to amend the Companies Act to strengthen the protection of minority shareholders of companies.	Prior action 15: Establish an online property and land registration system in Thimphu.
Prior action 11: Submit to Parliament an Enterprise Registration Bill to regulate the usage of a single business identification number and one-stop shop for enterprise registration.	Prior action 16: Certify the introduction of a single window for online business registration.
Prior action 12: Approve the Licensing Policy for creating a level playing field for companies.	
Prior action 13: Lower the threshold values in the foreign direct investment (FDI) Rules and Regulations for foreign institutional investors and for repatriation of profits.	Prior action 17: Approve a PPP policy and the PPP rules and regulations.
Prior action 14: Enhance the tax module of the government's revenue administration management information system by allowing electronic tax filing and payments.	

Source: Independent Evaluation Group.
Note: CIB = Credit Information Bureau; DPC = development policy credit; PPP = public-private partnership; SMEs = small and medium enterprises.

Relevance of Results Indicators

The relevance of the results indicators is assessed in table A.3 and discussed in the following subsection, on efficacy.

Table A.3. Results Indicator Relevance and Achievement

Results Indicators	Associated Prior Actions	Baseline and Target	Actual	Relevance of Results Indicator	Achievement of Results Indicator	Comment
Pillar 1: Strengthening Fiscal Sustainability and Self-reliance						
RI 1: Non-hydropower debt (% of GDP)	1 and 2	Baseline (FY14/15): 27 Target (FY17/18): 25 or less	FY17/18: 23.5 June 2021: 31.6	Satisfactory	2018: High 2021: Substantial	Relevance: Indicator directly reflects application of the Debt Policy supported by the DPC. Achievement: The indicator target was reached by the target date, and 2021 performance remains below the limit established in the policy. The denominator decreased sharply in the 2020 recession induced by the COVID-19 pandemic (GDP contracted by 10.1 percent).
RI 2: Increase in tax revenue (Nu, billions)	3	Baseline (FY14/15): 18.4 Target (FY17/18): 23.2	FY17/18: 27.1 FY20/2121: 20.6	Moderately satisfactory	2018: High 2021: Substantial	Relevance: The indicator measures a broader measure of tax revenue than the customs duties and tax exemptions targeted by the prior action; however, it may be difficult to isolate for these. Achievement: The target was substantially exceeded by the target date. Revenue declined from that level in 2020 and 2021, likely as a result of the COVID-19 pandemic, and still remains above the baseline.
Pillar 2: Increasing Access to Finance						

Results Indicators	Associated Prior Actions	Baseline and Target	Actual	Relevance of Results Indicator	Achievement of Results Indicator	Comment
RI 3: Share of MSME credit in Collateral Registry (number of MSME loans in the Collateral Registry)	4, 5, 7	Baseline (2014): 348 Target (2017): increase loans registered by at least 40 percent, or 488 loans	2018: No data Oct. 2020: 125	Satisfactory	Not verified (equivalent to negligible)	Relevance: The indicator is a credible measure of the amendments to the Movable and Immovable Property Act and strengthening of the Central Registry for Secured Transactions. It is less directly related to the Insolvency Bill, but there is some connection with the results chain of this reform because a better framework for insolvency can be expected to decrease banks' perceived risks of lending and increase lending. Achievement: The baseline does not measure MSME loans; rather, it measures total loans. Therefore, progress cannot be verified.
RI 4: Strength of Legal Rights Index under Getting Credit in the *Doing Business* report	4, 5, 7	Baseline (2016): 4/12 Target (2018): 6/12	2018: 4/12 2020: 4/12	Satisfactory	Negligible	Relevance: Strength of legal rights is a better measure of outcomes from the Insolvency Bill than RI 3 is. Achievement: The reform was not implemented, so no progress was made.
RI 5: CIB coverage of individuals and firms (% of the adult population)	6, 8	Baseline (2014): Total: 15.9 Male: 9.6 Female: 6.3 Target (2017): Total: 30 Male: 19.5 Female: 10.5	2018: 35.9 Male: 22.7 Female: 17.8 2020: 37.8	Unsatisfactory	High	Relevance: CIB coverage of individuals is not relevant to the project development objective of increased access to finance for enterprises in the absence of evidence indicating that such individuals are business owners (entrepreneurs, sole proprietors, or others). Relevance: The target was achieved and sustained. Note there is an issue with the gender disaggregation of the indicator, as the denominator used is total population and not the population of that gender.

Results Indicators	Associated Prior Actions	Baseline and Target	Actual	Relevance of Results Indicator	Achievement of Results Indicator	Comment
RI 6: Proportion of the adult population with a bank account, as measured from the Global Findex (% of ages 15 and over)	9	Baseline (2014): Total: 34 Female: 28 Target (2017): Total: 40 Female: 37	2017 (National Financial Inclusion Strategy data): Total: 64.5 Female: 44 No more recent data available	Unsatisfactory	High	Relevance: (i) The indicator is not a relevant measure of the related aspect of the project development objective, which is access to finance by enterprises. There is no evidence linking an increase in individuals with a bank account to an increase in business owners (entrepreneurs, sole proprietors, or others) with a bank account. (ii) The indicator is only a weak measure of outcomes from the prior action it is linked to, the FSDAP, which focused on nonbank financial institution regulation (not linked to this indicator), SMEs' access to bank financing (not linked to this indicator), and electronic payment systems (somewhat linked to this indicator). Achievement: The targets were achieved, but per a different source. Bhutan did not participate in the Global Findex Survey in 2017.

Results Indicators	Associated Prior Actions	Baseline and Target	Actual	Relevance of Results Indicator	Achievement of Results Indicator	Comment
Pillar 3: Improving the Investment Climate and Increasing Domestic and Foreign Investment						
RI 7: Time to register a property (days)	10, 15	Baseline (2013): 92 Target (2017): 47	2018: 77 2020: 77	Moderately satisfactory	Modest	Relevance: This indicator is not relevant to improving protection of minority shareholders (PA 10). The indicator measuring this aspect was dropped in DPC2. This indicator is relevant to the reform to establish an online property and land registration system (PA 15). Achievement: Only one-third of the expected reduction was achieved despite the reform being implemented.
RI 8: *Doing Business*: Starting a business	11, 12, 16			Satisfactory	Overall: Substantial	Relevance: This is a relevant measure of simplifying procedures for business registration (PA 11) and introducing an online single window for it (PA 16). The indicator's relationship with the Licensing Policy is less direct but still plausible. Achievement: Substantial progress was made on these indicators, although the associated reforms supported by the DPC were not implemented. The government reformed the process of starting a business in other ways (as discussed in the paragraph 2.53 of the main text).
RI 8a: Time (days)		Baseline (2013): 32 Target (2017): 10	2018: 12 2020: 12		Substantial	
RI 8b: Number of procedures		Baseline (2013): 8 Target (2017): 4	2018: 8 2020: 8		Negligible	
RI 8c: Cost (% of income per capita)		Baseline (2013): 5 Target (2017): 4	2018: 3.5 2020: 3.7		High	

Results Indicators	Associated Prior Actions	Baseline and Target	Actual	Relevance of Results Indicator	Achievement of Results Indicator	Comment
RI 9: Cumulative level of FDI (US$, millions)	13, 17	Baseline (2013): 100 Target (2017): 150 Target: A PPP pipeline based on PPP rules and regulations is prepared by the PPP steering committee by end 2017	2017: Inflows of 25.3 in 2014–17 (added to the baseline, actual would be 125.3) 2020: An inflow of 13.0 in 2019 and outflow of 2.79 in 2020 The PPP pipeline was prepared and presented to the Steering Committee in March 2018	Moderately satisfactory	Modest	Relevance: Actual FDI inflows are influenced by the country's attractiveness and global economic trends. A complementary measure, Bhutan's share in net global FDI flows, is used in the PPAR main text (paragraph 2.49). Achievement: Only half of the targeted increase in FDI was achieved. Inflows in 2018–19 remained moderate. A PPP pipeline was prepared with five projects, three months behind schedule.
RI 10: Tax payments per year as measured by *Doing Business*	14	Baseline (2016): 18 Target (2018): 6	2018: 18 2020: 18	Unsatisfactory	Negligible	Relevance: The indicator is not relevant to the reform, which was to provide an online system to file and pay taxes, thereby saving time. It did not target the number of procedures. Achievement: The reform was implemented but it did not affect the indicator used.

Source: Independent Evaluation Group.
Note: CIB = Credit Information Bureau; DPC = development policy credit; FDI = foreign direct investment; FSDAP = Financial Sector Development Action Plan; FY = fiscal year; GDP = gross domestic product; MSME = micro, small, and medium enterprises; Nu = ngultrum; PA = prior action; PPAR = Project Performance Assessment Report; PPP = public-private partnership; SMEs = small and medium enterprises

2. Efficacy

With two pillars rated **moderately unsatisfactory** and one pillar rated **satisfactory,** the overall rating for achievement of objectives (efficacy) is **moderately unsatisfactory** (table A.4). The ratings for efficacy are derived from the achievements of the targets for the results indicators considering the relevance of the results indicators. Two of the three pillars had ratings of **moderately unsatisfactory.** The weaknesses included (i) reforms supported by prior actions were not implemented; (ii) the reforms that were implemented did not make a substantial impact on access to finance or the investment climate because either complementary reforms were not implemented (in the case of collateral) or the reforms did not address critical constraints that would contribute to achievement of the program development objectives; and (iii) results indicators did not adequately measure the intended outcomes of the reform.

Table A.4. Achievement of Objectives Ratings

Results Indicator	Relevance Rating	Achievement	Pillar Efficacy Rating
Pillar 1: Strengthening Fiscal Sustainability and Self-Reliance			
RI 1	Satisfactory	Substantial (2021)	Satisfactory
RI 2	Moderately satisfactory	Substantial (2021)	
Pillar 2: Increasing Access to Finance			
RI 3	Satisfactory	Not verified (negligible)	Moderately unsatisfactory
RI 4	Satisfactory	Negligible	
RI 5	Unsatisfactory	High	
RI 6	unsatisfactory	High	
Pillar 3: Improving the Investment Climate and Increasing Domestic and Foreign Investment			
RI 7	Moderately satisfactory	Modest	Moderately unsatisfactory
RI 8	Satisfactory	Substantial	
RI 9	Moderately satisfactory	Modest	
RI 10	unsatisfactory	Negligible	

Source: Independent Evaluation Group.
Note: RI = results indicator.

3. Outcome

The overall outcome is rated **moderately unsatisfactory.** The relevance of prior actions was **moderately satisfactory,** and achievement of objectives was **moderately unsatisfactory.** The program had satisfactory results on fiscal discipline, was unable to bring about the reforms to collateral envisioned under the access to finance pillar, and was only partially relevant to addressing critical constraints in the investment climate. Some of the reforms in this pillar were not implemented.

4. Risk to Development Outcome

The main achievement of this development policy credit (DPC) series was on the fiscal side, and fiscal risks appear to remain substantial, particularly in the context of the COVID-19 pandemic. The data in paragraph 2.27 of the main text and in table A.3 show that tax revenue has declined and non-hydropower debt has increased from the levels achieved as of the DPC series target year (2018). The COVID-19 crisis was an exogenous shock that affected both of these measures, and economic and fiscal risks remain elevated. According to the World Bank's October 2020 *World Development Indicators* Macro Poverty Outlook for Bhutan, gross domestic product was expected to contract by 1.2 percent in FY20–21, "reflecting the standstill in the tourism industry and COVID-19-related disruptions in the non-hydro industrial sector" and "a delay in large hydro projects and spending pressures, including sizable COVID-19 relief measures, have exacerbated fiscal risks" (World Bank 2021, 198, 199).

The achievements on access to finance and the investment climate were more modest, and the risk of backtracking is related to capacity constraints rather than economic or policy risks. Several of the achievements were in technical areas that are less exposed to economic or policy risks, and thus there is lower risk of backtracking. These include the improvements to the Credit Information Bureau, Central Registry for Secured Transactions, property and land registration, and filing and payment of taxes. However, given that implementation support from the World Bank or other development partners was required to implement these reforms, there is a risk that capacity constraints may impede the smooth functioning of these systems now that such support is not being provided.

Regarding the access to finance and the investment climate reforms that were implemented, some policy risks remain but appear to be moderate. The relaxing of some constraints to FDI was a more substantial achievement, and the government has shown policy continuity by further relaxing some constraints in 2019. The Financial Sector Development Action Plan was implemented with support from the World Bank.

The main risk related to the program's development objective, particularly on access to finance and the investment climate, is that there will continue to be little progress related to the major constraints, and this will impede the private sector's ability to develop and create jobs.

5. Bank Performance

Overall, Bank performance is rated **moderately unsatisfactory** because of weaknesses in design and implementation.

Design

Parts of the DPC program had strong analytical underpinnings, continuous policy dialogue, and technical assistance, but other parts did not. The fiscal sustainability prior actions were designed well, based on country challenges, supported by government ownership, informed by sound analytics and dialogue, and coordinated with the International Monetary Fund. The access to finance prior actions aimed to address one critical constraint but omitted others, and the results framework was weak. The design of the investment climate pillar suffered from (i) excessive optimism on the government's commitment to opening to FDI and PPPs; (ii) an overreliance on *Doing Business* that limited the scope of the operation to aspects that would not address critical constraints; (iii) an incomplete approach to PPPs that did not take into account the institutions required to support successful implementation; and (iv) some weaknesses in the results framework. Positive aspects of the design of the investment climate pillar include the presence of reforms to ease FDI restrictions and sound analytical underpinnings in the reform areas covered by the operations.

The risks to the operation were identified appropriately, but the mitigating measures were not (see paragraph 2.23 in the main text). The weakness of such mitigating measures suggests that the lessons on capacity development and the link with technical assistance referred to in DPC2's Program Document were not sufficiently incorporated into the design (World Bank 2016). DPC2's Program Document also claimed to have learned that programmatic approaches support reform efforts; however, many of the prior actions in DPC2 were in different areas than DPC1, diluting the potential impact of a programmatic approach, and even when the series included sequential reforms, some were not implemented. Lack of reform implementation was also due to the design aspect that relied on submission of bills to Parliament, rather than their enactment. However, this is a characteristic of the World Bank's approach to development policy financing that goes beyond the Bhutan program.

Implementation

Complementary support by the World Bank (and by other development partners, coordinated with the World Bank) was key to reform implementation when the reforms did not require complex legal changes and there was government ownership to implement them. This was true with regard to the fiscal discipline measures and implementation of the Financial Sector Development Action Plan, Central Registry for Secured Transactions, Credit Information Bureau, electronic tax filing and payment, and online property and land registration system.

However, other reforms (i) did not have complementary support to overcome capacity constraints and ensure reform implementation, or (ii) the support was narrowly focused and insufficient to overcome concerns in Parliament. On access to finance and the investment climate, although Bank Group teams supported the government to prepare legislative reforms, the support provided was narrow and did not take fully into account the links and complementarities among the different pieces of legislation, including the Companies Act, Movable and Immovable Property Act, Insolvency Bill, Enterprise Registration Bill, and Licensing Policy, most of which still have not been passed by Parliament as of early 2022.

References

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[1] The first development policy credit had a slightly different formulation of this component of the objective: "contribute to enhancing access to finance to enterprises."

Appendix B. Fiduciary, Environmental, and Social Aspects

Fiduciary Aspects

Fiduciary risks were considered moderate. Both Program Documents stated that "the overall fiduciary risk associated with Bhutan's public financial management and the use of budget resources is moderate. Although challenges remain, the core elements of an adequate financial management system are in place, including publication of the budget" (World Bank 2015, 24; 2016, 23). The Program Document of the second operation also noted that "On fiduciary risk, the 2016 [Public Expenditure and Financial Accountability] assessment confirmed significant improvement in most aspects from 2010" (World Bank 2016, 3). As these were budget support operations, there was no procurement.

Environmental and Social Safeguards

The development policy credit series did not trigger any safeguards policies, and environmental and social risks were considered low. Program Documents stated that the development policy credit series is not expected to have any adverse environmental impact and that "Bhutan has adequate legislation, policy guidelines, and institutional mechanisms in place to protect against and manage any potential adverse effects on the environment, forests, and other natural resources" (World Bank 2015, 2016, 22).

References

World Bank. 2015. "Bhutan—First Fiscal Sustainability and Investment Climate Development Policy Credit Project." Program Document 90005–BT, World Bank, Washington, DC.

World Bank. 2016. "Bhutan—Second Fiscal Sustainability and Investment Climate Development Policy Credit Project." Program Document 108909–BT, World Bank, Washington, DC. http://documents.worldbank.org/curated/en/948231480689226936/Bhutan-Second-Fiscal-Sustainability-and-Investment-Climate-Development-Policy-Credit-Project.

Appendix C. Methods and Evidence

This report is a Project Performance Assessment Report (PPAR). This instrument and its methodology are described at https://ieg.worldbankgroup.org/methodology/PPAR. The methods and evidence used in this report were as follows:

- The PPAR team interviewed key World Bank personnel in Washington, DC, Bhutan, and elsewhere. The interviews were undertaken remotely because of the restrictions due to the COVID-19 pandemic.
- The PPAR team interviewed stakeholders in government and selected representatives of the private sector. The institutions interviewed are listed in appendix D.
- The PPAR team undertook an extensive review of World Bank documents and documents from the government of Bhutan, other development partners, and others. Documents referred to explicitly in the main text are listed in the bibliography; however, the full range of documents consulted is broader.

The evaluation questions were the following:

1. To what extent did the reforms supported by the prior actions support private sector development by addressing the most binding constraints in this area?
2. To what extent did the implementation of the prior actions contribute to Bhutan's fiscal discipline, access to finance by enterprises, and investment climate for business entry and investment?
3. What role did complementary support from the World Bank Group and other development partners play in supporting the reforms supported by the series?

Appendix D. Bhutanese Institutions Interviewed

All of the people interviewed participated through remote meetings.

Royal Government of Bhutan

1. Credit Information Bureau
2. Ministry of Economic Affairs
3. Department of Macroeconomic Affairs, Ministry of Finance
4. Division of Planning and Policy, Ministry of Finance
5. Foreign Investment Department, Ministry of Industry
6. Royal Monetary Authority of Bhutan

Others

1. Royal University of Bhutan
2. Thimpu Tech Park
3. Yangphel Private Limited

Appendix E. Implementation Completion and Results Report Review Methodology for Development Policy Financing

A new Implementation Completion and Results Report Review methodology for development policy financing was established after a decision by the World Bank's Operations Policy and Country Services to update the template and guidance for Implementation Completion Reports for development policy financing in mid-2020, and recognizing that a more rigorous and accurate assessment of performance was needed. Independent Evaluation Group and Operations Policy and Country Services collaborated on the new methodology for development policy financing Implementation Completion and Results Report Reviews. The new methodology was developed starting in mid-2020 and finalized in June 2022.

The new methodology is more thorough and systematic than the previous methodology, putting much more focus on the results chain. Table E.1 presents the main differences between the two methodologies.

Table E.1. Old and New Implementation Completion and Results Report Review Methodology for Development Policy Financing

Area	Old Methodology	New Methodology
Relevance of objectives and design	1. Relevance of objectives (rated) 2. Relevance of design (rated)	1. Relevance of objectives (not rated) 2. Relevance of prior actions (rated)
Relevance of results indicators	Not routinely discussed, not rated	Discussed and rated
Achievement of objectives (Efficacy)	Discussed and rated based on achievements of targets	Discussed and rated based on achievement of relevant results indicator targets (or other evidence)
Outcome	Rated based on the following: 1. Relevance of objectives and design 2. Achievement of objectives	Rated based on the following: 1. Relevance of prior actions 2. Achievement of objectives
Risk to development outcome	Discussed and rated	Discussed but not rated
Bank performance	Overall rating based on the following: 1. Quality at entry (rated) 2. Quality of supervision (rated)	Overall rating based on the following: 1. Design (rated) 2. Implementation (rated)
Borrower performance	Rated	Dropped
Monitoring and evaluation design, implementation, and utilization	Rated	Dropped

Source: Independent Evaluation Group.