

**PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE**

September 15, 2016
Report No.: 110968

Operation Name	Development Policy Credit 2: Fiscal Sustainability & Investment Climate
Region	SOUTH ASIA
Country	Bhutan
Sector	General industry and trade sector (40%); General finance sector (30%); General public administration sector (30%)
Operation ID	P157469
Lending Instrument	Development Policy Lending
Borrower(s)	Royal Government of Bhutan
Implementing Agency	Ministry of Finance Bhutan
Date PID Prepared	September 15, 2016
Estimated Date of Appraisal	October 17, 2016
Estimated Date of Board Approval	December 20, 2016
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Country and Sector Background

Bhutan's peaceful transition from a monarchy to a democratic constitutional monarchy in 2008 has accelerated further poverty reduction, shared prosperity and improvement in service delivery. The economy has grown on average 7.6 percent in the past decade, 16th highest among 135 countries. Gross Domestic Product per capita has almost doubled to US\$2,500 in 2014. Building on significant progress in achieving the Millennium Development Goals, Bhutan has been selected as one of the early mover countries in the Asia Pacific region for Sustainable Development Goals (SDGs) localization by the United Nations Development Program. The country's development approach, the Gross National Happiness principles, is anchored in the Constitution at the top level. The medium-term strategies have been implemented to realize GNH. The latest medium-term strategy, the Eleventh Five-Year Plan, has institutionalized regular monitoring mechanism such as the introduction of the GNH survey. By 2012, Bhutan mostly eliminated extreme poverty to 2 percent using the international poverty line of US\$1.90 a day (PPP). This is substantially lower than the regional average of 19 percent. Per capita consumption among the bottom 40 percent of the population has grown almost equal as the rest. Even using a higher international poverty line of US\$3.10 a day, the poverty rate was halved from 29 percent in 2007 to 14 percent in 2012.

Past economic developments have been driven by the public sector (including the developments of hydropower projects). While the public sector driven economic development has been successful, it has resulted in the increase in the current account deficits, reliance on donor financing and accumulation of public debt. Also, the absorption capacity of the economy to the new entrants to the labor market has been

limited. The current account deficits exceeded 25 percent of GDP and public sector debt reached nearly 100 percent of GDP. On the labor market, while the overall unemployment rate stood at 2.5 percent, the youth unemployment rate kept increasing to above 10 percent. Under these circumstances, achieving sustainable and inclusive high growth requires maintaining macroeconomic stability and a transition to the private-sector led economic development.

II. Operation Objective

The proposed International Development Association (IDA) development policy credit (DPC) of US\$20 million is the second (DPC2) of a programmatic series of two aiming to promote fiscal discipline, improve access to finance for enterprises, and improve the climate for business entry and investment in Bhutan. The series focuses on: (i) strengthening fiscal discipline and self-reliance; (ii) increasing access to finance; (iii) improving the business climate and increasing domestic/foreign investment. By addressing Bhutan's two key challenges (maintaining macroeconomic stability and a transition to the private-sector led economic development), this DPC series is designed to support Bhutan's Eleventh Five-Year Plan (2013–2018) objective of green socio-economic development and self-reliance.

Building on the completed prior actions under the first Operation (DPC1), this Operation proposes to include eight prior actions. Under the first pillar, cabinet approval on the public debt policy and the Ministry of Finance approval on tax rationalization measures are proposed. Bhutan's large fiscal gap funded by donor resources calls for fiscal consolidation and prudent debt policy. Enhancing tax collection is an integral component of achieving fiscal self-reliance. Under the second pillar, cabinet approval of the new insolvency bill, improving functions of the Credit Information Bureau, and cabinet approval of the Financial Sector Development Action Plan are proposed. Bhutan's firms and especially its SMEs have limited access to financial services. Both 2009 and 2015 Enterprise Surveys show that the top constraint that firms face is access to finance. These proposed prior actions are key to increasing access to finance. Under the third pillar, improving the electronic property and land registration system, introducing a single window for online business registration, cabinet approval of the Public-Private Partnership (PPP) policy, and MoF's approval on PPP rules and regulations are proposed. The Government recognizes that a credible and predictable policy environment that minimizes the cost of doing business, expedites business start-ups, and facilitates FDI is vital to achieving the objectives envisaged in the Eleventh Five-Year Plan. These prior actions are key to improving business environment.

III. Rationale for Bank Involvement

Self-reliance and inclusive "green socio-economic development" are the overarching objectives of Bhutan's Eleventh Five-Year Plan. A notable paradigm shift of the Eleventh Five-Year Plan is the adoption of a results-based planning framework that articulates clear outcomes and outputs to realize the objectives. The Government has identified 16 National Key Result Areas (NKRAs), national outcomes and outputs, to be achieved over the next five years. The 16 NKRAs are described under the four pillars of Gross National Happiness (GNH), the philosophy and framework that guides Bhutan's development

including (i) Sustainable and Equitable Socio-economic Development; (ii) Preservation and Promotion of Culture; (iii) Conservation and Sustainable Utilization and Management of the Environment; and (iv) Promotion of Good Governance. Bhutan's development strategies are consistent with Bank's twin goals. The Key Performance Indicators (KPIs) for NKRA 2 (Poverty Reduced and MDG Plus Achieved) include (i) Income poverty reduced (from 12 percent in 2012 to less than 5 percent by 2017-18); (ii) Multidimensional poverty reduced (reduce multidimensional poverty from 26 percent to less than 10 percent); (iii) Gini-coefficient reduced (reduce from 0.36 in 2012 to 0.3 by 2017-18) and (iv) MDG Plus achieved (ensuring gender parity at tertiary levels).

This Operation supports the macro-fiscal and investment climate components of the Government's program focusing on: (i) macroeconomic sustainability and fiscal governance; (ii) reduced volatility in liquidity and credit; (iii) counter-cyclical interventions to sustain the desired level of growth in the economy; (iv) priority areas identified for investment and private-sector development; and (v) investment in foreign government bonds. The Eleventh Five-Year Plan includes specific objectives in terms of macro-fiscal stability, *Doing Business* indicators, and FDI increase. While this Operation supports broader investment climate, it is expected to have positive impacts on other key sectors for economic growth, such as agriculture, tourism, trade, industries, and mining.

Bhutan's economy has been steadily recovering from the aftermath of the shortage of the Indian Rupee of 2012. GDP growth revived from a low of 2.1 percent in 2013 to about 6 percent (estimated) in 2015. The recovery has been sustained by a combination of accelerated investments in hydropower, good agriculture harvests, and supportive fiscal and monetary policy to boost the implementation of five-year-plan. On the demand side, private consumption has been supported by a resumption of credit (20 percent y/y as of June 2016), with services, automobiles and personal loans showing strong growth. Investments remained robust in hydropower through construction and services. The improved growth performance has been accompanied with macroeconomic stability. Inflation has been below 5 percent, exchange rate has marginally depreciated, and international reserves covered 11 months of goods and services imports in the first half of 2016. Although there have been high current account deficits (higher than 25 percent of GDP), these are related to hydropower projects and thus are mostly financed by loans from India.

As mentioned earlier, in 2012 Bhutan reduced extreme poverty to 2 percent, measured by the international poverty line of US\$1.90 a day (PPP). Using the international poverty line of US\$3.10 a day, Bhutan still shows an impressive poverty reduction from 29 percent in 2007 to 14 percent in 2012. During the same period, expenditures of households at the bottom 40 percent of the distribution grew virtually at the same rate as the overall average and the income share held by the bottom 40 percent of the population remained at 17 percent. Equally impressive improvements have been made in access to basic services and asset ownership. The Gross National Happiness Survey, Bhutan's unique measure of economic, social and spiritual development, showed further improvements in 2015. 98 percent of the households own mobile phones and 99 percent have access to electricity. The overall unemployment rate fell from an already low level

of 2.9 percent in 2013 to 2.5 percent in 2015. However, youth unemployment rate exceeds 10 percent.

Bhutan is under a two-year Article IV cycle. The latest Article IV review took place in April-May 2016 with a joint World Bank-IMF DSA presented to the IMF Board in June 2016. In addition, the IMF provides technical assistance focusing on macro-fiscal, budget, public financial management, and domestic revenue mobilization. A long-term IMF advisor on cash management is based in Bhutan. The proposed DPC2 is consistent with and reinforces the IMF Article IV recommendations, especially on the fiscal policy and monetary policy. This Operation also complements the macro-fiscal support provided by the IMF, and brings additional depth to key structural efforts to improving the investment climate and supporting private sector development over the medium.

IV. Tentative financing

Source:	(\$m.)
BORROWER/RECIPIENT	0.00
International Development Association (IDA)	20.00
Borrower/Recipient	
IBRD	
Others (specify)	
Total	20.00

V. Institutional and Implementation Arrangements

The World Bank works closely with relevant ministries and agencies. These include the office of the Prime Minister, the Ministry of Finance, the Ministry of Economic Affairs, the Gross National Happiness Commission, the Royal Monetary Authority, the Credit Information Bureau, and the Land Management Authority to monitor and assess reform progress and impacts during the course of the operation and in the context of the implementation of the Eleventh Five-Year Plan. The RGoB has just completed the mid-term review (MTR) of the Eleventh Five-Year Plan. Building on the MTR, the Annual Performance Agreement has been institutionalized along with FY2016/17 budget for all government agencies and ministries, setting annual targets to be reviewed regularly.

The World Bank has been supporting capacity development of statistics. Most results indicators will be obtained from existing government statistics as well as World Bank's publication such as Doing Business. Nevertheless, statistical capacity in Bhutan is underdeveloped. Thus, the Bank has been supporting statistics capacity development through Trust Fund for Statistical Capacity Development (TFSCB) and Advisory Services and Analytics (ASAs). Through the TFSCB, the Bank supported the formulation of the National Statistics Development Strategy (NSDS). Recently, the Bank has approved, under the TFSCB, support to carrying out the household survey in 2017 and economic census. To ensure sustainability, the Bank has been implementing a technical assistance (TA) on Bhutan Poverty and Shared Prosperity (P152474). Through this TA, the Bank is supporting the RGoB to strengthen their capacity to analyze, design and make policy decisions around poverty and social protection.

VI. Risk and Risk Mitigation

The overall risk rating to achieving the objectives of this Operation is moderate. Among the risk categories, political and governance; macroeconomic; sector strategies and policies; fiduciary and stakeholder risks are moderate, and environmental and social conditions risk is low. The political and governance risk is moderate taking into consideration that next general election is scheduled mid-2018m after the closing date of the Operation and the formulation of development strategies (e.g., ongoing Twelfth Five-Year Plan) are fully participatory (including members of opposition parties).. As elaborated in Section 2, macroeconomic risk is moderate. On fiduciary risk, the upcoming 2016 Public Expenditures and Financial Accountability (PEFA) assessment confirms significant improvement in most aspects of public financial management compared to the situation in 2010. The risks that are considered more substantial are related to the technical design of project or program, and institutional capacity or implementation and sustainability.

Technical design of project or program. Some of the critical reforms supported by the Operations are new to the RGoB, such as the legal framework for PPPs. While Bhutan has had several PPP transactions in the past, the legal framework was missing. Thus, establishment of PPP policy and rules and regulations (prior action 8) requires technical assistance and analytical support from the WBG; overall, implementation of these reforms to achieve the PDO requires continuous external support.. It should also be noted that achieving some results indicators such as that related to FDI will be affected by external global economic environment.

Institutional capacity for implementation and sustainability. Technical capacity, organizational structure as well as a lack of interagency coordination pose a risk to achieving the PDO. Due to the cross-cutting nature of this Operation, many ministries and agencies are involved. Coordination among them is challenging, in part due to limited number of capable technical staff who are over stretched and have limited time to reach out across ministries and agencies. Moreover, the Government's experience in collaborating across boundaries is limited. To mitigate this risk, the Bank's ongoing and future Advisory Services and Analytics (ASAs) are important to support on capacity development as well as fostering coordination across the implementing agencies. These TAs include Bhutan Macro-Fiscal Monitoring (P152381) including supporting tax rationalization (P156989); Implementing Action Plan for FSDAP); and Improving Bhutan Investment Climate (P153221). Also, new challenges related to institutional capacity will be picked up through supervision of this Operation.

VII. Poverty and Social Impact and Environment Aspects

Poverty and Social Impacts

The policies supported by this Operation are expected to have a positive poverty and social impact over the medium- and long-term. The three pillars under the proposed Operation, namely, (i) strengthening fiscal discipline, (ii) increasing access to finance and

(iii) improving the business climate, are expected to improve macroeconomic stability, enhance growth and create more employment opportunities, thereby contributing to the Bank's corporate goals of poverty reduction and shared prosperity in a sustainable manner. In the short-run, it is important to ensure inclusiveness in the implementation of some of the proposed policies as they have implications for the welfare of the poor and vulnerable.

Environment Aspects

This Operation is expected to improve the investment climate and development of Bhutan's private sector for green socio-economic development and self-reliance. The Program will not include any physical interventions. Thus, overall this Operation is not expected to produce any adverse environmental impacts. Measures to promote fiscal sustainability and financial sector development are expected to be environmentally neutral. The policies supported by the proposed DPC series is unlikely to cause significant effects on the country's environment, forests, or other natural resources. Furthermore, Bhutan has systems in place for reducing any adverse environmental effects (in reference to OP8.60) that may materialize. The RGoB's has good capability to manage any environmental impacts arising from private-sector development, as reflected in the country's consistently high Country Policy and Institutional Assessment (CPIA) score for environment. Bhutan has adequate legislative framework, policy guidelines, and institutional mechanisms in place to manage any potential adverse effects on the environment, forests, and other natural resources. Overall, the country gives high priority to environmental conservation and sustainable development.

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