

Bhutan

Country Economic Update: Accelerating Growth and Poverty Reduction

September 22, 2007

Poverty Reduction and Economic Management Unit
South Asia Region

CURRENCY EQUIVALENTS

Since its introduction in 1974, the Bhutanese ngultrum (Nu.) has been pegged to the Indian rupee, which is also legal tender in Bhutan. Accordingly, the exchange rate with the U.S. dollar was as follows:

Annual Averages

1997	US\$1.00 =	Nu 36.31
1998	US\$1.00 =	Nu 41.26
1999	US\$1.00 =	Nu 43.06
2000	US\$1.00 =	Nu 44.94
2001	US\$1.00 =	Nu 47.19
2002	US\$1.00 =	Nu 46.61
2003	US\$1.00 =	Nu 46.58
2004	US\$1.00 =	Nu 45.32
2005	US\$1.00 =	Nu 44.10
2006	US\$1.00 =	Nu 45.31

FISCAL YEAR

July 1 - June 30

The World Bank

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Abbreviations and Acronyms

ADB	Asian Development Bank	ITM	International Tourism Monitor
APF	Alternative Planning Framework	MDGs	Millennium Development Goals
BCCL	Bhutan Carbide and Chemicals Limited	M&E	Monitoring and Evaluation
BFAL	Bhutan Ferro Alloys Limited	MoF	Ministry of Finance
BPMAS	Bhutan Poverty Monitoring and Assessment System	MoLHR	Ministry of Labor and Human Resources
BST	Bhutan Sales Tax	MTEF	Medium Term Expenditure Framework
CEM	Country Economic Memorandum	MTFF	Medium-Term Fiscal Framework
CFAA	Country Financial Accountability Assessment	Ninth Plan	Ninth Five-Year Plan
DADM	Department of Aid and Debt Management	NGO	Non-Governmental Organization
DoT	Department of Tourism	PAS	Public Accounts System
DSIT	Dollar Spending International Tourist	PPD	Policy Planning Division
GDP	Gross Domestic Product	PEM	Public Expenditure Management
GoI	Government of India	PRSP	Poverty Reduction Strategy Paper
HIES	Household Income and Expenditure Survey	RGoB	Royal Government of Bhutan
IDA	International Development Association	RMA	Royal Monetary Authority
IMF	International Monetary Fund	RNR	Renewable Natural Resource
		SAFTA	South Asia Free Trade Area
		SOE	State Owned Enterprise
		TA	Technical Assistance
		Tenth Plan	Tenth Five-Year Plan
		W&MA	Ways and Means Account

Acknowledgements

This report was produced by a team led by Christian Eigen-Zucchi based on the findings of task-team-member visits to Bhutan in 2006 and early 2007. It draws on contributions by Asya Aklaque (private sector development and employment), Ananya Basu (poverty and human development), Kesang Choden (consultant), Bhaskar Bala Kalimili (macro-fiscal), Pedro Sanchez (hydropower), Corinne Siaens (poverty, human development and employment), Vinaya Swaroop (fiscal), Choiten Wangchuk (consultant). The report benefited from the detailed comments and suggestions of Edgardo Favaro (peer reviewer, PRMED), Enric Fernandez (IMF), Manuela Ferro (peer reviewer, SASPR), and Catriona Purfield (IMF). The report was processed by Shahnaz Ahmed, and prepared under the guidance of Alastair J. McKechnie (Country Director for Bhutan) and Ijaz Nabi (Sector Manager). The strong cooperation of the Royal Government of Bhutan is gratefully acknowledged.

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Bhutan: Country Economic Update Accelerating Growth and Poverty Reduction

Executive Summary

1. This report was prepared to help the Royal Government of Bhutan (RGoB) meet its felt need for more economic analysis and policy advice. It also seeks to provide information to a wider audience of development partners and interested parties. Much of the analysis was undertaken together with the RGoB as a part of the development of the Medium Term Fiscal Framework (MTFF), and the preparation of the 2005 Country Assistance Strategy (CAS) and the first Development Policy Grant (DPG-1).

2. Over the past 25 years, Bhutan has been developing rapidly, pursuing sound economic policies, exploiting hydropower, and enjoying strong support from external development partners. Solid growth continues to raise per capita income and support improvements in social indicators. In seeking to understand this process and comment on how this favorable development picture might be sustained or accelerated, this report constructs a mosaic with several thematic elements:

- Given that a large fraction of GDP flows through the government (hydropower and aid), and will continue to do so over the medium-term, the importance of effective public resource intermediation cannot be overstated.
- Improving the investment climate will be central to fostering a vibrant private sector that increasingly becomes an autonomous driver of growth.
- These will be critical for generating adequate and broad-based employment opportunities, as well as sustaining robust growth and development over the medium term, helping to mitigate vulnerability.
- Concomitantly, the RGoB places a high priority on striking an appropriate balance with environmental, cultural and spiritual considerations in mind.

Governance, Development Vision, Poverty and the MDGs

3. *Although accountability mechanisms are nascent, governance outcomes appear to be good.* Bhutan generally ranks higher than other countries in the region on indicators of governance (except the indicator on ‘voice and accountability’), and on ‘corruption control,’ Bhutan is in the top quartile of the world. Still, the RGoB needs to remain vigilant and seek to strengthen mechanisms of accountability and transparency as new governance challenges may arise with the inflow of revenues once the massive Tala hydropower project comes on-stream later in 2006. Substantial progress is being made in this area, with a draft constitution under consultation and independent constitutional bodies being established, as the Kingdom moves towards constitutional democracy.

4. *The notion of Gross National Happiness (GNH) guides Bhutan’s development vision, emphasizing the importance of balancing material, spiritual, emotional and cultural well-being as elements that together bring happiness to the individual.* These goals are further elaborated in the vision 2020 document and the Ninth Plan, seeking to

promote (i) human development, (ii) cultural heritage, (iii) equitable development, (iv) good governance, and (v) environmental conservation. The Ninth Plan builds on a tradition of consultation, and establishes spending priorities with a heavy focus on roads, education and health. The RGoB is in the process of developing an ‘Alternative Planning Framework’ (APF), which aims to: (i) strengthen the links between goals, strategies, and budgets, (ii) improve outcome monitoring of the plan, (iii) accommodate the award of annual grants to local governments (as mandated by Article 22 of the draft Constitution), and (iv) ensure fiscal discipline and sound PEM over the medium-term through the political transition.

5. ***Substantial progress has been made in recent years in reducing poverty, and Bhutan appears to be broadly on track for meeting the MDGs.*** While data is quite limited, an estimated 31.8 percent of the population was living below the poverty line in 2003, significantly lower than the findings of a pilot survey fielded in 2000. The Millennium Development Goals Progress Report 2005 suggests that most of the MDGs are likely to be met by 2015, and three targets have already been achieved (in the areas of hunger, water and sanitation). Redoubled effort is needed to promote gender equality in tertiary education and to reduce maternal mortality. Overall, the progress on human development is impressive, given Bhutan’s challenging terrain.

Recent Economic Developments

6. ***Economic performance has been strong over the past 25 years, and prospects are bright that the trend will continue.*** Real GDP growth was 6.8 percent in 2004/05, raising nominal GDP to about US\$790 million. The public sector continues to drive growth, as the revenues mobilized from external donors and hydropower sales are used to finance ambitious public investment (like in hydropower projects) and the provision of public services. Indeed, taken together, central government expenditure, off-budget spending on Tala, the State Owned Enterprises (SOEs – with varying levels of public ownership), and spending at the local level, may raise public spending as a share of GDP to over 70 percent. Growth has been led by the construction and electricity sectors. Although construction activity will be significantly impacted as the Tala hydropower project nears completion (at its peak the project accounted for over a quarter of the sector), non-Tala construction is sufficiently buoyant to see positive growth rates maintained through the transition. The tourism industry has grown by almost 50 percent in each of the past two years, and despite being a comparatively small economic sector (less than 2 percent of GDP), it holds significant growth and employment potential. Consumer price inflation has been in the 3-5 percent range, following price movements in India. Measured unemployment remains low, but is a growing concern for the RGoB, especially in the context of rising numbers of school leavers.

7. ***External imbalances are sizable, but are adequately financed and will be largely reversed once Tala comes on-stream.*** The current account deficit widened to the equivalent of over 25 percent of GDP in 2004/05, mainly as a result of the purchase of two new Airbuses. About 94 percent of exports are to India, dominated by hydropower in a pattern that will be amplified with Tala. Imports of Tala related construction

materials are also a major feature of the balance of payments. Tourism receipts rose by almost 50 percent, and the sector is the largest earner of hard currency. Grants amounting to about 42 percent of GDP and other financing enabled an increase in reserves to about US\$510 million at the end of 2005. Debt stocks have risen sharply in recent years, but much of this is associated with the development of Tala, and debt sustainability analyses suggest that the evolution is manageable, especially once Tala starts to generate revenue.

Macroeconomic Policy

8. *The overall fiscal picture is shaped by four features: (a) the expansion in the resource envelope associated with the Tala boom is likely to be smaller than widely anticipated, (b) volatility remains a major concern, (c) the RGoB continues to rely on external grants and loans for financing, and (d) recourse to domestic finance is becoming increasingly important.* The RGoB seeks to implement prudent fiscal policy, limiting the deficit to 4-5 percent of GDP, and meeting recurrent expenditure from domestic revenue, for example. In some years this is challenging, however, and the overall deficit including grants swelled to 7.4 percent of GDP in 2005/06. The fiscal accounts are extraordinarily volatile in Bhutan, and a recently prepared MTFE shows that just one or two factors can dramatically alter the picture. In particular, a delay of only a few weeks in the coming on-stream of Tala, or a setback on the request for two years' excise duty refunds in one fiscal year from the Government of India (GoI), could mean a 10 percent reduction in revenues. The MTFE also shows that the jump in revenue from Tala will be partially offset by the start of high debt service payments and the concomitant phasing out of GoI program grants. While external financing is generally adequate, the RGoB is relying increasingly on domestic finance, including bonds and an overdraft facility with the Bank of Bhutan. These aspects are likely to persist in the coming years, and the RGoB needs to strengthen efforts to mitigate their impact and reduce vulnerability. The implementation of multi-year rolling budgets can play an important role in this regard, helping the RGoB anticipate changes in available resources and adjust policy accordingly.

9. *Monetary and exchange rate policy are limited by the peg to the Indian rupee.* The Royal Monetary Authority (RMA - the central bank) directs policy at the management of liquidity consistent with the fixed exchange rate. With the influx of hydropower and donor funds boosting foreign assets and fueling the expansion of domestic credit, this can be challenging, and has at times led to a build up of 'structural liquidity surpluses' that are then deposited in India. Until recently, the RGoB had consistently made net deposits into the banking system. The exchange rate regime is unusual in that it operates like a currency board, but pegged to a currency that is not fully convertible. Ngultrum in circulation are 100 percent backed by reserves, and the rupee circulates freely in Bhutan as legal tender. Given the high degree of economic integration with India, and that over 90 percent of Bhutan's trade is with India, the IMF finds the arrangement generally suitable. In addition to a free trade agreement with India, much of the trade with Bangladesh is also duty free, such that around 98 percent of

Bhutan's trade is covered by these agreements. Arguably, Bhutan's economy is one of the most open in the World.

Architecture of Public Resource Management

10. *In seeking to effectively intermediate public resources into sustained development, the RGoB will need to deepen efforts to bolster budget systems.* The RGoB has embarked on a series of structural reforms aimed at: (i) strengthening the links between the annual budget and the five-year plans for better resource allocation, (ii) addressing general weaknesses with the present single year budgeting approach, especially the somewhat ad hoc adjustments made in the event of resource shortfalls, (iii) bolstering macro-fiscal sustainability by establishing hard budget constraints, (iv) ensuring an appropriate split between recurrent and capital expenditures, (v) implementing the RGoB's decentralization plans, (vi) improving the arrangements for financing the budget deficit, and (vii) fostering continued high levels of donor engagement, with greater predictability of resource flows. Implementing multi-year rolling budgets is a key tool in this process, but the RGoB has not been able to meet this goal yet. As a first step, the RGoB has prepared the MTFF, and following several iterations of the exercise, it is helping the RGoB frame the fiscal picture more clearly. Several initiatives are also underway on strengthening financial management, including a Public Finance Act and a Royal Audit Act, as well as the establishment of several new constitutional bodies, such as the Office of the Auditor, which are independent and report directly to the National Assembly. These steps are important in increasing accountability, transparency and efficiency in the use of public resources, which is especially significant in the Bhutanese context and will become more so with the commissioning of Tala.

11. *Effectively leveraging public resources will also hinge on avoiding the 'natural resource curse,' which can lead to weaker institutions and governance, higher fiscal volatility, and "Dutch disease." Although some of the natural resource curse effects are not apparent, volatility is a major issue and the RGoB is urged to remain vigilant.* With revenues from aid and hydropower summing to almost 50 percent of GDP (this, before the coming on-stream of Tala), Bhutan receives large revenues from sources that have been associated with natural resource curse effects in other countries. The negative effect on institutions and governance is postulated to arise from less interaction between the state and taxpayers when revenues are readily available from other sources, reducing the accountability of the state to provide good services and inducing corruption. While governance outcomes appear adequate in Bhutan, the RGoB should move forward in encouraging the development of stronger accountability mechanisms, like an independent media, civil society organizations, and the like. Though secondary to strengthening public expenditure management with sound multi-year budgeting, establishing an off-shore hydropower fund over the medium- to long-term might also be useful, with strong governance arrangements for accountability and transparency potentially setting an example for other parts of the government.

12. ***Managing fiscal volatility is a major challenge for the RGoB, and measures to mitigate this should be considered, even if this means stemming buoyancy during boom periods.*** By international standards, Bhutan faces a very high level of volatility resulting from variations in donor grants, hydropower revenues, and other key factors. This makes it more difficult for the RGoB to implement programs. Measures to mitigate these gyrations include: (i) conducting counter-cyclical fiscal policy, generating surpluses in good years and running deficits when the resource envelope turns out to be lower, (ii) using funds to invest in human capital and infrastructure, as well as otherwise creating an enabling environment for private sector development, (iii) continuing to develop and bolster the MTFE to help policy makers manage expenditure appropriately and anticipate revenue shortfalls, (iv) using the MTFE to help persuade donors to program their assistance with a view to reducing volatility, (v) over the medium- to long-term, establishing an external hydropower fund that could help stabilize the resources available to the RGoB. Such considerations argue for fiscal restraint and careful management of expectations associated with Tala.

13. ***The real effective exchange rate (REER) has not appreciated over the past few years, but careful monitoring is warranted to ensure that this ‘Dutch disease’ effect does not undermine the competitiveness of the nascent private sector and efforts to diversify the economy.*** In the late 1980s, after the Chukha hydropower plant came on-stream, the REER appreciated by about 10 percent. In recent years, the REER has been stable or has depreciated slightly, as measured price inflation has been equal to or slower than in India and Bangladesh. Still, close monitoring of this indicator of competitiveness is especially important with the imminent commissioning of Tala. Measures to mitigate any such appreciation include moderating the inflow of funds and boosting the competitiveness of the private sector through investments in infrastructure and human capital, as well as otherwise improving the investment climate.

14. ***The state owned enterprises (SOEs) play an important role in the economy, and warrant continual scrutiny.*** Seeking to counteract the effect of the small scale of Bhutan and address the need for critical goods and services as well as economic diversification, the RGoB has established a number of SOEs, whose spending is equivalent to over 16 percent of GDP. Although the RGoB has divested its holdings to varying degrees over time, the pressures to invest in more SOEs may mount once Tala comes on-stream. The SOE sector is profitable, even without including the rents from hydropower, but there are a range of issues like dynamic efficiency, compensation, and governance that should be studied as a part of developing a medium strategy for meeting the RGoB’s goal of increasing private sector participation and ensuring effective deployment of hydropower revenues.

Fostering Private Sector Development

15. ***Further measures to improve the investment climate are needed in order to boost the vibrancy of the small and nascent private sector, enabling it to contribute importantly to sustaining economic dynamism and generating employment.*** According to a 2002 Private Sector Survey, firms face constraints in several areas, including skilled

labor, bureaucratic burdens, lack of demand, and difficulties in accessing finance. Furthermore, the *Doing Business in 2006* indicators show that Bhutan's labor markets are the most rigid in the region, and that firms face significant barriers to entry, among other findings. In order to address these issues, the RGoB has embarked on a series of reforms, seeking to expand physical infrastructure, rationalize entry regulations, improve the functioning of the labor market, address skill shortages, attract FDI, deepen financial markets, reduce trade barriers, and strengthen the dialogue with the private sector. Following through with these initiatives will be central to realizing the potential of the private sector, generating broad based employment and mitigating vulnerability.

Prospects for Accelerating Growth

16. *Encouraged by effectively deployed public resources and improvements in the investment climate, the outlook for growth in Bhutan is favorable, led by hydropower, construction, tourism, and agri-business.* It should be noted that much economic activity in Bhutan is linked to public spending, and it will be some time before the private sector develops more autonomous growth poles.

17. *The exploitation of hydropower will continue to be the main driver of growth over the medium term.* The Tala hydropower project will raise generation capacity by over 230 percent, lift GDP by around 19 percent (if it is fully commissioned towards the start of the fiscal year 2006/07), and raise domestic revenue by 48 percent. Similar effects were enjoyed when Chukha started operations in 1987. Bhutan's hydroelectric potential is vast, while India's need for electricity is still greater, and other projects are being planned. Deriving maximal benefits from the exploitation of hydropower will require careful management, and several key issues stand out, including the need to: (i) integrate future projects into debt sustainability analyses to avoid undue risks, (ii) investigate the possibility of private sector participation to accelerate hydropower development, and (iii) review the domestic pricing strategy, especially for industrial users, in order to ensure that electricity is not used wastefully. Of particular note is that the RGoB is considering proposals for new industrial development that would require over 400 MW of electricity, or 40 percent of the installed capacity of Tala. The RGoB must carefully weigh the opportunity cost of providing low cost electricity against the desire to foster diversification, employment creation, and other social objectives.

18. *Despite the winding down of construction on Tala, which at its peak accounted for almost a quarter of the sector, non-Tala activity appears to be sufficiently buoyant to sustain positive growth through the transition.* The sector remains dependent on government spending on infrastructure, schools and health facilities, but private demand is becoming increasingly important. High credit growth, mainly to real estate, is financing a rapid expansion in housing construction, as well as new hotels. A key concern for the sector is access to labor, as many Bhutanese do not accept the arduous work of construction at the levels of remuneration on offer, and the industry relies heavily on expatriate workers.

19. ***The tourism sector is growing very rapidly, and holds much potential for contributing to economic growth and broad-based employment generation.*** Tourist arrivals and revenues have risen by almost 50 percent in each of the last two years, though from a very small base. The sector currently accounts for about 2 percent of GDP, but it is largest earner of hard currency, and it looks set to continue expanding. Several challenges need to be addressed, including seasonality, regional distribution, temporary employment, low occupancy rates, the quality of food and services, emergency services, the need for infrastructure improvement, and the pricing policy. The latter has been effective in promoting high value/low impact tourism, but it also has other effects, such as discouraging travel to the East, inducing very compact and busy visits, limiting options for small and medium sized enterprises, and dampening activity in areas like trekking and biking. A Sustainable Tourism Development Strategy has been prepared with the assistance of the Austrian government, providing a timely input into a much needed review of tourism policy.

20. ***Although the overall agricultural sector has been lagging the rest of the economy for many years, several parts of the sector and related activities have strong potential for contributing to robust growth.*** Seeking to raise the value added in the sector, the RGoB is pursuing the ‘triple gem,’ which hinges on (i) boosting productivity, (ii) improving access to markets, and (iii) enhancing the marketing of agriculture based products. Areas of strong potential include horticulture (oranges and apples), agri-processing, forestry based industries, and non-timber forestry products like shitake mushrooms, Cordyceps sinensis (a Chinese caterpillar fungus that is a high-altitude medicinal product) and lemongrass oil. Poverty reduction in poor rural areas, where the vast majority of the poor live, hinges on making progress on these initiatives.

Generating Employment

21. ***Measured unemployment is low in Bhutan, but there is concern that growing cohorts of school leavers will have difficulty in finding jobs.*** Data limitations are a major problem when trying to understand the evolving employment situation, but they suggest that over 60 percent of the workforce continues to work in the agriculture sector, while other sectors, like hydropower generate very few jobs. Even once Tala is completed, the sector may employ less than 3,000 people in total, while accounting for 25 percent of GDP. Concerned about the civil service becoming excessively large, the RGoB is looking to the private sector to generate more jobs. The difficulty is that the labor market in Bhutan is one of the most rigid in the South Asia region, and employers face other challenges like skills mismatch and a lack of worker continuity. A Labor Act is under consideration that aims to balance flexibility with the legitimate concerns of workers. The RGoB will need to take care not to contribute further to the inflexibility of the labor market. It is also streamlining the process for bringing in expatriate workers, who either work for low wages in jobs Bhutanese find unappealing, or bring needed skills. In both cases, they may generally be complements to Bhutanese labor and raise the latter’s productivity. Ultimately, the vibrancy of the economy will determine the level of employment opportunities available.

Conclusion and Medium-term Outlook

22. *The prospects for sustained growth and human development in Bhutan are bright.* Hydropower revenues and donor funding will continue to finance the central role of the public sector in the economy, enabling high levels of spending on social services and infrastructure investment. The further development of hydropower will provide a boost to the construction sector through the building period, punctuated by periodic large jumps when the multi-year hydropower projects are completed. Still, ensuring broad based economic dynamism that boosts employment and lowers vulnerability will depend on the private sector playing a greater role. Some difficult policy choices may be needed in this regard, continually rebalancing various priorities on the path to ever greater GNH.

Bhutan: Country Economic Update Accelerating Growth and Poverty Reduction

1. Introduction

1. Development in Bhutan has been rapid over the past two decades, underpinned by prudent macroeconomic management, advantageous exploitation of hydropower resources, and generous support from external donors. Four key features frame the development process and prospects:

- Effectively intermediating public resources into sustained growth and development is essential in Bhutan, since a large share of GDP passes directly through the government in the form of hydropower revenues and donor assistance.
- Ensuring the dynamism of the economy will hinge increasingly on a vibrant private sector, elevating the need for continued improvements in the investment climate.
- Progress in these areas is essential for generating adequate income earning opportunities for wide sections of the population, sustaining strong growth and reducing vulnerability.
- At the same time, the RGoB seeks to find a good balance with the other elements deemed to contribute to ‘Gross National Happiness’ (GNH), like Bhutan’s cultural, environmental and spiritual heritage.

2. Through the prism of these four elements, this report seeks to contribute to the policy discussion by providing an integrative analysis and update of the Bhutanese economy, as well as developing a set of key recommendations and issues that warrant consideration or further study. Section 2 describes ongoing governance reforms, outlines the objectives articulated in Bhutan’s Vision 2020 document and the Ninth Five-Year Plan (Ninth Plan), discusses the poverty reduction strategy, and notes progress towards meeting the Millennium Development Goals. Section 3 examines recent economic developments, including growth, the balance of payments, and external debt. Section 4 analyzes macroeconomic policy, highlighting the challenge of fiscal volatility and the need to manage expectations surrounding the coming on-stream of the giant hydropower project Tala. Section 5 discusses several structural aspects of public resource management, including ongoing fiscal and financial management reforms, the importance of avoiding the ‘natural resource curse,’ and the treatment of state owned enterprises. Section 6 investigates the role of strengthening the investment climate for facilitating private sector development. Section 7 comments on the prospects for accelerating growth, looking at the development of additional hydropower resources, construction, tourism, and agribusiness, emphasizing that while hydropower will continue to drive economic growth, tourism and value added activities in agriculture will be central to boosting growth and generating broad-based employment. Section 8 concludes with medium term development prospects and challenges.

3. The report is aimed at a wide audience, including the RGoB, development partners, and others with varying levels of familiarity with Bhutan. Much of the analysis was undertaken jointly with the RGoB through the preparation of a macroeconomic framework for the development of a Medium Term Fiscal Framework (MTFF), and as a part of a broader RGoB initiative to strengthen Public Expenditure Management. The RGoB and the World Bank are considering expanding this effort, engaging in a series of TA/capacity building activities, and jointly writing economic reports on focused topics of interest. The work undertaken as a part of this economic update also served as an input into the results based Country Assistance Strategy discussed by the Board in November 2005, and the Development Policy Grant that was approved by the Board in May 2006.

Brief Country Background

4. Nestled in the eastern Himalayas between regional giants China and India, the mountain kingdom of Bhutan is land-locked and has a land area of about 47,000 square kilometers.¹ Bhutan stretches about 300 kilometers east to west and 170 kilometers north to south, roughly equal the size of Switzerland. The results from the mid-2005 census indicate that the population is 672,425, with 33 percent of the population below the age of 15.² King Jigme Singye Wangchuk is the hereditary monarch, who has governed since 1972 with the support of a National Assembly and a Council of Ministers. In 1998, the King started a process of delegating government functions to these government bodies, and at the end of 2005, he made the surprise announcement that he will step down in favor of the Crown Prince, once a constitutional monarchy is established in 2008. Consultations on a draft constitution have been underway since October 2005, and it is to be adopted through a referendum in 2006 or 2007 (see the section on governance below for more detail). At present, the post of Prime Minister (the head of the cabinet) is rotated annually among the 5 ministers who received the most votes in the National Assembly. Bhutan has very close relations with India. In the 1949 Treaty of Perpetual Peace and Friendship with India, Bhutan agreed to be guided by the advice of India with regard to its foreign relations, free-trade was established between the two countries, and Bhutan adopted the Indian rupee as legal tender, among other provisions. Over 90 percent of Bhutan's trade is with India, and all hydropower exports are to India. The majority of foreign aid is also provided by India, including roads, hydropower plants, and about 60 percent of the grants received by the RGoB, amounting to 29 percent of total revenues and grants, and almost 10 percent of GDP in 2005/06.

5. Benefiting from sound economic management, the exploitation of hydropower, and strong support from external development partners, Bhutan has developed and modernized rapidly over the last two decades. This is reflected in growing per capita income (around US\$850 in 2005) and improving social indicators. The formidable geography poses serious challenges, however, with elevations ranging from 100 to 7,500

¹ This figure is from the World Development Indicators, and confirmed by several other sources. The RGoB figure suggests the total land area of Bhutan is 38,400 square kilometers.

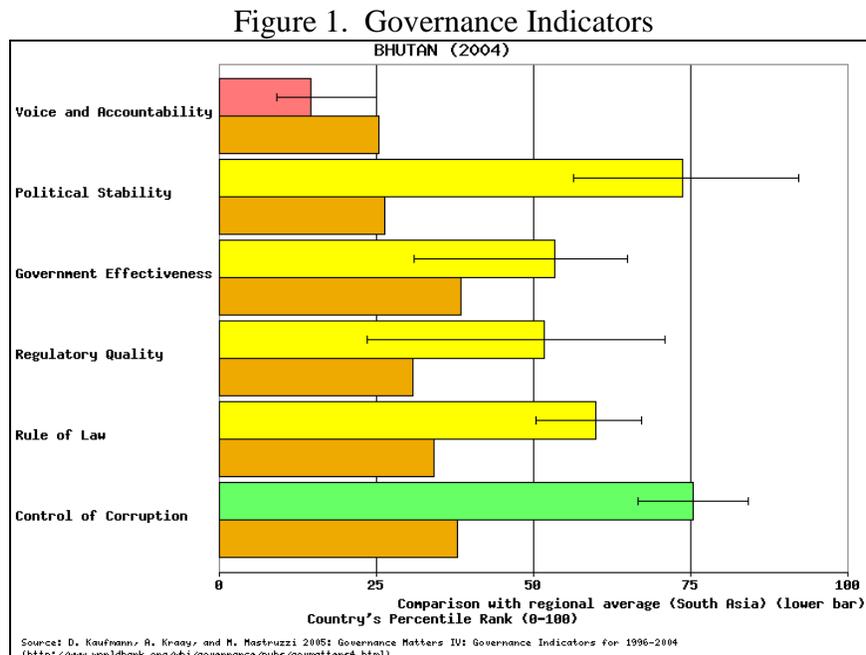
² Previously, the RGoB reported a population estimate of 734,000 in the *Statistical Yearbook of Bhutan 2003*, and other figures are noted elsewhere (including the World Bank's *World Development Indicators*). Greater consensus is expected once more demographic data analysis has been undertaken on the census.

meters above sea level, steep slopes, and the small size and dispersion of the population greatly increasing the marginal cost of providing services. Many villages are small and isolated, located several days walk from the nearest motorable road. Indeed, improving access to health, education, markets and economic opportunities is one of the defining development issues in Bhutan and was a central theme of the 2005 CAS. Although urbanization is continuing rapidly, almost 70 percent of the population lives in rural areas, and urban areas, such as the capital Thimphu (population of about 70,000), remain small. This makes it very difficult for the people of the Bhutan to take advantage of economies of scale, and the majority of employment remains in agriculture, much of it in isolated subsistence activities. With Indian assistance, hydropower resources (estimated at over 30,000 megawatts) are rapidly being developed, accelerating development. The RGoB seeks to limit the potential adverse effects from tourism and promote 'low volume/high value' tourism, but the sector has strong potential, as described in greater detail below. Environmental considerations are high on policy makers' agendas, with any logging tightly controlled and over 60 percent of the country's land area to be preserved under forest cover in perpetuity. These factors frame the unique development opportunities and challenges faced by the Bhutan.

2. Governance, Development Vision, Poverty and the MDGs

Ongoing Governance Reforms

6. Accountability mechanisms are nascent, commensurate with the level of development and small scale of Bhutan. For example, with a small dispersed population, the scope for a large variety of independent news media is limited, and there is only one regular newspaper, published bi-weekly (though two new private newspapers are to start publishing later in 2006). Still, governance outcomes appear to be good. With the exception of the indicator on ‘voice and accountability,’ Bhutan ranks highly on the governance indicators published by the World Bank Institute (especially on the ‘control of corruption’), and generally performs significantly better than the regional averages (Figure 1).



7. Still, the RGoB needs to continue efforts to strengthen accountability mechanisms, by encouraging the independence of the media and the formation of civil society organizations for greater public scrutiny, or by implementing other institutional changes. Such initiatives will be especially important ahead of sharp increases in revenue associated with Tala and the deepening democratization process, which may pose new governance challenges.³ It is worth noting that the small scale of Bhutan heightens the proximity of government officials and private interests.

8. Consistent with the RGoB's vision for a government that is accountable, uses resources responsibly, is underpinned by independent constitutional offices, upholds the rule of law, and provides for the protection of human rights, a draft constitution was

³ The first elections based on universal adult franchise were held in 2002/2003.

unveiled in March 2005. Broad based consultations are ongoing (comments can also be made on-line), and the constitution is to be adopted through a national referendum in 2006 or 2007.⁴ This will herald a major change in the governance structure of Bhutan, establishing a constitutional monarchy and replacing the royal decree of 1953, which gave the monarchy absolute power. The key features of the constitution are highlighted in Box 1.

Box 1: Key Provisions of the March 2005 Draft Constitution

The draft has 34 articles, outlining the role of the monarchy and the clergy, the separation of powers into legislative, executive and judicial branches, as well as describing the fundamental rights and duties of the people. The proposed constitution provides for:

- The preservation of the hereditary monarchy, with the power to appoint the justices, the election commissioner, the heads of the defense forces, and the head of the anti-corruption commission, among others, all upon the recommendation of the prime minister or other government institutions;
- The elaboration of the circumstances under which the parliament can require the abdication of the ruling monarch (in favor of the next heir apparent);
- The affirmation that Buddhism is the spiritual heritage of Bhutan to be promoted by religious institutions, while ensuring that religion remains separate from politics;
- The conservation and sustainable use of the environment, including the maintenance of 60 percent of the country's area under forest cover in perpetuity;
- The specification of the conditions of citizenship: both parents must be citizens, or one must have lived in Bhutan before December 31, 1958 and be registered in the official record of the RGoB, or one must naturalize (requiring residency in Bhutan for more than 15 years and meeting several other conditions);
- The declaration of fundamental rights (freedom of speech, religion, press, and assembly, among others), and the circumstances under which these may be restricted, as well as fundamental duties (preserving cultural heritage, respecting the national flag, safeguarding national property, paying taxes, and upholding the constitution);
- The promotion of Gross National Happiness by the state (among other endeavors);
- The convening of a Parliament, consisting of the Monarch, the National Council, and the National Assembly (the latter two continuing for a period of 5 years).
- The dissolution of the National Assembly by the Monarch upon the recommendation of the Prime Minister (the National Council is to complete its 5 year term);
- The formation of the National Council, 20 of whom are to be elected (1 from each Dzongkhag) and 5 of whom are to be appointed by the Monarch (members of the National Council shall neither belong nor have affiliation to a political party);
- The election of the National Assembly, comprising 75 members (assembling at least twice a year);
- The coming into force of bills passed by Parliament only with the assent of the Monarch – where assent is not granted, the bill shall be returned with amendments or objections for a vote by a joint sitting of the Parliament, after which, if the bill is again passed, the Monarch shall grant assent;
- The meeting of recurrent expenditures from internal resources;
- The maintenance of international reserves equivalent to one year's imports;
- The representation in the National Assembly by two political parties, determined after a 'primary round' of voting with the two parties winning the most votes being declared 'the' two parties;
- The circumstances under which parties may be dissolved by the Supreme Court;
- The formation of an anti-corruption commission.
- The amendment of the constitution, requiring a majority of at least three-fourths of the total number of members of Parliament.

⁴ Available at www.constitution.bt, where comments can be sent.

9. Three independent constitutional bodies were established at the end of 2005 and at the beginning of 2006, with a view to moving forward with the governance and institutional reforms needed ahead of the enactment of the Constitution in 2008. These are the Election Commission, the Office of the Auditor General, and the Anti-Corruption Commission, all of which are independent of the executive and report directly to the National Assembly.

10. Once the constitution is adopted, the existing National Assembly is to be dissolved, the ministers are to resign, and an interim government is to be appointed. The new government is to be formed within 90 days of the dissolution of the previous government.

11. As a part of this deepening process of political change, the RGoB held intensive discussions at the end of 2005, which developed a series of recommendations for improvements in governance in a report: *Good Governance Plus: In Pursuit of Gross National Happiness*. The main proposals that emerged from the process include:

- Enacting several pieces of enabling legislation before 2008, such as an Election Act, a Public Election Fund Act, a Civil Service Act, a Local Government Act, an Anti-Corruption Act, an Audit Act, an Attorney General Act, an NGO Act, a Property Act, a Contract Law, a Public Finance Act, a Labor Act, as well as preparing Rules of Procedure for Parliament (including a Code of Conduct for Parliamentarians).
- Clarifying the functions and mandate of government institutions, and sharpening accountability mechanisms.
- Integrating the preparation of a Medium-Term Fiscal Framework (MTFF) into the budget process, and using the MTFF to underpin the 'Alternative Planning Framework' that is to bolster the links between the setting of goals and projections of resource availability.
- Using an open and competitive selection process for the post of CEO in state owned enterprises. This recommendation has already become effective.
- Establishing a single window system to improve public service delivery.
- Fostering an independent media, strong civil society organizations, and greater use of information technologies, in order to increase the transparency and accountability of the government and underpin anti-corruption efforts.

Vision 2020 and the Ninth Five-Year Plan

12. Bhutan's distinctive approach to development is guided by the overarching notion of Gross National Happiness (GNH), propounded by the King in the late 1980s. It is based on four pillars: the promotion of equitable and sustainable socio-economic development, the preservation and promotion of cultural values, the conservation of the natural environment, and the establishment of good governance. The GNH development philosophy emphasizes the importance of balancing material, spiritual, emotional and cultural well-being as elements that together bring happiness to the individual.

13. These aspirations are further articulated in the document *Bhutan 2020: A Vision for Peace, Prosperity and Happiness*, which was prepared in 1999 through a highly consultative process involving representatives from the RGoB, the private sector, the non-governmental organizations, and the community. It seeks to translate the notion of GNH into a series of national objectives emphasizing: (i) human development, (ii) cultural heritage, (iii) equitable development, (iv) good governance, and (v) environmental conservation. Similar to the enunciation of the Millennium Development Goals (MDGs), *Bhutan 2020* also lays out several long-term targets, such as providing electricity to 50 % of the rural population, or ensuring that 75 % of the rural population live within half a day's walk from the nearest motorable road by 2012. The development path is further elaborated in sectoral policies, strategies and programs through the planning process, most recently the Ninth Five-Year Plan (2002/03–2006/07, also Bhutan's Poverty Reduction Strategy paper). The Ninth Plan sets more detailed targets, which are consistent with the MDGs, such as lowering the infant mortality rate from 60 per 1,000 live births in 2003, to below 30 in 2007.

Box 2: The Ninth Five-Year Plan (2002/03-2006/07)

The Ninth Plan has five overall goals:

- Improving quality of the life and income, especially of the poor.
- Ensuring good governance.
- Promoting private sector growth and employment generation.
- Preserving and promoting cultural heritage and environmental conservation.
- Achieving rapid economic growth and transformation.

The Ninth Plan has four strategies for achieving these goals:

- **Infrastructure Expansion:** High priority is given to expanding infrastructure, including roads, electricity (15,000 additional rural households are to be electrified during the Ninth Plan period), and telecommunications. Access is a major issue, especially in rural areas.
- **Sound Macro-economic Policy:** In order to sustain strong economic growth, the Plan aims to limit the current budget deficit at 2-3 percent of GDP, and inflation to around 7-8 percent per annum. In general, the RGoB seeks to meet recurrent expenditures with domestic revenues, an objective that until 2003/04 was successfully met. An important monetary and fiscal policy goal is to foster an expansion of bank lending to the private sector at competitive interest rates. The RGoB is also targeting an adequate level of reserves, and a sustainable path for public debt.
- **Ensuring Good Governance:** The Ninth Plan emphasizes good governance through increased decentralization. The *Dzongkhag* and *Gewog* elected councils are to have the autonomy to make plans, allocate resources, and frame rules and regulations applicable within their respective jurisdictions. To enable financial decentralization, the plan allocates separate budgets for activities, which will be directly formulated, approved and executed at the *Dzongkhag* and *Gewog* levels. The drafting of a constitution is also an important part of the governance initiative.
- **Improving Access and Enhancing Social Services:** A high priority is given to improving access for the rural population to opportunities and services. Hence, the Ninth Plan aims to foster rural development by expanding rural road infrastructure, modernizing agriculture, improving access to markets, and creating opportunities in agro-business, horticulture, and small-scale handicraft industries. In addition, access to primary education, primary health care and safe water and sanitation is to be expanded.

Source: Ninth Plan Main Document (2002-2007), Planning Commission, Royal Government of Bhutan pp 49-50.

14. The planning process in Bhutan has traditionally followed a very consultative process, and the Ninth Plan draws upon 201 *Gewog* (or block) plans, 20 *Dzongkhag* (district) Plans, and numerous sectoral plans, which were compiled into the main document of the Ninth Plan. The RGoB seeks to decentralize the functions of government, and the main document focuses on programs that require national (inter-*Dzongkhag*) coordination, and special resources and technical expertise; the *Dzongkhag* plans are to implement programs that require inter-*Gewog* coordination; the *Gewog* plans are to implement programs at the local level, such as the construction and maintenance of farm roads, health posts, local schools, suspension bridges, or mule tracks, depending on the capacity of the local community. The main objectives of the Ninth Plan, which are a variant of those outlined above, and the strategies for achieving these objectives, are described in Box 2 above.

15. These priorities are reflected in the sectoral allocations of the Nu. 70 billion Ninth Plan, which allocates 10 percent of total spending to roads, and 24 percent of expenditure to health and education. As discussed in greater detail in Section 5 on macroeconomic and fiscal management below, implementation would benefit from strengthening the links between the annual budgets and the Ninth Plan, for example by following through on the RGoB's stated intention of preparing rolling budgets.⁵ The Ninth Plan has been extended by one year to June 2008, in order to coincide with the scheduled taking office of a new government.

16. As noted above, the Good Governance Plus deliberations initiated a process for changing the approach to planning in Bhutan, through the 'Alternative Planning Framework' (APF). The main objectives of developing the APF are to: (i) strengthen the links between goals, strategies, and budgets, (ii) bolster outcome monitoring of the plan, (iii) accommodate the award of annual grants to local governments (as mandated by Article 22 of the draft Constitution), and (iv) ensure fiscal discipline and sound PEM over the medium-term through the political transition. Hence, the APF envisages substantial institutional changes, including using the MTFE as a starting point to provide a realistic overall resource envelop. While the APF is still a work in progress, the RGoB plans to adopt some of the recommendations and approaches developed through the Good Governance Plus discussions and the APF to prepare the Tenth Plan, due to commence in the second half of 2007. These efforts provide a clear articulation of the RGoB's goals and strategy for reducing poverty, as well as a commitment to meeting the development challenges faced by the people of Bhutan.

Poverty and the Millennium Development Goals

Poverty

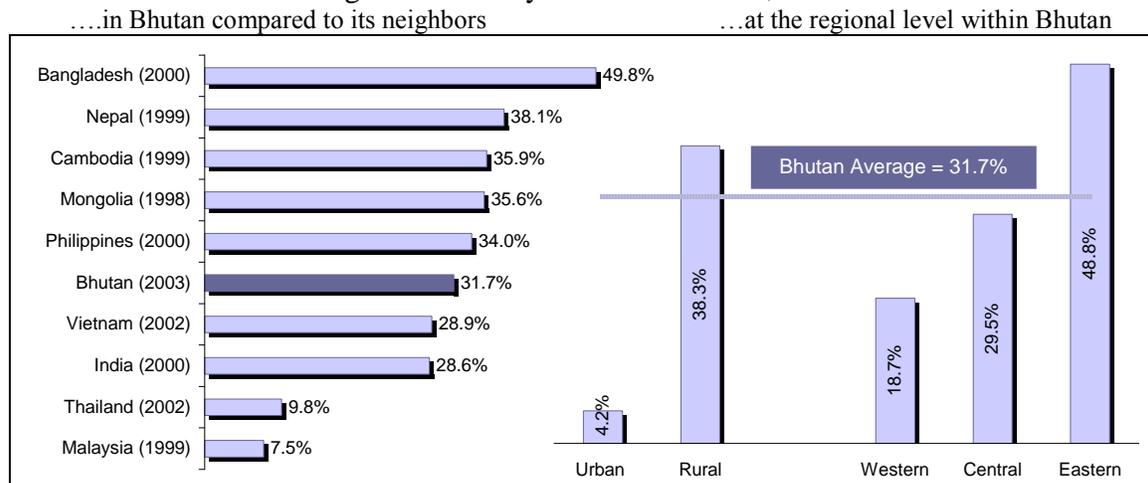
17. The people of the Bhutan have made significant progress in human development over the last two decades, and are broadly on track to meeting the MDGs. Sustaining this trajectory will depend on the effective management of macroeconomic and fiscal issues

⁵ Financial Rules and Regulations 2001 (FRR-2001), RGoB, Ministry of Finance.

(especially the net impact of the coming on stream of Tala), and on accelerating private sector development.

18. Significant data limitations continue to hamper accurate monitoring and evaluation, but available data generally point to positive trends.⁶ The first attempt to measure and analyze poverty more systematically at the household level did not take place until the pilot Household Income and Expenditure Survey (HIES) of 2000. The effort was expanded in 2003 with the Bhutan Living Standard Survey, which was a nationwide survey of households using the Living Standards Measurement Study (LSMS) methodology developed by the World Bank. The results of these surveys are not strictly comparable, but they suggest that poverty declined over the period. The most recent poverty profile is the report, *Poverty and Inequality in Bhutan*, based on the data collected through the BLSS in 2003 (with the support of the Asian Development Bank). It establishes a poverty line at Nu. 740.35 per person per month (about US\$0.53 per day), and was constructed using both food and non-food components, based on levels of consumption needed to meet basic needs. With this poverty line, the RGoB estimates that 31.7 percent of the population is poor, overwhelmingly in rural areas. While different methodologies and poverty lines raise questions of comparability, the findings of the BLSS suggest that poverty has fallen substantially since 2000. The HIES (2000) estimated an upper poverty line of 748.10 and found an incidence of poverty of about 36.3 percent. Sensitivity analysis on the BLSS poverty line shows that when the poverty line is raised to Nu. 750, the incidence of poverty rises slightly to 32.6 percent, still substantially below the HIES estimates. The findings also suggest that the incidence of poverty is 9 times higher in rural areas than in urban settings, 38.3 percent compared with 4.2 percent, and that about 97.4 percent of the poor live in rural areas. This disparity

Figure 2: Poverty Headcount Rates, 2003



Source: *Bhutan Poverty Analysis Report, 2004*.

⁶ The RGoB is making efforts to strengthen the statistical base, supported by international development partners, including the World Bank. The publication of the census in 2006 represents a major step forward.

partly reflects data limitations in adjusting for differences in the cost of living between urban and rural areas.⁷ With continued urbanization, it will be increasingly important for the RGoB to increase the accuracy of the adjustments. At the regional level, the East is the poorest part of Bhutan.

19. The report also estimates inequality based on the BLSS data. The calculated Gini coefficient, a measure of inequality ranging from 0 (perfect equality) to 1 (perfect inequality), is relatively high at 0.42 in 2003. It also appears to be growing, when compared with estimates of a Gini coefficient of around 0.36 presented in the HIES 2000 (difficulties with the comparability of the two surveys notwithstanding). This is higher than in India or Bangladesh, where the Gini coefficient was estimated at about 0.32 in 2000.⁸

20. The BLSS provides information on the characteristics of the poor, as described in the report, Poverty and Inequality in Bhutan. Compared with the non-poor,

- Poor households tend to be larger, with higher dependency ratios.
- Poor households are more likely to be headed by women.
- School enrollment is lower among children from poor households (where the inability to afford associated schooling costs, the need to work, and the distance to the school were the main deterrents to participation).
- Educational attainment among poor adults over 25 years of age is substantially lower (75 percent of all household heads have had no formal schooling, and this figure rises to 93 percent for poor, rural household heads).
- Poor households tend to be engaged in agriculture (95 percent of the rural poor), much of it subsistence, with little non-farm income.
- The urban poor tend to be migrants and day laborers.
- Access to safe water, electricity and basic facilities is much more limited for the poor.

In general, poverty is high in remote areas, where difficult terrain and climatic conditions constrain productivity as well as access to roads, markets and basic services. Education is also found to be a very important determinant of poverty in Bhutan.

21. The RGoB remains committed to poverty reduction and is engaged in an ambitious program of expanding the reach of public services. This is reflected in the high share of spending dedicated to capital expenditure in sectors like education and health. As these sectors typically require substantial subsequent recurrent spending in order to fully utilize and maintain the newly created assets, additional revenue sources such as Tala will be central to underpinning the sustainability of these programs. It should be noted that difficult geography and the dispersion of the population sharply raises the unit cost of public service provision. For example, it is difficult to improve maternal mortality rates, if women are giving birth unassisted by a qualified health care

⁷ The Poverty Analysis Report: Bhutan does compute Paasche regional price deflators, including for urban and rural areas. Data is only available for food, however, when the biggest differences in cost of living are likely to be in other areas like housing and rent. Hence, the urban and rural price deflators may be unduly close, overstating the disparity in the incidence of poverty in rural areas compared with urban centers.

⁸ World Development Indicators, August 2004.

professional, in a village several days walk from the nearest road. Indeed, the extensive reach of such initiatives as child immunization programs is remarkable, given the terrain and the challenges of access.

The Millennium Development Goals

22. While data limitations continue to be an issue, the *Millennium Development Goals Progress Report 2005* published by the RGoB at the end of the 2005 finds that Bhutan is likely to achieve most of its MDGs by 2015 (see Table 1). Three of the targets have already been achieved:

- Under the first goal of eradicating extreme poverty and hunger, the percentage of under-weight under-five children in 2000 was already less than half of the 1990 estimated indicator value.
- Under the seventh goal of ensuring environmental sustainability, the proportion of the population without access to improved water and sanitation has fallen to less than a third of its 1990 values.

Table 1: Millennium Development Goals: Bhutan's Progress and Remaining Challenges

Millennium Development Goal	Indicator to measure progress	Value of indicator in 1990	Value of indicator in 2000	Value of indicator in 2003 or 2004	Year 2015 target	Likelihood of Attainment
<i>(In percent, unless otherwise noted)</i>						
1. Eradicate Extreme Poverty and Hunger	Population below poverty line	52	36	32	26	Likely
	Underweight children under 5 years of age	38	19	-	19	Achieved
	Stunted children under 5 years of age	56	40	-	28	Likely
2. Achieve Universal Primary Education	Gross primary enrollment	55	72	84	100	Possible
	Pupils starting grade 1 who reach grade 7	35	81	86	100	Likely
	Pupils starting grade 1 who reach grade 5	73	91	94	100	Likely
3. Eliminate Gender Disparity in Education	Primary Education: Girls per 100 boys	69	82	95	100	Likely
	Secondary Education: Girls per 100 boys	43	78	96	100	Likely
	Tertiary Education: Girls per 100 boys	12	41	53	100	Unlikely
4. Reduce Child Mortality	Under-five mortality rate (per 1,000 live births)	123	84	-	41	Likely
	Infant Mortality Rate (per 1,000 live births)	90	61	-	30	Likely
5. Improve Maternal Health	Maternal Mortality Ratio (per 100,000 live births)	560	255		140	Likely
	Births attended by skilled health personnel	15	24	32	100	Unlikely
6. Combat HIV/AIDS, malaria and other diseases	Reported Tuberculosis Cases	4232	1140	1002	0	Likely
	Reported Malaria Cases	22126	5935	2760	0	Possible
7. Ensure Environmental Sustainability	Population without access to safe water	55	22	16	28	Achieved
	Population without access to improved sanitation	33	12	7	18	Achieved

Notes: The likelihood of attaining the MDGs is based on linear projections from available time series data (the HIES and BLSS for poverty, the National Health Survey for health, the Education MIS for education, and other data as presented in the *Millennium Development Goals Progress Report 2005* prepared by the Department of Planning, RGoB). The MDG analysis reported here is based on piecing together available data through linear trend analysis. Officially, the MDGs are set in terms of targets for 2015 relative to the attainment levels of 1990. In order to get the 1990 value of an indicator for Bhutan, linear extrapolation is used from actual available data. The 2015 target is then estimated from the extrapolated figure for 1990. This is compared with the predicted value of an indicator for 2015 from its actual linear trend. Thus, the actual path is compared to the MDG target path to judge whether Bhutan is on track to achieve an MDG target. More rigorous analysis is constrained by the lack of data. For more information, see "Poverty and Human Development in Bhutan: Past Achievements and Future Challenges," World Bank Note, October 2005.

23. The review indicates that the RGoB needs to focus more attention in two areas if these are to be met by 2015:

- Under the third goal of promoting gender equality and empowering women, the ratio of females to males in tertiary institutes is improving more slowly than the trajectory needed to reach 100 percent in 2015,
- Under the fifth goal of improving maternal health, the percentage of births attended by skilled personnel is rising slower than would be needed to reach 100 percent by 2015.

It is worth again emphasizing the challenges posed by geography. For example, with many births occurring in remote areas, some that are several days walk from the nearest motorable road let alone a hospital, it is often too late to access needed birthing services when complications arise. Given these circumstances, Bhutan's overall development progress has been impressive.

24. In addition to assessing the current status of the MDGs, the review also identifies areas where targeted policy interventions would have a strong impact. Expanding the road network, including feeder roads, will be central to improving the access and opportunities of the rural poor. Reducing the incidental expenses associated with sending children to school will be a key component of efforts raise retention and enrollment rates for better educational attainment. Expanding access to Emergency Obstetric Care (EOC) services, reducing maternal anemia, and increasing the share of deliveries attended by skilled health personnel will be essential if the MDG on Maternal Mortality is to be reached. The RGoB remains committed to following up on the findings of the report and galvanizing stakeholders for continued effort to meet the MDGs.

3. Recent Economic Developments

25. Over the past two decades, Bhutan has enjoyed strong economic performance, with economic growth averaging over 7 percent a year. This section provides an update on the Bhutanese economy, analyzes the policies that helped generate the positive trend, and makes several policy recommendations.

Real GDP Growth and Prices

26. With the deceleration in the rapid pace of expansion in the electricity and construction sectors, economic growth slowed slightly in 2004/05 to 6.8 percent, compared with 7.3 percent in 2003/04 and 7.9 percent in 2002/03 (Table 2). Sustained growth raised nominal GDP to US\$ 793 million in 2004/05.

Table 2: GDP Growth and Prices

	2001-02	2002-03	2003-04	2004-05
			<i>Prov. Est.</i>	<i>Prov. Est.</i>
	<i>(Annual percentage change)</i>			
Real GDP	8.2	7.9	7.3	6.8
Primary	4.1	2.9	2.6	2.4
Agriculture (Crops)	3.4	2.9	2.5	2.0
Livestock	5.4	2.5	1.9	1.9
Forestry	3.6	3.7	3.8	3.6
Secondary	14.8	9.5	5.7	7.0
Mining	13.4	8.0	-1.7	-1.2
Manufacturing	2.2	4.4	5.6	4.8
Electricity	6.2	4.7	4.6	5.4
Construction	28.3	14.9	6.9	9.4
Tertiary	4.9	9.9	12.2	9.3
Trade & services	11.2	15.5	21.3	14.6
Transport, storage, and communication	5.9	4.6	11.9	14.1
Financial, insurance and real estate	-5.3	3.4	12.5	5.2
Government services	5.9	8.7	3.9	3.3
Consumer prices	2.7	1.8	3.5	3.7

Source: NSB, Selected Economic Indicators, December 2005, RMA, and staff estimates.

27. On the expenditure side, the public sector remains a key driver of growth. Large revenues from external donor assistance and hydropower sales to India flow through the government, and public investment (like in hydropower projects) and spending on the provision of public services plays a central role in ensuring the continued buoyancy of the economy. State owned enterprises (with varying levels of private participation) also account for a significant portion of GDP (roughly 16 percent in 2004-05).

28. Government investment rose by over 40 percent in 2004/05 compared with the previous year, partly driven by the large cost of purchasing two new DrukAir planes. The RGoB also expanded facilities in the education and health sectors, and undertook other capital spending projects in power, roads, and telecommunications. Private

investment has also been buoyant, with large investments in the construction sector, fueled by the rise in credit to the private sector. Current expenditure also grew strongly in 2004/05, as a pay increase was implemented and the RGoB endeavors to deliver high quality and expanding public services.

29. Central government spending, investment in Tala (which is off-budget), expenditure by State Owned Enterprises (SOEs), and small amounts of spending at the sub-national level (often contributions in kind), taken together may lift public spending as a percentage of GDP to over 70 percent. As will be elaborated below, crowding out does not appear to be a major issue in Bhutan, however, as net credit to the central government has consistently been negative. Generous donor support and revenue from the sale of hydropower has enabled the RGoB to be a net contributor of liquidity into the financial system. Still, interest rates remain high, with spreads between deposit and lending rates ranging between 5 and 11 percent. With the purchase of the aircraft, net exports were negative and large in 2004/05 (the current account deficit widened to almost 24 percent of GDP), but the external sector is having a less contractionary effect in 2005/06.

30. On the supply side, GDP growth has been driven largely by the construction and electricity sectors, and the small slowdown in GDP growth in 2004/05 compared with the previous year is largely attributable to these components. Building has been spurred by government investment in roads, schools, urban development, and other infrastructure, as well as private investment in housing and several new hotels. Still, with the winding down of the Tala construction project, which at its peak accounted for more than a quarter of construction activity, the sector is slowing. Electricity generation through run of the river hydropower plants, varies with the water levels in the rivers, and enjoyed very good years in 2003/04 and 2004/05. The growth in the sector will be more limited in 2005/06 as water levels return to normal. The share of the electricity sector in GDP has been stable at between 10 and 12 percent of GDP, but it is set to rise dramatically to about 25 percent of GDP once the Tala hydropower project comes on stream later in 2006. Total electricity generation capacity currently amounts to 437 megawatts, and Tala will have an installed capacity of 1020 megawatts, more than tripling power generation and sharply raising economic growth. Indeed, when the Chukha hydropower plant was activated in 1987, GDP also jumped by 17 percent.

31. Agriculture employs about 63 percent of the workforce, but accounts for less than 25 percent of GDP. Although some components of the agriculture, like horticulture are doing well, the sector overall has been growing slowly in recent years, leading to a decline in the sector's contribution to output. As discussed in more detail in Section 6 below, the tourism industry has been booming over the past two years. Despite being a comparatively small economic sector, accounting for around 2 percent of GDP, tourism holds significant growth and employment potential and is specifically highlighted in the Ninth Plan as a driver of growth.

32. The RGoB has undertaken a series of labor force surveys, and the most recent *Bhutan Labor Force Survey 2004*, suggests that unemployment rose from 1.8 percent in 2003/04 to 2.5 percent in 2004/05 (though the survey results are not strictly comparable).

Furthermore, the 2005 census indicates that unemployment was 3.1 percent in that year. The data may understate unemployment since most workers are not covered by formal contracts, and underemployment may be a significant issue in remote areas. With increasing cohorts of school leavers, there is growing concern about unemployment in the coming years, and the impact of labor market rigidity on the evolving employment picture. In order to address some of these issues, the RGoB seeks to implement labor market reforms that strike an appropriate balance between the legitimate protection of workers and the need for labor market flexibility, as described in more detail below in Section 7.

33. The calculation of the consumer price index (CPI) was significantly revised in 2004/05 to broaden the consumer basket to include more items, and to change the weights based on the findings of the 2003 BLSS. As a result, there is a break in the series. Data issues notwithstanding, the CPI rose by 4.9 percent in 2005 over the previous year, led by housing, utilities and food. Higher world prices for petroleum products are raising the CPI mainly through its indirect effect on other imported products. Prices in Bhutan broadly follow trends in India, and the Indian Wholesale Price Index increased by about 5.0 percent over the same period. As noted above, the Bhutanese ngultrum is pegged to the Indian rupee, and policy makers remain wary of possible Dutch disease effects, in which higher relative inflation in Bhutan would lead to a real effective appreciation of the ngultrum and a concomitant loss of competitiveness. The rate of inflation in Bhutan has remained close to that in India, and Dutch disease effects have not been manifest in recent years.

Balance of Payments and External Debt

34. The current account deficit widened sharply from US\$55 million in 2003/04 to US\$190 million in 2004/05, equivalent to about 24 percent of GDP (Table 3). The larger deficit was mainly the result of the jump in imports as a result of the purchase of the Airbus for DrukAir. Hence, the deficit is likely to narrow substantially this year. Two features of the balance of payments stand out: (i) the share of imports and exports in GDP is high, far beyond any of the other countries in the region and exceeding 75 percent of GDP in 2004/05, and (ii) convertible currency balances have been negative for some years. The high level of trade is driven by the small scale of the Bhutanese economy, where much is imported (financed in large measure by grants), and there has not been a felt need to protect domestic manufacturing with tariffs and the like. Given that the rupee is not convertible, the negative hard currency balance has meant that the availability of foreign exchange for the import of goods from countries other than India may at times be limited. As discussed in greater detail below, the currency peg with the Indian rupee generally serves Bhutan well, but may be a factor constraining the diversification of trade with other countries.

35. Export receipts grew strongly in 2004/05, rising by 18 percent to reach US\$186.0 million in 2004/05. About 94 percent of Bhutan's exports go to India, mostly electricity, and a further 5 percent of exports are accounted for by Bangladesh, mostly vegetables and fruits, as well as mineral products. Although other exports have also risen, especially

processed agricultural goods, the rise in exports was largely the result of electricity sales, which benefited from the power tariff increase from Nu. 1.5 to Nu. 2.0 per unit (effective from January 1, 2005), as well as unusually high water levels powering the run-of-the-river hydroelectric plants. The share of total exports going to India has been stable at about 94 percent over the previous five years, and these trends are likely to have continued into 2005/06, given the continued good performance of the power sector. The predominance of electricity exports will be amplified further by the coming on stream of the Tala hydropower project in mid-2006, as described in greater detail in Section 5.

Table 3: Summary Balance of Payments

	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
	<i>(In millions of U.S. dollars)</i>						
Current account balance	9.0	-43.3	-26.4	-48.3	-67.0	-55.4	-189.8
Trade balance	-57.6	-70.7	-70.3	-82.9	-76.8	-87.3	-224.5
Exports, f.o.b.	104.7	114.3	99.5	103.6	112.8	157.6	186.0
Of which to India	98.2	109.3	94.4	97.5	106.3	149.1	169.8
Imports, c.i.f.	-162.3	-185.0	-169.8	-186.5	-189.6	-244.9	-410.6
Of which from India	-115.5	-139.0	-160.9	-145.0	-171.2	-215.6	-226.9
Of which related to Tala	-26.2	-33.9	-29.4	-11.8	-37.3	-45.7	-37.1
Services (net)	-0.3	-11.4	-4.0	-4.5	-16.7	-8.0	-10.1
Income (net)	9.6	-3.9	2.6	-4.9	-11.4	-16.3	-16.6
Current transfers (net)	57.3	42.7	45.3	44.1	37.9	56.2	61.5
Credit	121.3	88.1	87.2	91.7	91.1	107.1	135.8
Of which grants	120.8	83.3	80.0	85.6	84.7	94.4	122.7
Of which India	89.5	58.4	55.0	59.3	30.1	50.9	68.8
Of which budgetary grants	45.3	50.1	55.0	52.5	18.5	50.4	58.9
Debit	-64.0	-45.3	-41.9	-47.7	-53.2	-50.9	-74.3
Non-monetary capital (net)	27.0	41.1	30.8	103.1	225.9	178.9	214.7
Of which foreign direct investment	1.1	-	-	2.1	2.5	3.5	9.0
Foreign aid (loans, net)	33.0	41.1	49.8	59.0	94.5	102.8	77.7
Net errors/omissions.	7.3	37.4	0.7	-29.0	-104.4	-115.3	7.7
Overall balance (change in reserves)	43.4	35.1	5.1	25.8	54.5	8.1	32.7
Memorandum items:							
External debt (millions of US\$)	150.3	173.8	236.9	290.9	413.1	515.4	608.7
Of which Tala		33.7	76.3	108.1	178.2	259.4	328.0
External Debt (as a percentage of GDP)	38.3	39.9	51.1	56.9	71.4	75.2	77.8
Of which Tala (as a percentage of GDP)		7.7	16.4	21.2	30.8	37.8	41.4
Debt service (millions of US\$)	14.1	6.5	6.2	6.1	7.6	9.8	12.0
Debt service (% exports, goods, NFS)	11.5	4.9	4.7	4.6	5.5	5.2	5.2
Exchange rate (ngultrum/US\$)	42.59	43.64	46.39	48.21	47.93	45.41	44.61

Source: Statistical Year Book 2004, NSB, Selected Economic Indicators, December 2005 RMA, and staff estimates.

36. The value of imports (c.i.f.) jumped by 68 percent in 2004/05 over the previous year, in large part due to the purchase of the two new airplanes noted above. These were valued at about US\$78 million, accounting for 18 percent of total imports and equivalent to almost 10 percent of GDP. Other imports also grew strongly, spurred by items related to the development of the Tala hydropower project, including base metal and mineral products. The share of Bhutan's imports coming from India fell to about 55 percent in 2004/05 due to the purchase of the airplanes (which came from Europe), but it is likely returning to more normal levels this year, exceeding 75 percent.

37. The tourism sector has been very dynamic over the past two years, with arrivals surging by 47 percent in both 2004 and 2005 and reaching 13,626 in the latter year. Tourism receipts increased slightly faster, reaching \$18.5 million in 2005, and are the

second largest source of convertible currency after grants. The RGoB expects tourism arrivals to rise to 15,000 by the end of 2006, and the purchase of the two new Airbus jets was an important step, expanding capacity by over 40 percent over the previous two planes (which are to be sold). The sector holds much potential, but the RGoB will need to resolve several constraints as well as find an appropriate balance between seeking to foster further tourism development and maintaining the balance it places at the core of GNH. Some of these issues are discussed in greater detail in Section 6 below.

38. Total grants (including non-budgetary grants) rose from US\$94.4 million in 2003/04 to US\$122.7 million in 2004/05, mainly as the GoI increased its grant support from US\$50.0 million to US\$68.8 million. These grants do not include the grant portion of Tala, which amounted to another US\$39.7 million, also from the GoI. This external support is further augmented by other capital transfers, mainly equipment in kind, which are captured below the line in financing, and amount to US\$93.3 million. Taken together, these items exceed US\$314.6, or about 42.7 percent of GDP, one of the highest proportions in the world. Indeed, total grants cover much of the import bill, and remain a key part of the macroeconomic picture in Bhutan.

39. The large current account deficit was largely financed by donors, who provided official medium and long-term flows of foreign aid amounting to US\$77.7 million, continuing to underpin the development of hydropower, roads, education, and other key RGoB initiatives. This figure is US\$25.1 million lower than the previous year, but is largely because Tala disbursements are falling as the project nears completion. FDI rose from the US\$2-3 million range in 2002-2004, to US\$9.0 million in 2004/05, helped by the passage of the FDI Act in 2002 which clarifies the investment climate faced by external investors. FDI is attracted into the tourism sector to finance the construction of new hotels and resorts. Combined with other components, including the significant capital transfers mentioned above under grants, these flows permitted an increase in official reserves to US\$417.9 million in June 2005, which rose further to US\$511.7 at the end of 2005. Despite the increase in reserves over the past few years, imports have been growing faster, and the surge in imports in 2004/05 lowered the import cover from the equivalent of 23.5 months of imports in 2002/03 to 12.2 months of imports in 2004/05. This is close to the 12 month minimum of import cover of reserves stipulated in the draft constitution, but is likely to rise again with the coming on-stream of Tala, as described below.

40. With the adoption of the ambitious Ninth Plan aiming to accelerate development, the RGoB has availed itself increasingly of foreign as well as some domestic loans. External debt consists exclusively of medium and long-term government or government guaranteed borrowings, and continues to rise sharply with the development of Tala and government spending to expand public services in rural areas. It rose to US\$608.7 million at the end of June 2005, which is equivalent to about 77.8 percent of GDP, compared with 39.9 percent of GDP five years ago in 1999/2000. The bulk of the increase, however, is associated with the development of Tala, which continues at an annual expense of almost 10 percent of GDP per year. The project is being financed by India, 60 percent in grants, and 40 percent in loans at 9 percent interest (repayable in 12

years). The loan portion of the project now accounts almost half of Bhutan's external debt stocks, and India is Bhutan's largest foreign creditor. It is worth noting that the purchase of one of the two Airbus passenger jets for DrukAir alone raised external debt stocks by US\$38.6 million (the other was financed domestically), and was contracted on commercial terms. Overall, most of Bhutan's external debt is concessional, however, and the debt service ratio has remained stable in the 5 percent range for the past 5 years.

41. Domestic debt has grown with the issuance and subsequent rolling over of bonds, as well as the financing of the second DrukAir plane through the provident fund, and reached US\$51.6 million in 2004/05. The development of domestic financial instruments is a positive step, and is an indication of the deepening of the Bhutanese financial market. This will also help the Royal Monetary Authority (RMA) manage liquidity going forward.

42. Overall, the debt picture that emerges from a snap-shot of key indicators suggests a high level of indebtedness and growing risk (qualifying Bhutan for 100 percent grant support from IDA in 2005/06). However, this does not reflect that the borrowing financed accelerated development and the creation of productive investments, including the massive (more than 100 percent of GDP) Tala hydropower plant, which when commissioned later in 2006 will dramatically alter the debt situation. Debt sustainability analyses (DSA) undertaken by the IMF in the 2005 Article IV consultations suggest that debt stocks will peak at about 90 percent of GDP in 2005/06 before falling again sharply, assuming Tala is commissioned in 2006 and that no new major hydropower projects are started. The revenues from Tala will depend on the power tariff currently under negotiation with the GoI, but the recent increase in the rate agreed for power exports from Chukha suggest that the rate is likely to be between Nu. 1.75-2.0 per unit. As will be elaborated below, a key issue will be the timing of Tala coming on stream and the net impact of Tala revenues.

43. The RGoB is endeavoring to monitor these issues more closely and in greater depth going forward. Through the preparation of MTFs, Tala is being explicitly included multi-year budgets. The RGoB has acquired new debt management software that will soon enable the preparation of periodic DSAs and fiscal sustainability studies. Volatility remains a major concern, where items like the purchase of airplanes, or the timing of Tala, have a large impact on the macroeconomic and fiscal picture. It would be prudent for the RGoB to implement mechanisms for moderating this volatility, and thereby also mitigate vulnerability.

4. Macroeconomic Policy

44. Prudent macroeconomic management has underpinned strong economic performance over the past 20 years. The macroeconomic landscape hinges on the close links with India, involving budget support grants (equivalent to 25 percent of total revenue and grants in 2004/05), a fixed exchange rate with the Indian rupee (resembling a currency board arrangement), a free trade agreement with India (accounting for over 90 percent of Bhutan's foreign trade), and the exploitation of hydropower for sale to India. These features shape the policy environment, and also constrain the ability of the RGoB to pursue independent policy.

Fiscal Policy

45. In recent years, the fiscal deficit has been the equivalent of 4-10 percent of GDP, but volatility is a major issue. The 2006/07 budget was presented to the National Assembly in June 2006, and envisages a reduction in the overall deficit from 7.4 percent of GDP in 2005/06, to about 3.2 percent in 2006/07 (Table 4). The RGoB outlined several broad fiscal objectives in the Poverty Reduction Strategy Paper (completed in July 2004) :

- Limit government expenditure to less than 40 percent of GDP.
- Reduce the overall budget deficit to no more than 4 – 5 percent of GDP.
- Devote about 55 percent of total spending to capital expenditure, financed through external assistance, largely grants.
- Finance recurrent expenditures from domestic revenues.

Meeting these objectives is a challenge, however, and in 2003/04, 2004/05, and 2005/06, the RGoB was unable to meet its long held objective of covering recurrent expenditures through domestic revenues. Although the 2006/07 budget generally meets the above fiscal objectives, the RGoB's MTFE (also presented in Table 4) shows that domestic financing is becoming increasingly important in covering the budget deficit, including net withdrawals from the Ways and Means Account (W&MA) held with the Bank of Bhutan, reducing the amount of net liquidity injected into the financial system by the RGoB. The MTFE projects a smaller expansion in the resource envelope associated with the coming on-stream of Tala than is widely expected, and will serve as an important tool to help manage expectations. The MTFE is also central to RGoB efforts aimed at ensuring an appropriate composition of deficit finance, between project-tied external resources and budget support / domestic borrowing.

46. While maintaining a balanced budget or even a surplus during times when adverse shocks are not manifest constitutes an important vulnerability mitigation measure, the RGoB has embarked on ambitious government programs in an effort to accelerate development and extend public services. Part of the cost of this strategy is higher volatility in expenditure, when there are unexpected revenue shortfalls.

Table 4: Summary of Central Government Finance and Medium-Term Fiscal Framework

	2001-02	2002-03	2003-04	2004-05	2005-06 <i>Prov. Est.</i>	2006-07 <i>Budget</i>	2007-08 <i>Proj.</i>
<i>(In millions of ngultrum)</i>							
Total revenue and grants	8848.5	7054.3	10422.6	10439.2	13191.3	16356.7	16526.8
Expenditure and net lending	9910.2	9842.1	9795.8	12697.8	16151.8	17901.7	18162.6
Current balance	632.1	204.4	-94.0	-104.5	-393.0	2159.9	2634.2
Overall balance (excluding grants)	4810.2	-5056.9	-4740.6	-6631.7	-9346.1	-7779.7	-6818.4
Overall balance (including grants)	-1061.7	-2787.8	626.8	-2258.6	-2960.5	-1545.0	-1635.8
Financing	1061.7	2787.8	-626.8	2258.6	2960.5	1545.0	1635.8
Of which foreign	1396.7	1537.3	932.1	1414.8	1054.4	-702.5	-273.7
Total public debt (end of period)	15049.1	21342.0	23737.5	28893.7	33529.7	35108.2	36937.1
Domestic	833.4	2137.0	625.1	2378.1	3753.1	4375.3	6227.7
<i>(In percent of GDP)</i>							
Total revenue and grants	35.9	25.4	33.5	29.5	33.1	33.4	30.3
Of which grants	15.2	8.2	17.2	12.4	16.0	12.7	9.5
Of which India	10.3	3.3	7.3	6.7	9.6	8.5	5.5
Expenditure and net lending	40.2	35.5	31.5	35.9	40.6	36.5	33.3
Current balance	2.6	0.7	-0.3	-0.3	-1.0	4.4	4.8
Overall balance (excluding grants)	-19.5	-18.2	-15.2	-18.7	-23.5	-15.9	-12.5
Overall balance (including grants)	-4.3	-10.0	2.0	-6.4	-7.4	-3.2	-3.0
Financing	4.3	10.0	-2.0	6.4	7.4	3.2	3.0
Of which foreign	5.7	5.5	3.0	4.0	2.6	-1.4	-0.5
Total public debt (end of period)	61.1	76.9	76.2	81.7	84.2	71.6	67.7
Of which foreign	57.7	69.2	74.2	75.0	74.8	62.7	56.3
Memorandum items:							
Nominal GDP (millions of ngultrum)	24635.7	27747.8	31142.6	35371.6	39829.7	49000.8	54526.0
Nominal GDP growth (percent)	14.5	12.6	12.2	13.6	12.6	23.0	11.3
Expenditure and net lending growth (percent)	-11.3	-0.7	-0.5	29.6	27.2	10.8	1.5
Revenue and grants growth (percent)	2.9	-20.3	47.7	0.2	26.4	24.0	1.0

Source: RGoB Annual Financial Statements 2003-04, Selected Economic Indicators, September 2005, RMA, National Budget - Financial Year 2005-06, June 2005 and staff estimates. The Medium Term Fiscal Framework was developed by the Macroeconomic Framework Coordination Committee of the RGoB, and presented to the Council of Ministers at the beginning of 2006.

Revenues and Grants

47. Total revenue and grants are estimated to have risen by 26.4 percent in 2005/06, after being flat in 2004/05. As discussed in Section 5 below, volatility remains a major concern. For example, grants rose by 136.5 percent in 2003/04, fell by 18.5 percent in 2004/05, and then rose by 46.0 percent in 2005/06. Budget data for 2004/05 show that about 73 percent of total revenues and grants are raised from four categories: grants (45.3%), Chukha hydropower (17.3%), the excise duty refund from GoI (5.1%), and the Bhutan sales tax (5.1%). Hydropower revenues are a central part of the resource envelope, and as noted above, the Chukha tariff was increased from 1.5 to 2.0 rupees per unit of power sold to India, effective January 1, 2005. This increase helped sustain revenues despite the significantly reduced power generation from Chukha due to lower water levels. Direct tax revenue has been relatively stable.

48. The RGoB needs to implement revenue broadening measures. The introduction of a personal income tax (PIT) in 2002 was a step in this direction, but the National Assembly passed large cuts in the PIT in 2003/4, and it accounted for less than 1 percent of total revenue and grants in 2004/05 and 2005/06, and its share is set to fall in the 206/07 budget. The RGoB may wish to try reducing revenue volatility, possibly by

creating a stabilization fund or seeking multi-year commitments from external donors. The ongoing effort to move to multi-year budgets would facilitate such efforts.

Expenditures

49. Total expenditure and net lending of the central government also shows a high degree of volatility. After several years of declines, expenditure and net lending increased by over 27 percent in both 2004/05 and 2005/06, and is to rise by around 10 percent in the 2006/07 budget. Much of this is driven by specific items, such as high power sector investments in 2000/01, and the purchase of aircraft in 2004/05. This is part of the reason why the RGoB has excluded the mega-project Tala from the Ninth Plan and the annual budgets. Even excluding power, however, volatility is a significant concern, also impacting high priority areas like education and health.

50. Expenditure prioritization is driven largely by the allocations determined through a highly participatory process in the Ninth Plan. In 2004/05, about 23.5 percent of spending was devoted to the social sectors (largely pro-poor spending to improve access to health and education services), followed by public works and roads receiving 14.9 percent, and agriculture accounting for 6.7 percent of total government expenditure. Spending on electricity (non-Tala) slowed last year to receive 3.6 percent of total spending, compared with a 30.7 percent share in 2000/01. The Ninth Plan also lays out decentralization objectives, with 75 percent, 21 percent, and 4 percent of spending to be channeled through the Center, the Dzongkhags (Districts), and the Gewogs (Blocks), respectively.

51. Spending volatility is also reflected in the pattern of spending between capital and recurrent expenditures. After several years of modest growth, current spending rose by 23.3 percent in 2004/05, mainly as a result of a major civil service pay increase (which was subsequently paid for in part by the higher tariff on Chukha power sales to India). Capital spending fell in 2003/04 by 12.4 percent, rose by 42.4 percent in 2004/05, and is estimated to have increased by another 34.6 percent in 2005/06. The 2006/07 budget sees more moderate growth of capital spending of around 10 percent. It is worth noting that large investments in schools and health facilities will require a substantial increase in recurrent spending to maintain and fully utilize the newly created assets, and Tala will be important in sustaining these ambitious government programs. Ongoing efforts to prepare multi-year budgets will be central to fully addressing the recurrent cost implications of capital spending.

Financing the Budget Deficit and Fiscal Sustainability

52. In the past, much of the financing for the budget deficit came from external donors in the form of concessional loans. In 2004/05 and 2005/06, however, the RGoB relied increasingly on domestic financing, and the 2006/07 budget anticipates a further large draw. The funds are raised through the use of overdraft facilities and the issuance of treasury bills. The Bank of Bhutan extends overdraft facilities to the government through the Ways and Means account (W&MA), and up until 2003/04, the accumulated

balances were small. In 2004/05 and 2005/06, the outstanding balances rose significantly, and they are likely to increase further in the coming years, with W&MA funds becoming an important part of the overall financing picture. Together with the Bhutan National Bank and the National Pension Provident Fund, the Bank of Bhutan also purchases treasury bills. The RGoB first issued Nu. 500 million in bills in 2001/02, and more were issued in subsequent years. With most of the outstanding bills rolled-over, the stock of bonds in 2004/05 reached Nu. 2.3 billion, equivalent to about 7.1 percent of GDP. As noted above, persistent budget deficits have led to some increase in public debt, but most of the debt is associated with the development of Tala, and is contracted on concessional terms.

The Medium Term Fiscal Framework

53. The RGoB has prepared an MTFF that has been refined through 4 iterations of the exercise between 2005 and early 2006, in a process described in greater detail below. The MTFF initiative represents a significant departure from past practice, and has generated several key messages. In particular, the expansion of the resource envelope over the MTFF period with the commissioning of Tala is likely to be significantly smaller than widely expected, because of high debt service and lower grants. The 40 percent loan portion of Tala is to be amortized over only 12 years, and Tala interest payments sum to about Nu. 1.3 billion, equivalent to about 8 percent of the 2005/06 total expenditure and net lending. The net gain from Tala to the treasury is estimated to be between Nu. 2-3 billion (depending on assumptions made), helping boost domestic revenue by about 48.7 percent. Concomitantly, however, the GoI plans to phase out its program grant from Nu. 1.75 billion in 2005/06, to Nu. 1.05 billion in 2006/07, to zero in 2007/08. While this is more than offset in 2006/07 through a bunching of activity financed by project-tied grants, total grants are expected to fall significantly in 2007/08. With continued expenditure growth to sustain ambitious government programs, this means that the RGoB expects a deficit of 3.2 percent of GDP in the boom year of 2006/07, and a similar sized deficit in 2007/08. As noted above, high capital expenditures in education and health presage increased recurrent expenditures, which will need to be substantially financed by Tala. The critical message from the foregoing is that the resource envelope is not growing as fast as expected, and any available fiscal space is being absorbed by the effort to sustain ambitious government programs. Hence, spending agencies, as well as donors and other stakeholders, need to manage their expectations.

54. The MTFF also highlights several key issues that will determine the fiscal position: the Tala tariff (which is still being negotiated), the date of commissioning, the forecast output level (90 percent dependable or average), and the level of excise duty refunds. The importance of these few factors underscores the volatility faced by the RGoB. The MTFF conservatively assumes a Tala electricity price of Nu. 1.75 per unit. If instead the price is set at Nu. 2.00 per unit (as is the current price of Chukha hydropower sales, but above the price of other hydro plants), then revenues rise by Nu. 1.0 billion, about 10 percent of total domestic revenue. Similarly, it remains uncertain whether Tala will be ready by July 1, 2006 (as assumed in the MTFF), and the Department of Power has suggested that the commissioning may be delayed by 6 weeks.

This seemingly small difference deprives Tala of peak generation time during the summer, lowering output by almost a quarter for the year as a whole, and reducing receipts by about Nu. 1.4 billion, or 14 percent of domestic revenue. There is also considerable uncertainty surrounding the water flow levels. Finally, the evolution of excise duty refund plays an important role. Each year, the RGoB seeks excise duty refunds from the GoI, but these are currently running with a lag of several years. With a view to reducing this lag, the RGoB had sought 2 years' worth of excise duty refund from the GoI, and in the 2005/06 budget. Instead, the RGoB received only one year's refund, lowering revenue by the equivalent to 6-7 percent of domestic revenue (two year's refund are again being sought in the 2006/08 budget). It is worth noting that any revenue shortfalls are likely to be met in part through recourse to domestic finance.

55. The overall fiscal picture that emerges from the discussion above is one that is dominated by four features: (a) smaller expansion in the resource envelope than widely anticipated with the Tala boom, (b) continued high volatility, (c) further reliance on external grants and loans, and (d) growing recourse to domestic finance. These aspects are likely to persist in the coming years, and the RGoB needs to strengthen efforts to mitigate their impact and reduce vulnerability. As described in more detail below, for example, implementing multi-year rolling budgets can help the RGoB anticipate gyrations in the resource envelope and take appropriate measures to lessen the impact of this volatility on expenditure and government programs, while ensuring fiscal sustainability.

Monetary and Exchange Rate Policy

56. The scope for independent monetary policy is sharply constrained due to the currency peg to the Indian rupee (resembling a currency board). Policy is aimed at managing liquidity at a level that is consistent with the maintenance of the peg, and currency in circulation is more than 100 percent backed by reserves. The inflow of hydropower revenues and aid is reflected in the build up of foreign assets, backing an expansion of domestic credit and at times leading to 'structural liquidity surpluses.'⁹ Claims on the central government (net) have been consistently negative, due to the excess liquidity flowing through the central government into the banking system. Much of this liquidity is then deposited in India, as there are apparently limited opportunities for holding ngultrum denominated assets in Bhutan.

57. With the elimination of credit controls, the RMA has increasingly relied upon indirect instruments to manage liquidity in the banking system, including the Cash Reserve Ratio (CRR) and the sale of central bank bills. The CRR has been adjusted several times over the past decade, most recently in March, 2004 when it was lowered from 20 percent to 13 percent of total deposit liabilities to ensure adequate liquidity for credit growth and investment. The issuance of short-term bills remains modest, with about Nu. 200 million in 91 day discount bills outstanding in mid 2005. Still, the bills are

⁹ The build up of 'structural liquidity surpluses' due to capital, aid, or commodity export boom induced inflows, is described in International Monetary Fund, 2004, *Monetary Policy Implementation at Different Stages of Market Development*.

an important part of efforts to deepen financial markets, and provide a frame of reference for interest rates.

58. Private sector credit has been growing rapidly in recent years, expanding by over 36.9 percent in 2004/05 compared with the previous year. Hence, despite persistent deficits and growing recourse to domestic finance, the private sector does not appear to be crowded out due to a lack of liquidity. Indeed, the RMA needs to carefully monitor both the rate of expansion and the quality of private credit to ensure that problems do not emerge in the banks' balance sheets. Still, the interest rate spread remains substantial, and smaller enterprises face difficulties in accessing credit, especially the longer term funds needed to finance investment. The high interest rate spread also indicates that there is scope for improving the efficiency of the financial sector.

59. The exchange rate system is unusual in that the ngultrum is pegged to the Indian rupee, a currency that is not fully convertible. It resembles a currency board, with reserves fully backing ngultrum in circulation, but not formalized *de jure*. The Indian rupee is also legal tender in Bhutan. A recent study suggests Bhutan meets some of the stylized criteria for currency union with India, and the IMF considers the regime broadly appropriate.¹⁰ As will be discussed in greater detail in Section 5, a recurring concern is the possibility of the emergence of a "Dutch disease" phenomenon and an attendant loss of competitiveness. To date, this effect does not appear to be manifest, but needs to be closely monitored to help mitigate vulnerability.

Trade policy

60. The scope for independent trade policy is also sharply constrained. Bhutan has a free trade agreement with India (since 1949), and over 90 percent of Bhutan's trade is with India. Bhutan also has a free trade agreement with Bangladesh covering certain product lines. With over 98 percent of Bhutan's trade covered by these trade arrangements, Bhutan is arguably one of the most open economies in the world. Average tariffs on imports from other countries are about 24 percent and there are 7 tariff bands, ranging from zero to 100 percent. The highest rates are applied to alcohol and tobacco products, as well as plastics to discourage their use for environmental reasons. The impact of these customs duties on trade is quite limited, however, since there are many exemptions, such as donor financed project procurement, imports of vehicles by senior civil servants (once every 7 years), and the US\$1,500 exemption on goods brought in by passengers arriving on DrukAir, for example. As a result of these factors, customs revenue is small – less than 0.5 percent of GDP.

61. The Bhutan Sales Tax (BST) is also a factor, being applied to all imports and the sales revenue from hotels, restaurants, and cement. Although in principle this does not constitute a protective measure, it does have an impact on trade, being levied mainly on tradeables. Indian exporters enjoy an advantage not available to exporters from other countries in that they are able to claim the BST as a rebate against the Indian sales tax liability, offsetting its effect.

¹⁰ 2004, Bhutan Studies.

62. Much of Bhutan's trading pattern is determined by geography, however, and the free trade arrangements with India appear to be serving Bhutan's development well. Still, the RGoB should be mindful of the possibility of trade diversion, with geography, the free trade agreement and BST refund arrangements for Indian exporters, and the currency peg combining to limit the possibilities of trade diversification with other countries. Measures that will help address this issue include the South Asia Free Trade Agreement (SAFTA) signed in 2004, and WTO accession (negotiations began in 2005). The RGoB is seeking to develop a "dry port" to lower transactions costs by enabling bonded shipment of goods through India. Eventual Indian rupee convertibility would also be helpful in this regard.

5. Architecture of Public Resource Management

63. A key challenge for the RGoB is to intermediate large financial resources from hydropower and donors into sustained development that also helps mitigate vulnerability. In the pursuit of these goals, the RGoB will need to concentrate efforts towards: (a) strengthening the budget preparation and implementation process, (b) avoiding the ‘natural resource curse,’ which can potentially impair governance, increase volatility, and induce ‘Dutch disease,’ and (c) pursuing sound policy on State Owned Enterprises (SOEs).

Strengthening the Budget Preparation and Implementation Process

64. The RGoB has embarked on a series of structural reforms aimed at improving the process of budget preparation, implementation, and monitoring, in order to help address significant fiscal challenges and opportunities. Strong fiscal management is especially important in the Bhutanese context, where the public sector (including state owned enterprises that have varying levels of private share ownership) spends around 70 percent of GDP, and continues to be the primary driver of the economy. In addition, the transition through Tala commissioning will need to be handled carefully, to ensure that stakeholders manage expectations appropriately, and that governance arrangements are adequate for the increased revenues.

65. A key part of the RGoB’s effort to change its budget process was the revision and expansion of the 1988 Financial Manual into four separate manuals on budgeting, accounting, procurement, and revenue and property management. Together, these comprise the 2001 Financial Rules and Regulations (FRR). The new budget manual of the FRR calls for the establishment of multi-year rolling budgets (MYRB),¹¹ in order to

- (i) Strengthen the links between the annual budget and the five-year plans for better resource allocation.
- (ii) Address general weaknesses with the present single year budgeting approach, especially the somewhat ad hoc adjustments made in the event of resource shortfalls.
- (iii) Bolster macro-fiscal sustainability by establishing hard budget constraints.
- (iv) Ensure an appropriate split between recurrent and capital expenditures, such that growing recurrent expenditure demands associated with ongoing capital spending can be met.
- (v) Implement the RGoB’s decentralization plans.
- (vi) Improve the arrangements for financing the budget deficit, including anticipating the financing needs that are to be met through domestic bond issues and contributing to the deepening of domestic capital markets.
- (vii) Foster continued high levels of donor engagement, with greater predictability of resource flows.

To date, the RGoB has been unable fully to implement MYRB, mainly due to capacity constraints and concerns about the extent to which the existing budget system would need

¹¹ The multi-year rolling budget envisaged in the FRR broadly corresponds to the Medium Term Expenditure Framework.

to be changed. Still, several important steps have been taken, including, as discussed above, the preparation of a preliminary MTFF, which has been strengthened through four successive iterations during the course of 2005 and 2006.

66. The preparation of these MTFF's involved compiling systematic macroeconomic projections, producing robust forecasts of the overall resources available (including tax, non-tax, and grants), and making an announcement/commitment to a sustainable path of major fiscal variables (such as deficit, debt, and financing). At the end of 2005, the RGoB formally established two committees which bring together various parts of the government to prepare MTFFs on a regular basis: a Macroeconomic Framework Coordination Committee (MFCC) and a Macroeconomic Framework Coordination Technical Committee (MFCTC). In addition to helping the RGoB implement MYRB, the initiative will improve overall monitoring of the evolving macroeconomic and fiscal situation, and facilitate possible policy changes to address emerging issues. As described in greater detail below, this is of heightened importance in Bhutan, where one or two factors can dramatically change the outlook.

67. The output of the most recent iteration of the MTFF exercise, reflecting the 2006/07 budget, is contained in Table 4. While there is substantial uncertainty, the MTFF makes assumptions explicit, and will facilitate wider understanding for needed policy responses, underpinning its credibility. Indeed, disseminating the MTFF is an important function of the MFCC, and in January 2006, the MTFF was endorsed by the Council of Ministers. The RGoB plans to integrate the MTFF fully into the preparation of the budget as well as the Alternative Planning Framework (as described above), providing an overall resource envelope that is consistent with a sound macroeconomic framework, and helping to move the budget process from a needs basis to an availability basis.

68. The preparation of the MTFF is the first step towards implementing MYRB. A workshop was held by the Department of Budget and Accounts of the Ministry of Finance in January 2006 to review how the MTFF envelope could be best used to develop sectoral expenditure envelopes and move to MYRB through: (i) the existing budget system, (ii) the APF, (iii) the revised framework being developed by the Planning Commission, and (iv) the structure proposed by the Ministry of Health. The approaches were congruent, but some effort is needed to resolve coordination issues and develop a template for the line ministries. The MTFF will be instrumental in implementing MYRB, which is to be piloted in at least one sector over the coming year, following the preparation of guidelines.

69. Several reforms have also been implemented to enhance public financial management and accountability. The Council of Ministers is reviewing a draft Public Finance Act, after which it is to be considered by the National Assembly. Among other goals, the act aims to establish a legal basis for the RGoB's financial rules, provide a framework for legislative oversight of RGoB budget management, encourage sound fiscal policy (including specifying rules for fiscal responsibility and transparency), and strengthen financial management. In a similar vein, the RGoB split the Department of

Budget and Accounts at the end of December, 2005, with a view to ensuring that budget functions do not crowd out accounting and treasury functions. This change is expected to help increase the efficiency and timeliness of accounting and reporting. Finally, the Royal Audit Authority (RAA) is to be strengthened. A draft Audit Act has been prepared, providing a stronger legal basis for the independence of the RAA, and the Office of the Auditor was established as an independent constitutional body reporting directly to the National Assembly.

70. Together with other governance reforms, like the establishment of an Anti-corruption Commission that reports directly to the National Assembly, these steps aim to strengthen accountability, transparency, and efficiency in the use of public resources. The initiatives are timely, given that the commissioning of Tala later in 2006 will generate substantial revenues, potentially testing governance arrangements. The reforms will also help address a key longer term issue: volatility. Making the most out of the opportunity presented by Tala and meeting the challenge of volatility will be important to mitigating vulnerability and promoting the effective implementation of government programs.

Avoiding the ‘Natural Resource Curse’

71. The ‘natural resource curse’ hypothesis suggests that the abundance of natural resources hampers rather than promotes development over the medium to long-term. Several empirical studies support this apparent paradox, and there is a growing literature on the subject.¹² Parallels have also been drawn with aid flows and high levels of aid dependence, which can have similar effects.¹³ Both of these factors are manifest in Bhutan. Revenue from hydropower sales averaged about 7 percent of GDP between 2001/02 and 2004/05, while aid (including all grants and concessional lending, net) averaged more than 41 percent of GDP over the same period, placing Bhutan among the highest aid recipients in the world.¹⁴ Taken together, revenues equivalent to almost half of GDP are of a type that have been found to generate natural resource curse effects in other countries. The natural resource curse is postulated to have negative effects through three channels: (i) undermining institutions and governance, (ii) increasing volatility, and (iii) inducing ‘Dutch disease.’¹⁵ Although only volatility appears to be a major concern at present, the ‘natural resource curse’ issue warrants further attention and RGoB vigilance.

Institutions and Governance

72. A growing body of literature has highlighted the importance of good institutions for underpinning strong economic performance and development. The curse hypothesis

¹² See, for example, Sachs and Warner, 1997, Isham, et al, 2003, or Murshed, 2003.

¹³ Harford and Klein (2005) raise the possibility of foreign aid causing natural resource curse as foreign aid is a key resource for some countries. Knack (2000) and Djankov et al (2005) conclude that countries that receive high levels of aid relative to GDP show political deterioration over time.

¹⁴ As noted by Knack, 2000, most researchers use aid as a percentage of GDP in their empirical studies, including loans with a grant element of more than 25 percent in their definition of aid. In the case of the Tala hydropower project financed by India, the grant component is 60 percent.

¹⁵ See for example, Harford and Klein, 2005, and Sala-i-martin and Subramanian, 2003, among others.

suggests that revenues derived from natural resources or aid may inhibit the positive evolution of institutions by reducing the interaction between governments and citizens in their role as taxpayers, weakening reform initiative, encouraging corruption, and lowering the incentive to provide public goods. In addition, the presence of natural resources may induce outright conflict to control the rents. As discussed in the section on governance above, the problems associated with weak governance are not apparent in Bhutan. There is a long tradition of consultation and collective action in Bhutan, such as providing for the community of monks, which then translates more readily into strong engagement with stakeholders and the provision of public services. Indeed, with about 21 percent of public spending being devoted to education and health, the proportion of spending on social services is among the highest in the world. The small scale of Bhutan, including the dispersion of the population in small communities may also act to curb corruption, as the opportunities for misusing public office for private gain are limited, and ill-gotten gains are likely to be detected.

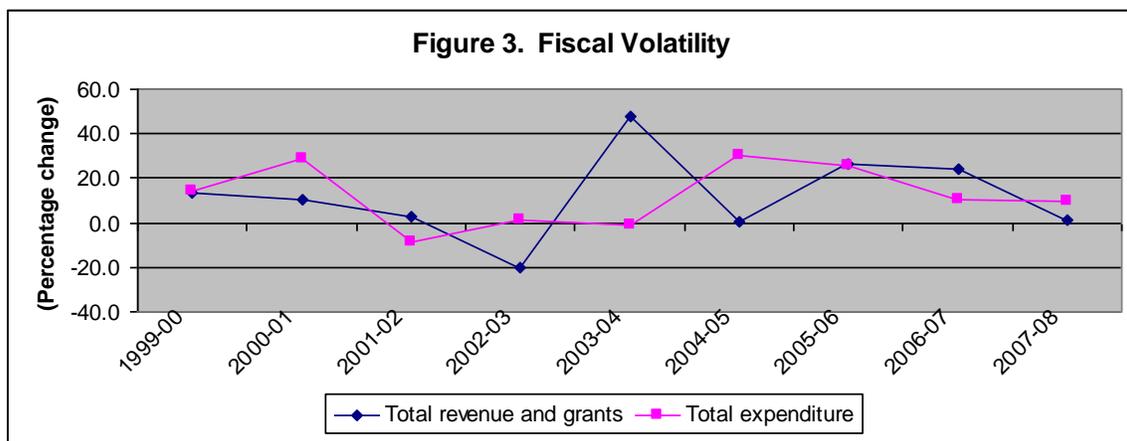
73. Despite these positive factors, however, the RGoB should continue efforts to strengthen accountability mechanisms, involving independent media, civil society organizations, and the like, as noted above. With the influx of Tala revenue, the burden on existing governance arrangements may rise, and bolstering the institutional framework will be central to ensuring maximal development impact from the opportunities afforded by Tala. Over the medium- to long-term, the RGoB may also wish to consider establishing an off-shore hydropower fund. Although these are more typically associated with the exploitation of non-renewable resources like oil, they have also been found to be useful tools in mitigating the existence or emergence of natural resource curse effects, including governance issues. Strong, internationally monitored governance mechanisms can be established for accountability and transparency in the management of the funds, potentially also serving as a precursor to such efforts elsewhere in the public sector. Such measures will also be important in mitigating vulnerability, by moderating the risks associated with the high level of dependence on a single asset.

Reducing Fiscal Volatility

74. Like many other small states, Bhutan faces a major challenge in managing fiscal volatility. Revenues show a high degree of variance based on a small number of key determinants, and smoothing the impact on expenditures is difficult (Figure 4). After falling by over 20.3 percent in 2002/03 due to delays in budget support from India and lower tourism revenues, total revenues and grants increased by 47.7 percent in 2003/04, mainly due to the resumption of budget support from India. As a percentage of GDP, total revenues and grants fell from 35.9 percent in 2000/01 to 25.4 percent in 2002/03, and rose again in 2003/04 and 2004/05 to around 33 percent. As noted above, grants are the largest part of the budget, and have been very volatile in recent years.

75. This revenue volatility translates into highly variable spending patterns, even when mega projects like Tala are kept off budget. Expenditure as a share of GDP, fell from 51.9 percent in 2000/01 to 31.5 percent in 2003/04, before rising again to 40.6 percent in 2005/06. To get a sense of how this compares with other countries, it is worth

looking at the standard deviation of the percent change in expenditure as a share of GDP. This was 0.20 between 1999/00 and 2005/06 for Bhutan, compared with 0.14 for low-income economies, 0.09 for middle-income economies, and 0.03 for high-income economies.¹⁶ There were several large annual changes in Bhutan over this period, such as an 11.3 percent fall in expenditure as a share of GDP in 2003/04 followed by a 14.1 percent increase in 2004/05, compared with a maximum absolute annual change in the samples noted above of 13.0 percent. This level of volatility is comparable to that felt by countries experiencing oil booms for example, and is partly the result of natural resource curse phenomena, since grants are variable, as are the revenues from hydropower. For example, a delay in the program grant from the GoI in 2003/04 contributed to the fall in spending (despite a swelling of the overall deficit including grants to over 12 percent of GDP). In this regard, a contributing factor appears to be the implementation of the 5 year plans, where delays in initially planned projects lead to a reprioritization to projects that can be more quickly implemented, and a bunching of spending at the end of the plan period. Hydropower volatility is associated with price changes and water flow. In 2003/4 and 2004/05, the water levels were quite high, and the hydropower plants were able to operate closer to full capacity for longer periods, generating substantially more revenue. So far in 2006, however, the snows have been significantly less, and unless rainfall increases in the area, this summer's output may be significantly reduced.



76. The volatility in the resource envelope increases vulnerability and impairs the implementation of government programs. For example, in 2003/04, the budget was cut across the board by almost 10 percent, making it difficult for the sectors to meet their goals and targets. Several mitigation mechanisms are worth considering, including:

- Conducting counter-cyclical fiscal policy, generating surpluses in good years and running deficits when the resource envelope turns out to be lower. This could be supported by developing fiscal rules.
- Continuing to develop and bolster the MTFE to help policy makers manage expenditure appropriately and anticipate revenue shortfalls.
- Using the MTFE to help persuade donors to program their assistance with a view to reducing volatility.

¹⁶ See Wolf, 2005. The calculations for the low-, middle-, and high-income economies spanned 1960-2002.

- Over the medium- to long-term, establishing an external hydropower fund that could help stabilize the resources available to the RGoB.
- Use funds to invest in human capital and infrastructure, as well as otherwise creating an enabling environment for private sector development.

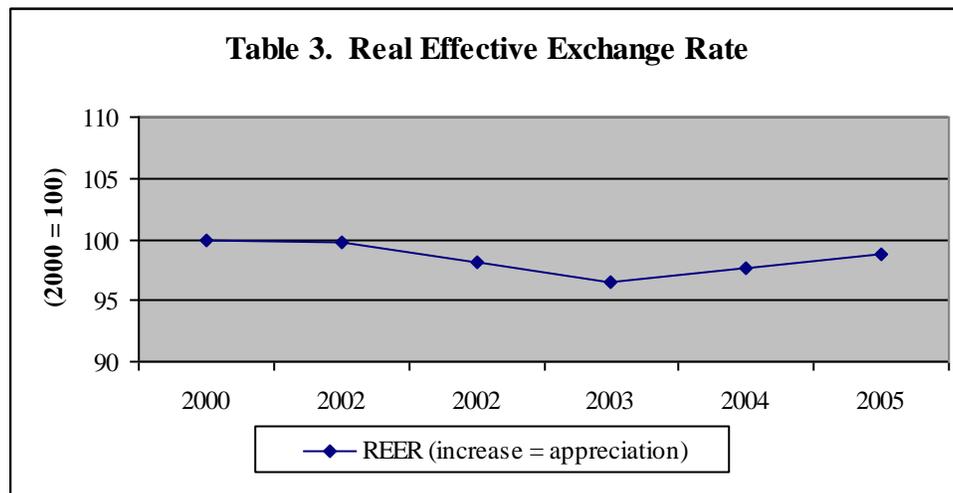
77. These measures are not a panacea, and in some cases expenditure continues to follow the boom and bust cycle, reserve funds are mismanaged or are matched by increasing liabilities in the form of heavy borrowing, and funds aimed at diversification end up being used to ‘pick winners’ and underpin a system of patronage. Still, experience with such measures from other parts of the world suggests that they could under gird a strategy for mitigating volatility and reducing vulnerability. It should be emphasized that the essential trade-off to be weighed by policy makers is whether to restrain spending in the boom years in order to boost spending in leaner years, lessening the vacillations. Managing the expectations of the public is a central part of the process, and an area where careful review may be needed. While Tala will generate substantial revenues and is a major opportunity for the people of Bhutan, it is notable that the MTFP points deficits over the medium-term, even in 2006/07, the year that Tala comes on stream. Addressing volatility would argue for a tighter fiscal path, and is an issue that warrants further study.

Avoiding “Dutch Disease”

78. The notion of ‘Dutch disease’ describes the apparent association of resource booms and de-industrialization (observed in the Netherlands in the 1970s). The suggestion is that an inflow of revenues from a natural resource boom (or aid) raises the demand for non-tradables, causing an increase in their prices relative to the price of tradables, which are fixed internationally. This change in relative prices (real effective exchange rate appreciation) attracts resources into the non-tradables sector, and discourages production and investment in the non-booming tradable sector. When the boom is over, the tradable goods sector, such as manufacturing, does not return as quickly as it left, and countries frequently resort to trade protection and other interventionist policies.

79. In the case of Bhutan, the inflow of hydropower revenue and foreign aid could potentially have these effects, undermining the competitiveness of the nascent private sector, and short-circuiting diversification, an oft stated goal of the RGoB. The effects might also become apparent in factor markets, where resource inflows boost land prices and wages. While it is unclear whether ‘Dutch disease’ effects have hampered the development of manufacturing and other tradables (the small size of the sector could equally be the result of other factors like high transactions costs and small scale), a useful indicator for the presence of these effects is the real effective exchange rate (REER). The REER is intended to help capture the evolution of competitiveness by tracking exchange rates adjusted for relative inflation, and weighted by the share of trade accounted for by various trading partners.

80. A study undertaken by the World Bank in 2002 as well as the IMF Article IV consultations of 2005 found that while the real effective exchange rate appreciated by about 10 percent in the years immediately after the coming on-stream of the Chukha, it has been comparatively stable through the 1990s. More recent calculations also suggest that the REER has been stable, even depreciating slightly, indicating that for a given exchange rate, the rate of inflation in Bhutan has been lower than with its trading partners (Figure 3).



81. The REER presented above was calculated based on relative exchange rates and price movements (as captured by respective CPIs) with Bhutan’s biggest trading partners, India and Bangladesh. India accounts for 85-95 percent of Bhutan’s imports and exports, and Bangladesh another 5-6 percent, determining the weights used to generate the REER. It should be emphasized that the use of the REER to measure competitiveness can be complicated by price controls and other data limitations. Distortions may also arise due to taxes. Still, the REER is a useful indicator of competitiveness, and even though the loss of competitiveness through ‘Dutch disease’ type effects does not appear to be manifest, the RGoB should monitor the REER and consider options for stemming possible rises of the REER once Tala is commissioned later in 2006.

82. The two main strategies for mitigating possible ‘Dutch disease’ effects is by increasing the competitiveness of the non-booming tradable goods sector, and slowing the influx of funds, thereby stemming an incipient appreciation of the REER. Investing in human capital, infrastructure, and the investment climate will contribute to maintaining the competitiveness of the tradable goods sector. Boosting domestic savings through incentives to private savers, running a budget surplus in boom years, as well as establishing an off-shore hydropower fund over the medium- to long-term in order to manage the inflow of funds, could all help stem any emerging appreciation of the REER.

83. The RGoB is encouraged to continue efforts to strengthen the accountability mechanisms underpinning good governance, elevate the issue of volatility in its policy making, and track the REER to stem potential ‘Dutch disease’ effects. Such initiatives

will be important to fostering other economic activities and employment generation, as well as contribute to mitigating vulnerability.

Pursuing Sound Policy on SOEs

84. As noted above, public sector enterprises are a central feature of the Bhutanese economy, with expenditures amounting to 16.6 percent of GDP in 2004 (Table 5). The biggest companies in Bhutan by far are those that were started by or with the RGoB, such as Bhutan Carbide and Chemicals Limited (BCCL - now completely private) or others where the RGoB maintains a significant stake. Government ownership levels vary across the sector, ranging from a 25 percent stake in Bhutan Ferro Alloys Limited (BFAL), to 100 percent government ownership of the hydropower companies. The RGoB generally seeks to privatize enterprises once they have been established, and has reduced its stake in such entities as the Bank of Bhutan. Still, the RGoB increased its share of Druk Air with the purchase of a new Airbus, which was contributed in equity. Overall, the SOEs are profitable, with the 6 loss makers generating losses of about Nu. 163 million, equivalent to about half a percent of GDP, compared with about Nu. 4.0 billion in profits of the 15 other SOEs. Druk Air accounts for almost half of these losses. While an in-depth study of the SOE strategy is beyond the scope of this report, it would be useful to analyze some of the specific aspects of SOEs in the Bhutanese context from the perspective of the RGoB's efforts to intermediate public sector resources into long-term growth, employment generation and poverty reduction. Furthermore, the pitfalls of industrial policy, especially in the presence of natural resource booms should also be noted.

Table 5: State Owned Enterprises - Summary Finances

	Income	Expenditure	Taxation	Net Profit
	<i>(In millions of ngultrum)</i>			
Total SOE	9929.3	5480.0	930.7	1909.7
(as a percentage of GDP)	30.0	16.6	2.8	5.8
Army Welfare Project (2004)	253.6	202.3	13.0	29.5
Bhutan Agro Industries Limited (2004)	26.2	25.3	0.0	-3.5
Bank of Bhutan (2004)	661.5	422.6	68.3	164.9
Bhutan Board Products Limited (2003)	239.9	194.0	4.5	9.3
Bhutan Broadcasting Service Limited (2004)	43.5	40.7	0.0	-32.5
Bhutan Development Finance Corporation (2004)	153.7	67.0	0.0	61.8
Bhutan Ferro Alloys Limited (2003)	669.1	509.3	39.5	90.7
Basochu Hydropower Corporation (2004)	121.2	18.6	46.4	0.0
Bhutan National Bank (2003)	384.9	253.0	24.4	56.9
Bhutan Postal Corporation (2004)	63.8	57.5	0.0	-3.2
Bhutan Power Corporation (2004)	858.1	544.1	0.0	-27.8
Bhutan Telecom (2004)	619.5	183.5	57.8	134.8
Chukha Hydropower Corporation (2004)	2447.2	512.1	567.0	1293.1
Druk Air Corporation (2004)	629.9	595.4	0.0	-79.1
Food Corporation of Bhutan (2004)	327.5	315.7	2.8	3.6
Forestry Development Corporation Limited (2004)	200.9	133.7	12.7	20.2
Kuensel Corporation (2004)	61.1	42.7	2.8	6.5
Kurichu Hydropower Corporation (2004)	551.0	106.3	0.0	-16.6
Penden Cement Authority Limited (2003)	960.8	615.8	86.4	191.2
State Trading Corporation of Bhutan (2004)	641.9	628.4	5.2	9.7
Wood Craft Center (2003)	13.8	12.0	0.0	0.1
Memorandum items:				
Nominal GDP (millions of ngultrum) (2004)			33,104.1	

Source: Ministry of Finance, Royal Government of Bhutan.

85. In addition to keeping hydropower fully in the public sector at present, the RGoB's effort to develop SOEs is shaped by three main issues:

- (i) The small scale of Bhutan often means that in the absence of such government intervention, many critical goods or services may simply be unavailable.
- (ii) The development of alternative economic activities may be an important part of diversifying the economy to mitigate vulnerability.
- (iii) The SOEs play a substantial role in generating employment.

86. While additional study is needed on the extent to which the private sector could play a more active role, anecdotal evidence suggests that the lack of scale and the high fixed costs of operating in Bhutan constrain private sector participation. For example, informal discussions held with international airlines that could take advantage of landing rights in Bhutan through reciprocal arrangements found that they are not interested in doing so. This is mainly because of the extreme seasonality of the market and the difficult approach into Paro International Airport, which requires special training. It is possible that the lack of interest is in part also due to concern about competing with an existing national carrier in a very small market, but it could well be that without Druk Air, access would be limited to arduous land routes. This would hamper the tourism industry, and business travel, as well as emergency medical services. Similarly, Citibank, a major US bank, was invited to operate in Bhutan in 2001, and after just a few years it left. In the absence of the state owned banks, financial intermediation would be much more limited and even today key features of modern commerce, like credit card use/acceptance is very low in Bhutan. Hence, it is unclear to what extent the SOEs crowd out the private sector, and the need to ensure that essential goods and services for modernization are available appears to be an important consideration in the RGoB's establishment of SOEs.

87. Efforts to diversify the economy away from agriculture and hydropower, and thereby mitigate vulnerability, also appear to be a key motivation for RGoB support for industrial activity. Several of the largest enterprises, like the BCCL, BFAL and the Penden Cement Authority Limited receive substantial support also in the form of low cost electricity.¹⁷ Key questions include: What is the cost of the diversification and perceived reduction of vulnerability? Is there positive value added to the activity when the full cost of all inputs is accounted for? For example, are energy intensive industries generating value added equivalent to the opportunity cost of the electricity they are consuming?¹⁸ Are they selling their products with 'embodied hydropower' to other markets, effectively diversifying and addressing concerns about Bhutan's dependence on a single commodity export (power) to a single buyer (India)? The answers to these

¹⁷ About 50 percent of the cost of producing ferro alloys is electricity.

¹⁸ As discussed below in Section 7 on hydropower, the domestic tariff on electricity is about half the price received when sold to India. This is also attracting more companies seeking to take advantage of cheap electricity, and the Bhutan Power Co. has received requests for new demand from energy intensive industries amounting to 400 MW, equivalent to about 40 percent of Tala's installed capacity, as noted above.

questions will be critical to assessing the RGoB's support to SOEs and how effectively the RGoB is intermediating resources to lower vulnerability through this channel.

88. Finally, the SOEs play a major role in the employment picture. As discussed in greater detail below, data on employment is quite limited, and the labor force surveys did not distinguish between public and private sector employment. Still, the largest non-hydropower firms in Bhutan are those that were started by or with the RGoB, and employment generation is a key goal of government policy. Plans to develop industrial estates, where enterprises would have access to reliable and inexpensive services and utilities, aim to boost employment opportunities for new entrants into the labor market and those leaving the agricultural sector. One issue that the RGoB is studying is the compensation of SOE employees. Overall, the pay scale of SOE employees was set significantly above similarly qualified civil servants, who themselves tend to be higher paid than private sector employees. In a context of limited availability of managerial talent, for example, the brightest people often prefer to join the civil service and SOEs, contributing to the difficulties faced by the private sector in meeting its skills gaps.

89. While the issues noted above provide some additional motivation for government support to particular industries, the RGoB should be mindful of the failures strewn across the development landscape. This is particularly worrying in countries enjoying a resource driven boom, where investing in any number of questionable projects may become irresistible. For example, it has been suggested that the single biggest mistake made in Nigeria and Trinidad and Tobago in managing windfall resource rents was to use them for establishing and maintaining SOEs, or implementing protectionist policies.¹⁹ Unproductive investment booms can also have long-lived consequences for countries attempting to diversify their economies.²⁰

90. In this regard, the need for a prudent and conservative policy cannot be overemphasized. Although the SOE sector, even excluding hydropower rents, contributes positively to government coffers, there are a range of issues pertaining to dynamic efficiency, governance arrangements, employee compensation, privatization,

¹⁹ World Bank, 2004.

²⁰ McMahan, 1997, notes that:

“First, from approximately 1955 to 1980 industrialization via import substitution dominated development thinking. When the booms took place, many of the resource abundant countries were trying to diversify away from a reliance on primary production to a more modern industrial economy, with manufacturing as the leading sector. Resource booms allowed the government to accelerate the process of import substitution far beyond the absorption capacity of the economy... Second, countries following import substitution strategies generally had repressed financial systems in order to direct credit to the priority sectors and prevent capital outflows. When the boom took place, there were few profitable investment options that the private sector could do with its part of the windfall. Thus, a large part of the private sector windfall was either transferred to the government via high implicit taxes on domestic financial instruments or spent on durable consumer goods and construction projects... Third, for many countries that previously were not following import substitution policies, or had very limited programs, the boom windfall was an irresistible temptation to change course. The end result was similar to, and often worse, than that suffered by countries that had long been on the import substitution path... Fourth, political pressure on the government to spread investment across all of the regions of the country or to support failing industries was often an important factor behind the perverse investment booms.”

and competition, to name a few, that need to be carefully scrutinized to ensure that public resources from hydropower and aid are indeed being intermediated effectively into robust development. Hence, the RGoB is urged to study the issue in depth, and prepare a medium-term strategy for moving forward on its stated intention of increasing private sector participation and development.

6. Fostering Private Sector Development

91. To realize the twin goals of rapid growth and employment generation, the RGoB places a high priority on the development of the private sector whose potential remains, for the most part, untapped. As discussed in more detail below, hydropower does not generate much employment.²¹ Agriculture employs over 60 percent of the labor force, but overall, the sector has been lagging the rest of the economy for some time (its share of GDP has fallen from 52 percent in 1980 to about 23 percent currently), and labor is moving out of subsistence agriculture to participate in the modern economy. The RGoB's strategy for achieving faster growth and job creation is predicated on improving the overall investment climate for the private sector, combined with a focus on sectors with a potential comparative advantage for growth (discussed in Section 7).

92. Data limitations make it difficult to construct a comprehensive picture of the size, structure, and contribution of the private sector in Bhutan, but a good indicator for measuring private sector growth is the number of licenses issued per annum for establishing private sector business. Progress in this regard is reflected in the rapid expansion in the number of licensed private sector enterprises in recent years (Table 6). By the end of 2003, the government had issued 32,035 commercial and industrial licenses – an almost threefold increase since 1998.

Table 6. Licensed Business Establishments in Bhutan

	1998	1999	2000	2001	2003
Manufacturing	447	486	523	569	730
(percentage of total)	3.8%	2.9%	2.9%	2.7%	2.3%
Construction	1874	2308	2606	4270	9102
(percentage of total)	15.6%	13.9%	14.4%	2.3%	28.4%
Services	2530	2922	3281	3773	4478
(percentage of total)	21.2%	17.5%	18.1%	7.9%	14.0%
Trade	7045	10947	11724	12455	17725
(percentage of total)	59.2%	65.7%	64.7%	59.1%	55.3%
Total	11896	16663	18134	21067	32035

93. Of the 32,035 licensed establishments, the majority are in the trade (55%) and construction (28%) sectors, followed by the services sector (14%). Manufacturing establishments comprise just over 2% of the number of establishments, and regional disparities are significant, with almost 80% of registered firms operating in the Thimphu/Paro – Phuentsholing corridor. The forest, agro, and mineral based industries dominate the manufacturing sector (Table 7).

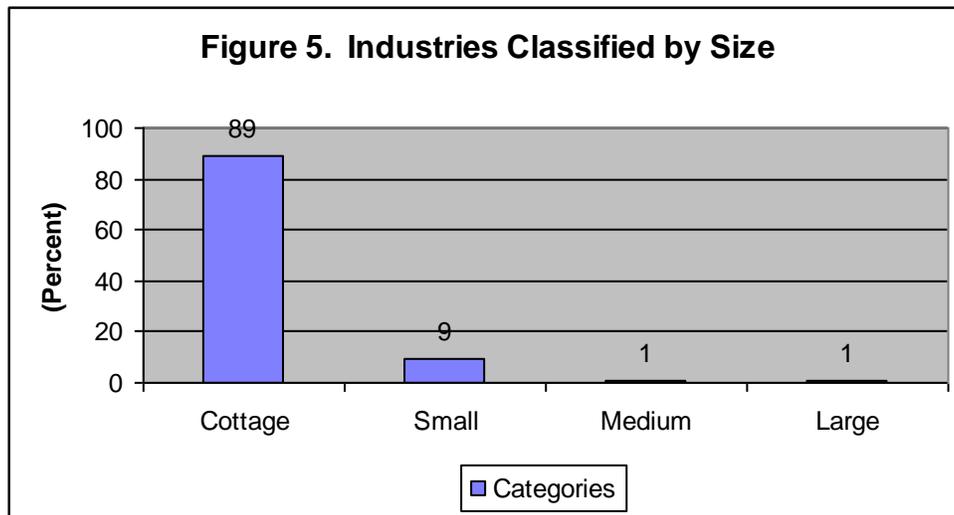
²¹ Hydropower accounts for 12 % of GDP and 37% of government revenue in 2003/2004, but it directly employs less than 3,000 persons.

Table 7: Breakdown of Manufacturing

Type	Number of Businesses 2003
Agro based	126
Forest based	336
Mineral based	46
Others	222
Total	730

Source: National Statistical Bureau, *Statistical Year Book 2004*

94. As Figure 5 indicates, 98% of all the licensed entities are cottage and small enterprises, reflecting both the nascence of the private sector, and the absence of scale economies.²² The medium and large enterprises account for the major share of private sector's business turnover and revenues.²³



Source: Wangyal, T., 2005

95. Despite the growth in the number of establishments, private sector performance is constrained by a combination of factors: history, geography, policy, and institutions. Bhutan did not have a well-established tradition of formal private enterprise and entrepreneurship prior to the recent modernization of the economy, which combined with the daunting geography, partly explains the limited development of the private sector.

96. The experiences of other countries, however, suggest that such inherent disadvantages can be offset by aggressive policy and institutional reforms. Policy makers have designated the private sector as “the engine of growth” for generating income as well as employment opportunities. Some of the measures initiated in the 1990s to boost

²² Size of establishment is determined by their capital input: *cottage* Nu. 0.5m (US\$10,500) or less, *small* Nu. 0.5 to 5 million (US\$10,500 – US\$105,000), *medium* Nu. 5 to 20 million (US\$ 105,000 - US\$420,000), *large* Nu. 20 million or more (more than US\$420,000). The cottage scale firms include micro enterprises (largely comprised of small family run businesses such as restaurants, tea stalls, and rice mills). Most of these enterprises are sole proprietorships facing both demand and supply side constraints.

²³ The medium and large industries include agro processing units, cement, ferro silicon, calcium carbide, distilleries, the airline, the telecom company, and power units. These have either been established by the government, and are now privatized or under joint ownership, or are still held as government-owned corporations.

the private sector include the privatization of transport services, road infrastructure and maintenance, and the tourism industry. The RGoB also divested a significant portion of the government's holdings in public sector enterprises as noted above. It corporatized the airline, the postal service, the telecommunications and media services, and (more recently) the power utilities. These efforts are directed towards the RGoB's long-term objective of gradually withdrawing from all commercially viable areas of economic activity and focusing on the provision of essential social services and basic infrastructure.

Improving the Investment Climate

97. The 2002 Investment Climate Assessment and the 2006 Doing Business indicators are useful diagnostic tools to help better understand the nature of the constraints faced by the private sector. The main findings of the private sector survey are summarized in Annex 1, and indicate that skilled labor, bureaucratic burdens, lack of demand, and difficulties in accessing finance were the top four constraints perceived by businesses (Table 8).

Table 8: Please Identify Your Three Biggest Business Problems

Problems	Number of Times Cited as	
	Number 1 Problem	Weighted
Skilled labor	20	0.51
Bureaucratic burden	16	0.38
Lack of demand	17	0.36
Credit and Finance	16	0.30
Infrastructure	8	0.20
Business support services	1	0.06
Import regime	0	0.05
FOREX regulations	1	0.03

Source: Bhutan Private Sector Survey 2002

98. These findings are augmented by the 2006 Doing Business indicators, which benchmark Bhutan against other countries in the region as well as global best practice in a range of areas including the time taken to start a business or the challenges associated with enforcing contracts. These diagnostic tools are helping to inform an ongoing RGoB effort to deepen micro-level policy and institutional reforms. Key areas of reform include:

- *Expanding physical infrastructure.* The lack of agglomeration economies of scale, the difficulty in obtaining flat land, and the high costs of infrastructure development, are major obstacles to industrial development in Bhutan. To address this issue, the RGoB is planning to develop several industrial estates with reliable, cheap power, and to build a dry port for trade facilities and services. In addition, India has agreed to explore the potential of extending railway links to the Bhutanese border.
- *Rationalizing entry regulations:* As the reported in *Doing Business in 2006*, the time taken to register a business in Bhutan is relatively long. Specifically, it takes 62 days, with 11 procedures, to register a company in Bhutan in comparison to the South Asian average of 47 days (global best practice stands at 2 days). The RGoB

recognizes that business registration and regulations pose a significant barrier to entry for new firms. To improve efficiency in the business registration process, the Department of Industries has undertaken a reform initiative to simplify and automate the registration process.

- *Labor market issues:* The poor functioning of labor markets is a key constraint for private sector growth. Bhutan ranks 67th worldwide on the ease of hiring and firing, near the middle of South Asian countries. Regulations governing labor markets are rudimentary in Bhutan. Employment of *Bhutanese* nationals falls under the draft *Rules and Regulations on Employment of Bhutanese Nationals in the Private Sector* (1997). Although procedures for dismissing workers are relatively flexible, costs of firing, such as the cost of advance notice requirements, severance payments, and penalties, is one of the highest, standing at 94 times the weekly wage (the SAR average stands at 85, while the country that fares best in the region is Bangladesh at 47). Restrictions on term contracts discourage new job creation. The minimum wage officially applies only to Bhutanese public sector workers, with limited impact on private businesses. Part of the inflexibility can also be explained by the segmented nature of the labor market: of the total formal sector employment, it is estimated that non-nationals (predominantly Indian) represent approximately 50 percent. Stringent restrictions exist for the recruitment of *foreign* workers; and when permitted, it entails time-consuming procedures. To address labor market duality and gaps, the RGoB is trying to develop a more flexible labor policy, including laws and regulations to reduce constraints on young people (the most affected by stringent labor institutions) finding jobs. A critical element of reform in this area involves drafting a Labor and Employment Act that aims to balance the legitimate needs of workers with the objective of promoting private sector activity. As discussed in greater detail below, key issues in the draft act relate to the power of labor inspectors, employee working hours and night work, activities prescribed for 15-18 year olds, and employment of foreign workers.
- *Skills shortages:* On the supply side, shortages of skilled workers are a binding constraint for industry. In this regard, raising the retention of children in school through secondary education, adapting the secondary school curriculum more closely to the needs of the private sector, and strengthening vocational education, training, and entrepreneurship will be critical to raising the availability of skilled workers. Moreover, key instruments for assessing labor market skills – such as enterprise surveys and labor force surveys – need to be strengthened. The Ministry of Labor and Human Resources (MoLHR) is endeavoring to match labor supply and demand through vocational training, job counseling, job information, and other programs.²⁴ The challenge will be to ensure that these programs are effective and do not become too costly or supply-driven, especially given the mixed results of such initiatives in other countries.

²⁴ MoLHR is a new ministry, created in 2003 in response to the Royal Government's concern with labor markets and employment issues.

- *Attracting Foreign Direct Investment (FDI):* Creating an enabling environment for foreign direct investment (FDI) is an important element of the RGoB's private sector development and employment generation strategy. The overall objectives of encouraging FDI are to broaden employment and training opportunities, benefit from technology and skills transfer, broaden the revenue base, and enhance foreign exchange. Towards achieving these goals, an FDI Policy was passed as an Executive Order in 2002. This provides a clear policy on the regulation of foreign investment, particularly the entry of such investment, and policy on other matters, including guarantees that pertain only to foreign investors. More recently, accompanying FDI Rules have been prepared, and their approval is considered an important first step in helping operationalize a transparent FDI registration system. Within the highly regulated Bhutanese economy, it is expected that this will give comfort and protection to foreign investors.
- *Developing effective financial markets and financial instruments:* The difficulties cited by firms in the Private Sector Survey in accessing credit are corroborated by the *Doing Business in 2006* indicators. These suggest that despite a highly liquid domestic financial system primed with donor and hydropower funds, credit market institutions are weak. There are no credit registries in Bhutan, so creditors have difficulty assessing the creditworthiness of borrowers, constraining lending. Bhutan also ranks poorly on an indicator of legal rights of borrowers and creditors in terms of posting collateral for loans and seizing the collateral in the event of default, again hampering access to finance. Improving access to credit will involve developing and strengthening the legal and regulatory framework, standardizing accounting and auditing procedures, increasing the efficiency of payment mechanisms, developing new non-bank financial institutions, and boosting market-oriented human resources.²⁵
- *Reducing trade barriers:* In order to benefit from its participation in the South Asian Preferential Trading Arrangement, the RGoB needs to rationalize its trade and tariff regime. Some efforts to improve trade and transit arrangements with India and Bangladesh and to negotiate preferential trading arrangements with Nepal and Thailand are underway.²⁶
- *Consultations on the development of the private sector:* A number of countries have successfully used business-government consultations to enhance policy or promote market-oriented reforms. With its small and nascent private sector, Bhutan is keen to capture the benefits of systematic consultation—including broadening ownership of reforms, improving the accountability of public officials, increasing transparency and building trust. A Private Sector Development Committee (PSDC) was initially established in 2000 as a public-private consultative forum for maintaining regular and

²⁵ In 2002, RGoB implemented new prudential regulations and established a Monetary Operations Committee to formulate and implement policy instruments for a sound financial system.

²⁶ The tariff structure was simplified in 2002 and the weighted average tariff rate was lowered to 15 percent. Sales tax and customs duty on a wide range of domestic and commercial goods was abolished and the customs duty on spare parts for all vehicles was reduced from 30 percent to 10 percent. To facilitate import procedures for the private sector, the authority for issuing import licenses was transferred in July 2002 from the Ministry of Finance to the Ministry of Trade and Industry.

structured dialogue on cross-cutting and sector-specific policies and strategies for facilitating private sector development. The Committee ceased operation in 2003 owing to a lack of a clear mandate and weak follow-up action, among others. At the request of the private sector, the PSDC is expected to be re-invigorated with some restructuring to ensure its efficacy.

99. Moving forward with these efforts to address key constraints will be instrumental to realizing the potential of the private sector and boosting economic dynamism. This will also reduce vulnerability by generating income earning opportunities in a broader range of activities, especially in tourism, agri-business, forest-based industries, and ICT. The services sector, including such areas as domestic commerce and retail, is also becoming an increasingly important part of the economy.

7. Prospects for Accelerating Growth

100. With the effective deployment of public resources and improvement of the investment climate underpinning private sector development, the prospects for accelerating growth are favorable. It should be emphasized that much of the economic activity in Bhutan remains linked to public sector spending. Of note is the large contribution to growth made by the construction sector, accounting for 27 to 51 percent of growth over the past 5 years (Table 9), driven in large measure by public investment. Hydropower, construction, tourism, and agribusiness are likely to be the key drivers of growth over the medium term. Progress in these areas will also be critical to ensuring adequate employment generation, as will be discussed in Section 8.

Table 9: Sectoral Contribution to GDP Growth

	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
					<i>Proj.</i>	<i>Proj.</i>	<i>Proj.</i>
	<i>(Percentage share of growth)</i>						
Real GDP	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Primary	13.6	9.8	8.9	8.3	8.8	2.6	6.1
Agriculture (Crops)	5.1	4.3	3.8	3.2	3.5	1.0	2.4
Livestock	5.7	2.6	2.1	2.1	2.5	0.7	1.7
Forestry	2.8	2.8	3.0	3.0	2.8	0.8	2.0
Secondary	63.8	45.0	29.5	38.5	42.8	83.6	60.0
Mining	2.6	1.7	-0.4	-0.3	1.7	0.5	1.3
Manufacturing	2.1	4.2	5.7	5.1	6.1	1.8	4.4
Electricity	8.2	6.3	6.6	8.0	5.3	73.5	35.1
Construction	50.9	32.8	17.6	25.7	29.7	7.8	19.3
Tertiary	22.5	45.3	61.6	53.1	48.4	13.8	33.9
Trade & services	8.0	11.7	18.7	15.6	11.9	3.3	8.3
Transport, storage, and communication	6.8	5.3	14.4	19.2	14.2	3.7	9.0
Financial, insurance and real estate	-4.3	2.5	9.5	4.4	4.6	1.4	3.3
Government services	10.2	15.1	7.4	6.5	13.3	4.0	9.9

Source: NSB, *Selected Economic Indicators*, December 2005, RMA, and staff estimates.

Exploiting Hydropower

101. The exploitation of vast hydropower resources will continue to drive growth in Bhutan in the coming years. As described above, the evolution of Tala is central to the macroeconomic picture and to ensuring fiscal and debt sustainability. Current hydroelectric capacity amounts to 437 megawatts, which generates about 10 percent of GDP. Tala will add another 1020 megawatts, which will raise total electricity generation by 233 percent and boost GDP by over 25 percent during 2006 and 2007. Similarly, GDP grew by 17 percent in 1987 when Chukha was switched on. The impact on domestic government revenues will be of a similar magnitude. It is estimated that Bhutan possesses about 30,000 MW of hydroelectric potential. This is mostly run-of the river, so the need for dams is limited, lessening the environmental, social, and relocation issues typically associated with the exploitation of hydropower (the downside of this is that capacity is reduced to 18 percent during the dry season, leading to a relatively low plant load factor, as noted in Table 10). An Umbrella Agreement is being discussed with the GoI, whereby India would purchase 5,000 MW of hydropower by 2020. Alternative modes of financing projects are also being considered. Developing hydropower represents a key opportunity for accelerating growth and mitigating vulnerability in Bhutan.

Table 10: Hydropower Projections up to 2020

Power Station	Year of Construction	Capacity (MW)	Firm Capacity (MW)	Energy (GWh)	Plant Load Factor
Chukkha	1986	336	84	1,700	58%
Kuriuchu	2001	60	24	400	76%
Basochhu u/s	2002	24	5	105	50%
Basochhu l/s	2004	40	10	186	53%
Tala	2006	1,020	170	4,865	54%
Punatsangchhu 1	2012	870	145	4,330	57%
Mangedchhu	2014	360	94	2,000	63%
Punatsangchhu 2	2017	990	150	4,667	54%
Chamkarchhu 1	2012	568	95	2,713	55%
Total		4,268	777	20,966	56%

Source: *Development of Hydropower in Bhutan - The Way Forward*, Department of Energy RGoB - 2004

102. Deriving maximal benefits from the sector will depend on how it is managed and several key questions and policy issues warrant careful investigation:

- Feasibility studies and DPRs have been completed for two further projects included in the Master Plan: Punatsangchu (870 MW) and Mangdechu (360 MW), but they have not been included in fiscal and **debt sustainability analyses**. The financing arrangements for these projects are likely to follow the current scheme used to develop Tala. *These projects need to be integrated into fiscal and debt sustainability analyses to ensure that there are not some years of unduly elevated risk, even if temporary.*
- Given that the existing arrangements for developing hydropower projects are based on 60 percent grant and 40 percent loan financing from India, and per unit pricing is established through bilateral government negotiations, it is unclear whether the **internal rate of return** of hydropower is sufficiently high that it would attract private sector participation. Is hydropower development in Bhutan competitive with other possible projects in the region, especially northern India? What is the relevant demand for power, given transmission constraints and the availability of other competing sources? *Studying the sector and making some estimates of the rate of return, comparing the results with regional alternatives, will be central to possibly accelerating development with private sector participation.*
- As noted above, **alternative modes of developing hydropower resources** involving the private sector participation will be considered. The RGoB plans to initiate a technical assistance project to analyze the various options, including BOT schemes and joint ventures between private sector companies and the Druk Generation Co. (currently being formed by merging the four generation companies, Tala, Chukka, Kuriuchu and Basochu). Involving the private sector may help relieve financing constraints, given the RGoB's high level of indebtedness. Joint ventures will give outside investors some comfort, while helping the RGoB diversify the risks associated with mega hydropower projects. *The RGoB is encouraged to pursue alternative modes as a way of accelerating development, and mitigating vulnerability by sharing*

risk with other stakeholders. The RGoB may also wish to consider accessing the Carbon Fund, or using guarantees from the international financial institutions to help leverage more funds.

- The **legal framework** will also be important for attracting private sector involvement. The recent progress on establishing rules for Foreign Direct Investment as well as other aspects of the regulatory environment will be of particular import in this regard. *The RGoB is urged to review the legal environment to ensure that it is conducive to attracting the participation of other stakeholders, as needed to meet the RGoB's goals for the sector.*
- Pursuing an appropriate **pricing strategy for domestic power sales** is becoming increasingly important. At present, electricity is sold to domestic consumers at a substantial discount, and as electrification has expanded and power usage has risen, the implicit subsidy has also been growing (Table 7).

Table 11: Electricity Subsidies

	1998-99	1999-00	2000-01	2001-02	2002-03
	<i>(Ngultrum per unit)</i>				
Average price					
Local consumption	0.60	0.63	0.67	0.75	0.82
Exports	0.98	1.48	1.44	1.50	1.51
Implicit domestic electricity subsidy (Nu. Millions)	91.3	239.4	208.0	287.5	325.6
(as a percentage of expenditure)	1.3	2.9	1.9	2.9	3.3
(as a percentage of education expenditure)	10.4	21.4	17.1	20.0	22.1
(as a percentage of health expenditure)	15.1	31.2	25.9	25.2	38.4
(as a percentage of GDP)	0.5	1.3	1.0	1.2	1.2
Implicit domestic electricity subsidy (US\$ millions)	2.1	5.5	4.5	6.0	6.8

Source: Statistical Yearbook of Bhutan (2004).

Hence, the implicit subsidy has risen from 1.3 percent of expenditure in 1998-99 to 3.3 percent in 2002-03, and is likely to have increased further more recently with the tariff revision on Chukha exports and the continued growth in domestic demand for electricity. The pricing strategy for domestic power sales to industry is also attracting more firms seeking access to cheap power. As noted above, the Bhutan Power Co. is reviewing requests for new demand from energy intensive industries totaling about 400 MW, almost 40 percent of Tala's installed capacity. Given the seasonality of power production (mainly during the summer when melt waters swell the rivers), the establishment of such industries (that will require power year-round) might lead to elevated power imports during the low months. *The RGoB is encouraged to review pricing policy, to ensure that electricity is not used wastefully, and that subsidies are targeted to meet clear social objectives set by the RGoB. This is especially urgent with regard to industry, for although an industrial policy that fosters diversification has many attractive features, the opportunity cost could be very high, with only moderate gains in terms of employment.*

103. The development of hydropower represents a major opportunity for the people of Bhutan to reach their development goals. Circumstances are favorable for project development, including a very large market for the electricity in India, which is growing

rapidly. Beyond avoiding possible ‘natural resource curse’ effects, however, the RGoB will also need to follow through on some of the issues raised above, in order to ensure that hydropower continues to fuel robust and sustainable growth, while mitigating vulnerability.

Boosting Construction

104. The construction industry is closely tied to public spending on infrastructure such as the Tala hydropower project, roads, schools and health facilities. Indeed, Tala alone is estimated to have accounted for over 20 percent of the sector between 2000 and 2004. With Tala nearing completion, there will be a substantial impact on the economy from the winding down of related construction activities. Still, non-Tala construction activity is also growing rapidly, and the RGoB expects growth in the sector to remain positive (albeit small) through the transition to post-Tala. Credit growth to the sector is adequate, comprising about 41 percent of the loan portfolios of Bhutanese financial institutions.

105. Construction firms comprise about a third of registered companies, and are well represented by the private Construction Association of Bhutan, established in 2000 to provide a forum to discuss and address concerns related to the industry. A Construction Development Board (CDB) within the Ministry Works and Human Settlement was established in the late 1980s, with representation from both the government and the private sector, aimed at promoting the efficiency of the sector and the quality of construction. The CDB is also charged with regulating the sector, registering companies, setting building standards, and ensuring that all formal companies have equal and fair access to government contracts. The CDB operates in a transparent manner, sharing information through its website on contractors, architects, meetings (including minutes of the meetings), and the like. A Standard and Control Authority was also established in the Ministry to improve the quality of construction and related practices such as measurement and testing of construction materials. Several key challenges facing the sector have emerged from these forums, augmented with information received from the construction firms interviewed as a part of the Private Sector Survey in 2002:

- Attracting **Bhutanese labor** is quite difficult in the construction sector, as many Bhutanese are unwilling to undertake the menial and backbreaking work on construction sites and in road building, at the wages on offer. There is also a lack of capacity for construction supervision by government engineers, especially at the Dzongkhag level. Hence, the typical construction firm often has very high levels of non-national employment - frequently above 90 percent. *In seeking to address this issue, the RGoB should avoid the imposition of additional restrictions on expatriate labor, as these workers frequently complement and help raise the productivity of Bhutanese workers. They are also critical to managing the high costs of construction. The authorities should continue focusing on expanding vocational training and certification programs, building the pool of available skilled labor that can apply new and improved construction techniques.*
- There is a need for greater **mechanization**, as the methods typically used in the construction industry are quite labor intensive (partly encouraged by the

availability of cheap labor from neighboring countries), which may be impinging on quality. Capital requirements relative to the scale of activity are quite a barrier. For example, cement tends to be mixed by hand, or in small batches by machine, but heavy cement mixing machinery is absent. *Ensuring the availability of adequate finance, especially leasing finance, would help encourage the mechanization of the sector and the adoption of new technologies. This would also help make construction sector jobs more appealing for an increasingly trained workforce.*

- The adoption of new technologies will hinge in part on the availability of **new materials and designs**, including a greater reliance on **pre-fabricated, factory based (rather than construction site based) modular and standardized construction components**, without compromising unduly on the unique appearance of buildings in Bhutan. For example, the use of light steel frame construction of some schools reduced the cost of construction for more durable buildings, without impacting the external appearance. *It would be useful to review building codes and standards in an effort to facilitate the expanded use of prefabricated inputs, opening new opportunities for small and medium sized enterprises, raising productivity, and significantly improving the quality of construction.*
- **Contracting** is a major concern of the construction industry, as capacity is generally weak, and Bhutanese contractors have difficulty in winning the award of major construction activities. In the case of Tala, for example, Bhutanese firms received about Nu. 1.2 billion in contracts for a project that will eventually disburse around Nu. 43.0 billion. Similarly, the widening of the Thimphu-Phuentsholing highway financed by India will see only about 15 percent of the work being contracted to Bhutanese firms. Furthermore, many of these firms are considered ‘fronts’ in that they often take a very passive role, employing hardly any Bhutanese across all levels. *The RGoB is urged to resist calls to tighten restrictions on expatriate workers, and focus on helping the domestic contracting companies build capacity through relevant training in association with appropriate institutes, and transparent procedures for participating. Facilitating joint venture arrangements with foreign partners may also help Bhutanese nationals improve their expertise in increasingly complex, specialized and high value construction activities.*
- There is a need for greater **competition** in the sector. Although the number of trade licenses has increased, these are located mostly in three cities, and competition is limited in much of the country. Joint ventures with foreign partners have often had the same problems as noted above for contracting, where the Bhutanese party does not play a very active role. *Establishing a legal framework for international competitive bidding and encouraging joint venture arrangements that bring transfers of technology, knowledge, and resources would generate more competition help lower the unit cost of construction.*

106. As noted above, inflows of aid and elevated hydropower revenues will continue to fuel high public investment in infrastructure, as well as strong private spending on

housing and tourism related facilities. In addition, several major new hydropower projects are anticipated over the coming years, providing a significant boost during the construction period. Hence, the sector will continue to be a major source of economic dynamism, and present major opportunities for broad based entrepreneurship and employment across a range of related activities. Through such agencies as the CDB, it will be important to ensure that domestic firms and individuals can seize these opportunities, improving skills, upgrading technology, raising productivity through mechanization, and boosting the capacity to undertake complex projects from bidding to procurement to financial management. It should be noted, however, that care will need to be taken in managing the expansion of the sector, as construction booms are one of the main channels of the natural resource curse, where growing government coffers can end up being used to finance unproductive investment. In addition, through ‘Dutch disease’ effects on relative prices, the large financial inflows fuel rapid increases in the price of housing and other real estate, attracting new private investment into the sector. To some extent, this is already visible in the growth of Thimphu. The large reward to prudence is the avoidance of a property market bust, for example, and sustained growth.

Tourism as an Engine of Growth?

107. On the back of a major policy shift by the RGoB in the early 1970s, the tourism sector has been growing rapidly in recent years, and holds substantial potential for further expansion. While it will not drive the economy in the foreseeable future, it is an important source of hard currency and can play a central role in mitigating vulnerability by expanding the range of options for generating income at both the local and national levels. Small and medium enterprises, in particular, could flourish in providing tourism services. Realizing the potential of the industry, however, will require some targeted interventions and a clear vision articulated in the Tenth Plan. A key issue in this regard is the RGoB’s effort to find an appropriate balance between seeking to help underpin economic dynamism with tourism, while maintaining the pillars of GNH.

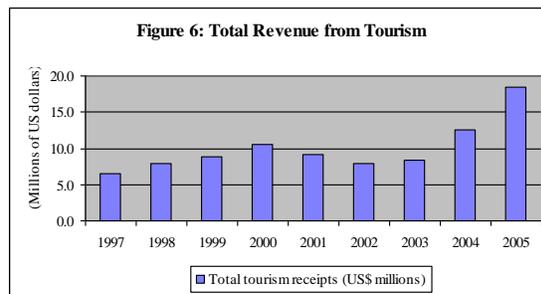
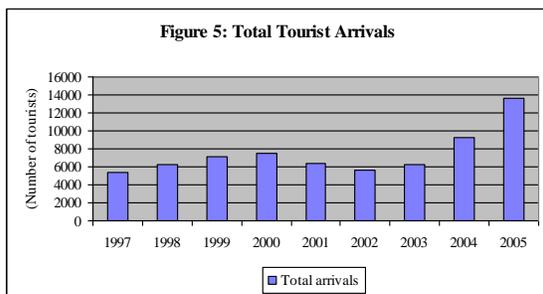
108. Tourism began in 1974, as a state run enterprise, with the arrival of the first 274 tourists. With the gradual easing of restrictions, the sector has transformed over the past three decades, as described in Box 3.

Box 3: Key Milestones in the Development of Tourism

- The Bhutan Tourism Corporation was corporatized in 1982.
- Paro International Airport was opened in 1983.
- BAe Passenger jets started operations in 1988.
- The daily tourist tariff was increased from US\$130 to US\$200 in 1989.
- The Tourism Authority of Bhutan (TAB) was established to regulate the sector and the Bhutan Tourism Corporation was privatized in 1991.
- The tourism rules and regulations were issued in 1999, covering tour operations, lodging, and trekking, and the opening of the Dzongs and monasteries to tourists.
- The TAB was transformed into the Department of Tourism in 2000.
- The Association of Bhutanese Tour Operators was founded in 2000.
- The importance of tourism was recognized in the Ninth Plan in 2002, highlighting the sector’s role both in generating employment and in raising revenue for the central government.

- Two new Airbuses were put into service in 2004, expanding capacity by over 40 percent over the previous two planes (which are to be sold).
- Several ultra-luxury resorts were opened in 2004.
- An additional point of entry and exit was opened in Samdrup Jongkhar, the far eastern corner of Bhutan in 2005.
- Three additional parks were opened to tourists in 2005, the Merak, Sakten and Manas parks, catering to those interested in trekking.
- A domestic helicopter service was begun in early 2006, dramatically shortening trips to other parts of the country from Paro (a trip to Trashigang in the far-east which might take 3 days one way by car can be undertaken by the helicopter in a little over an hour and a half).

109. Following the 9/11 terrorist attacks and the outbreak of SARS, tourist arrivals fell sharply in 2002 and 2003, and only surpassed their pre 9/11 levels in 2004, when they grew by 47 percent. The number of arrivals increased by a similar amount in 2005, reaching 13,626. Revenues increased slightly faster, and the Department of Tourism is the second highest revenue generating agency of the RGoB, after the Chukha Hydropower Corporation. The sector is also an important source of convertible currency (non-rupee), second only to donor grants. It should be noted that these tourist arrivals figures include only ‘Dollar Spending International Tourists’ (DSIT, those paying the daily tourist tariff), of which the largest share (about a third) come from the US. Visitors from India, the Maldives, and Bangladesh do not require visas and are not counted in these figures. The 2003/04 data indicate that over 11,000 Indians visited Bhutan, compared with about 7,000 DSITs in the same year. Although tourists from India, Bangladesh and the Maldives do not spend as much as the DSITs, they are a significant part of the tourism industry, but data on their spending is not collected.



110. Several initiatives are underway to improve the understanding of the nature of the industry in Bhutan and develop appropriate policy strategies, including the preparation of the *Sustainable Tourism Development Strategy (STDS)*, which is close to being finalized. Information is being collected from tour operators and through the ‘International Tourism Monitor’ (ITM), where departing tourists are surveyed randomly by the DoT. The profile of tourists that emerges suggests that visitors tend to be older (29.5 percent are above 60 years of age, and a further 20.5 percent are between 46-55 years of age), highly educated and well traveled, with most visiting Bhutan for the first time as a part of a group that would also be visiting other destinations in the region. Most come for cultural tourism and stay an average of about 8 days.

111. The STDS highlights several key issues that need to be addressed at the policy level:

- **Seasonality** remains a major challenge, with most visitors coming in April and October. About 46 percent of tourists surveyed indicated that the timing of their visit had been based on the recommendation of the tour agent and followed the timing of religious festivals (like *Tshechus*). *Publicizing the advantages of other seasons and the celebration of Tshechus during the rest of the year, as well as diversifying the tourism product would help address this issue. In addition, Bhutanese tour operators could combine with tour operators in neighboring countries to develop regional packages during “shoulder” seasons.*
- The **regional distribution** of tourism is heavily focused on Paro and Thimphu, which account for over 56 percent of bednights. With Punakha and Bumthang, this proportion rises to 83 percent of all bednights, and much of the rest of the country is not benefiting meaningfully from tourism, especially the remote areas in the east, which require several days of driving. *Whilst this is a factor of Bhutan’s relatively recent “opening-up” to tourism, improving infrastructure, opening new entry points from India, and altering the pricing structure will be central to broadening tourism opportunities and reducing regional disparities. The helicopter service currently being piloted by Druk Air may also be helpful in this regard.*
- **Employment** in the tourism sector has been growing. Direct employment in tourism (hotels and restaurants, tour operators, and DrukAir) amounts to about 3,000. Though a small share of overall employment, these jobs represent important sources of income. Due to fluctuations in tourist arrivals, however, many of these workers are hired on a temporary basis. *Addressing seasonality, as noted above, diversifying the tourism product away from accommodation (towards a greater range of activities, goods and services), and investing in hospitality training will be important to ensuring the continued expansion of employment opportunities in the sector.*
- **Low occupancy rates** are a major concern for hotels, and are also related to the high degree of seasonality in Bhutan. The average occupancy rate for the most popular regions noted above is about 10 percent for DSITs, discouraging further investment and jeopardizing long-term viability. Even if one were to double the occupancy figures to account for the Indian tourists, occupancy would still be very low by international standards. *Addressing seasonality, improving promotion, upgrading services, increasing available products and activities, and revising the tariff structure to encourage longer stays could help raise the occupancy rates.*
- Most of the tourists coming to Bhutan do not have very high expectations of the **quality of food and lodging**, but it is an important aspect framing the tourist’s visit that needs improvement. The RGoB has established a services division to standardize and categorize facilities. *A sustained hospitality training strategy is needed in order to improve quality.*
- **Emergency services** are a concern in the event of accidents in remote areas. A helicopter service would be the best way to provide emergency services in

the rugged terrain of Bhutan. *Although Druk Air is piloting a helicopter service, the RGoB may wish to consider investing in such a capacity through the Royal Bhutanese Army.*

- The need for investment in **infrastructure improvement** is an oft cited constraint on the expansion of tourism. As a part of the ITM effort, departing tourists were asked to make suggestions for improvement. The top nine responses are compiled in Box 4, most of which would require substantial investment. *Reviewing this list and encouraging private investment in ATM facilities or better communications, for example, would help make some of the improvements most sought after by tourists.*

Box 4: Suggestions for Improvement (percentage of respondents)		
i.	Roads	14.6%
ii.	Improvement in hotel standards	13.6%
iii.	Better air services/competition for Druk Air	10.9%
iv.	More variation in food	7.6%
v.	Better, cleaner toilets	7.2%
vi.	Credit card and ATM facilities	6.9%
vii.	Better communication/internet facilities	6.6%
viii.	Dog care	6.2%

- Finally, the **price and tariff policy** is a key lever for influencing the course of tourism development. The present policy of levying a tariff of US\$200 per day, regardless of the quality or category of service, serves the purpose of restricting tourism to ‘high value/low impact,’ but it also has other effects, including:
 - Reducing activity in certain categories, such as trekking and biking (which could be important for mitigating seasonality).
 - Attracting mainly older visitors interested in cultural tourism.
 - Inducing very busy and compact visits, leaving tourists exhausted.
 - Discouraging visits to the east, where tourists would still be paying US\$200 per day for the several days in transit needed each way.
 - Limiting options for small and medium sized businesses and for diversifying the tourism infrastructure, since tourists are typically traveling in all inclusive tours and there is little space left for other activities or dining away from the hotel.

The RGoB may wish to consider the revising the pricing structure, with a view to maintaining or raising revenue, increasing transparency, giving a strong incentive for longer stays, and facilitating the differentiation of products, service levels, and quality. The recommendations in the STDS merit further consideration to operationalize them.

112. The tourism sector is an important component of a strategy to sustain robust growth and employment generation, especially one that is more broad-based. The preparation of the *Sustainable Tourism Development Strategy*, covering all aspects of the sector including the image of Bhutan abroad, marketing, and the pricing structure, is very timely in this regard. The strategy recognizes the trade-off that the RGoB is making in terms of promoting tourism as a source of economic dynamism, while limiting the impact

on the environment and culture, both essential components of GNH. Still, there is substantial scope for more tourism activity without unduly compromising these aspects of GNH, and the RGoB expects tourism arrivals to rise to 15,000 by the end of 2006.

Commercializing Agriculture and Forestry Products

113. Although the prospects for agricultural productivity growth are limited due to the rough terrain, poor soil quality, fragmentation of landholdings into small family-run farms, and limited availability of arable land, there is scope for substantially increased value added in the sector.²⁷ The RGoB is keen to make progress in this area, and emphasizes a strategy labeled the “triple gems,” involving (i) increased productivity, (ii) improved access to markets, and (iii) more effective marketing of agricultural products. Given the widespread dependence on crop and livestock production for income, food security, and employment, the success of such initiatives will be central to poverty reduction in rural Bhutan.

114. **Cash crops**, particularly potatoes, mandarins, and apples, have demonstrated the potential to increase and diversify farm incomes. Horticulture accounts for nearly all agriculture exports and half of the total value-added in the sector, though accounting for only 7 percent of the crop area. The estimated value of marketable surplus to Bhutanese farmers is estimated at \$18.8 million, and this could grow to around US\$30.0 million by 2015. While existing yields in cereal and horticultural crops are generally poor, the use of improved varieties and better management practices could readily double or triple yields. The dispersion of the population and lack of rural access are major constraints to income generation through agriculture. Farmers incur heavy losses of their output due to wildlife and post-harvest damage, amounting to as much as 30 to 40 percent of total production. Much needs to be done in providing appropriate labor-saving technology and efficient post harvest and agri-processing methods, so that productivity of labor per unit area is enhanced. With large ready markets in Bangladesh and India, external trade is especially attractive, given that local markets are prone to oversupply. However, future urban expansion and overall income growth will likely stimulate demand for farm products. There may be tremendous potential for the development of ‘organic’ agro-production, including the opportunities to increase the cultivation and export of sub-tropical fruits (citrus and mangoes), winter vegetables, strawberries, plums, cherries, pears, as well as organic red rice.

115. **Agri-processing** is another potential source of growth in Bhutan. Out of 730 registered industrial enterprises, 126 are in agri-processing (Table 7 above). The agro-based industries include a wide range of products including fruit processing plants, alcoholic beverage production units, and non-timber forest products. Dominated by the private sector, fruit processing and alcoholic beverage production sub-sectors account for the largest share of turnover and employment in this sector and are primarily export-oriented. Nonetheless, opportunities for private sector development in these sub-sectors exist if concerted inroads are made in addressing the binding business environment constraints. Some of the notable constraints of the agro-based industries relate to the

²⁷ Small family run farms have an average size of 3.4 acres. Only 7.8 percent of the land is arable.

high cost of raw materials, logistical difficulties, low labor productivity, low levels of technology, inadequate quality standards, poor management, marketing and export market development capabilities, and weak product diversification and innovation.

116. Another potential area lies in exploiting the high-value and low-volume **non-timber forestry products** such as shitake mushrooms, *Cordyceps sinensis* (Chinese caterpillar fungus, a high-altitude medicinal product) and lemongrass oil. The significance of cordyceps currently is probably masked by illegal exports through Tibet; if the auction market was open to international buyers, prices incomes, and volumes might increase. With its rich forests, Bhutan could also be a major supplier of medicinal and aromatic herbs and plants. All of these products command very high prices in export markets especially as markets for these products in the United States and Europe are growing rapidly. In total, Bhutan could conceivably achieve a target of agricultural exports of about US\$30 million over the coming decade, or approximately three times current export levels.²⁸ The natural availability of these products could be increased through better husbandry and in some cases through commercial cultivation. The main challenges in developing this potential lie in the industry's ability to gain appropriate accreditation and certification, secure markets and maintain strict and high quality control measures.

117. **Forestry-based industries** represent the largest number of industrial establishments in Bhutan (Table 7), reflecting Bhutan's plentiful natural resource endowment. The forest-based industries range from small sawmills and furniture houses to medium-sized firms that manufacture and export ready-to-assemble furniture, enjoying a modest level of value addition. The scale of mechanization in the sub-sector is minimal and processes are quite labor intensive. The private sector investment in the forest sector has significant potential to provide increased employment opportunities in the near to medium-term. With the prevailing ban on the export of timber and semi-finished products and the shortage of available skilled and unskilled labor, however, growth in this manufacturing sub-sector has stagnated in terms of both output and employment. To reverse the trend will require an improved investment climate with rational and stable marketing and pricing policies, expanded opportunities to export value-added wood products, increased adoption of better processing technology, and strengthened management capacity. The realization of the potential will depend on how effectively the key challenges of enhancing economies of scale, balancing environmental concerns and timber availability, improving the poor quality of design skills, and raising low productivity, are addressed.

118. Hence, while a large portion of the agricultural sector is focused mainly on the provision of food security, there is a substantial segment that could make a strong contribution to boosting economic dynamism. The Ministry of Agriculture has now made the conceptual shift away from food self-sufficiency and protection of the cereal sub-sector to the promotion of income through agricultural diversification. Of particular note is that activities based on agricultural or forestry products could provide income earning opportunities to a broader section of the population, reaching other regions

²⁸ *Bhutan Private Sector Survey*, World Bank, 2002.

besides the areas around Thimphu, Paro and Phuentsholing. Realizing this potential will depend on expanding access to markets, improving extension services, raising value-added through processing and packaging, and nurturing the growth of private sector entrepreneurs.

7. Generating Employment

119. There is a growing concern about employment, especially for youth and rural-urban migrants, which can only be addressed through the strong growth described above. With the rapid expansion of the education system, large numbers of school leavers are entering the job market with expectations of employment off the farm, preferably in the public sector. Much of the economic growth (such as in hydropower) does not contribute directly to employment generation, however, raising the onus on other sectors to provide job opportunities. The current information base for understanding the employment picture and developing appropriate policy is weak. Efforts need to be aimed at ensuring that effective public resource use and an improving investment climate are matched by an alleviation of the constraints to foster employment generation.

Tracking Employment

120. The main sources of information on employment come from the Bhutan Living Standard Survey 2003 (BLSS) and a series of labor force surveys, the most recent of which was undertaken in 2004. There are significant data issues that complicate comparisons between these surveys, and even between the various years of the labor force surveys.²⁹ Still, several features of the employment picture are discernable from the data. A striking issue is the high level of informality in Bhutan, where 83 percent of the workforce is either an “own account worker” or “family worker,” with a very disproportionate impact on women and workers in rural areas (Table 12). Most of these workers fall outside the scope of labor regulations and social protection.

Table 12: Status in Main Occupation, by Area and Gender

	All	Urban		Rural	
		Male	Female	Male	Female
Population share	100.0%	8.1%	8.7%	37.5%	45.7%
Employee	11.5%	73.9%	40.7%	6.2%	1.4%
Member of cooperative	1.3%	2.0%	2.8%	0.8%	1.4%
Own account worker	17.5%	16.2%	23.8%	22.1%	13.0%
Employer	0.2%	0.7%	0.8%	0.1%	0.0%
Family worker	65.3%	4.7%	25.9%	64.8%	81.2%
Collective farmer	1.2%	0.1%	0.3%	1.5%	1.3%
Other	3.0%	2.4%	5.9%	4.4%	1.6%

Source: BLSS 2003. Sample is population above 9 years and who was employed for the last 7 days.

121. The BLSS also informs that about 80 percent of the working population is found in the agriculture sector, mostly in subsistence (Table 13). The second most important sector is public administration, which employs about 59 percent of the men in urban areas. As mentioned above, the key hydropower sector employs fewer than 1 out of 1000 workers. Of note is the importance of retail trade, and hotel and restaurant services for urban women.

²⁹ Recommendations for the next round of labor force surveys include revising the definition of employment and search period, following the RGOB’s system of national accounts, redesigning the questionnaire format, reducing the sample size (the urban sample may be un-necessarily big, especially when the occupation codes are aggregated to 11 codes only), improving surveyor’s training, and improving presentation and dissemination of the results.

Table 13: Employment by Sector, by Area and Gender

	All	Urban		Rural	
		Male	Female	Male	Female
Population share	100.0%	8.1%	8.7%	37.5%	45.7%
Agriculture	80.2%	2.6%	12.4%	86.5%	95.9%
Mining	0.1%	0.4%	0.2%	0.2%	0.1%
Manufacturing	1.1%	4.7%	9.1%	0.6%	0.1%
Elec., gas, water	0.1%	0.6%	0.0%	0.2%	0.0%
Construction	1.1%	4.9%	1.2%	1.5%	0.1%
Retail trade	2.6%	9.8%	20.5%	1.0%	1.0%
Hotel, restaurants	0.8%	2.9%	5.5%	0.3%	0.4%
Transport	0.8%	4.8%	1.0%	0.7%	0.1%
Finance, real estate	0.0%	0.2%	0.1%	0.0%	0.0%
Insurance	0.1%	0.1%	0.2%	0.0%	0.1%
Public administration	8.5%	59.1%	28.6%	4.2%	0.7%
Education	0.3%	1.3%	2.0%	0.3%	0.0%
Health, social work	0.2%	0.3%	1.3%	0.2%	0.0%
Other	4.0%	8.2%	17.9%	4.5%	1.5%

Source: BLSS 2003. Sample is population above 9 years and who was employed for the last 7 days.

122. The 2004 labor force survey estimates the unemployment rate at 2.5 percent of the economically active population, with a significantly higher incidence of unemployment among urban females than males. The 2005 census suggests that unemployment may have risen further to 3.1 percent in 2005. Both surveys also suggest that unemployment is a major issue for the youth (people aged 15-24). Although rising school enrollment rates have lowered labor force participation rates of youth, they still constitute over 40 percent of the unemployed, and growing cohorts of school leavers combined with rural-urban migration are increasing pressure on limited job opportunities. Recent estimates by the Ministry of Labor and Human Resources based on information received from the Ministry of Education and the Royal University of Bhutan suggest that a minimum of 56,853 thousand school leavers are expected on the labor market by the end of 2012, out of which only 36,218 would be able to find employment in the private sector. Overall, the data may understate unemployment, since most workers are not covered by formal contracts, and underemployment may be a more significant issue in remote areas.

123. It is worth noting that even with stringent rules in place governing the employment of expatriates, there is a sizable foreign labor force in Bhutan, amounting to 40-50,000 workers, and representing more than half of formal sector employment. Work permits are generally granted if the request is in an 'allowable category,' and the recently streamlined approval process is usually swift. Although many foreign workers bring special skills in fields like medicine or engineering, most take up jobs in construction and other activities that tend to be difficult and low paid.³⁰ There is a de facto minimum wage of Nu. 100 per day and formal legislation is planned.³¹

³⁰The employment of nationals in the construction industry has grown modestly, and was about 6,900 workers in 2004. Construction work is widely regarded as a low social status job in addition to being poorly paid and entailing enormous physical hardship. Most of the 32,000 registered expatriate workers in the country are engaged as construction laborers.

³¹ The minimum wage for Bhutanese workers in the public sector is fixed at Nu100 per day. Some large private sector firms have followed the public sector's lead. Overall wage levels vary considerably with nationalities and regions.

Perspectives from the Private Sector

124. Available information from the private sector survey of 2002, the establishment survey, as well as *Doing Business in 2006*, point to several key issues concerning the expansion of employment. The establishment survey identifies access to land and credit as being the main constraints on the expansion of their business and hiring. *Doing Business in 2006* indicates that labor market rigidity is a major issue, ranking Bhutan as having one of the most rigid labor markets in South Asia, in terms of the difficulty of hiring and firing workers, and the regulations surrounding working hours. In addition, the report finds that the cost of firing a worker is the highest in the South Asia region. These factors contribute to the size of the informal economy. Representatives from the private sector also report difficulties in hiring skilled foreign workers, skills mismatch and shortages, job-hopping, Bhutanese youth being unwilling to take low paid or arduous jobs, a perception that the youth are reluctant to take up jobs in the private sector, in particular blue collar jobs, and the like as obstacles to generating more income earning opportunities. The rapid increase in female job seekers and the lack of jobs in rural areas adds to employment pressures.

Labor Market Reforms

125. Improving the functioning of labor markets is a priority for the government. The government has prepared a draft Labor and Employment Act that looks to balance the legitimate needs of workers with the promotion of private sector activity. Once effective, this Act will: (i) allow Bhutanese, particularly youths, to be employed in a wider spectrum of economic activities, (ii) permit more flexible working hours, (iii) allow night work in industries requiring a round-the-clock-work schedule, and (iv) help streamline processes and reduce the time required for recruiting foreign workers (see Box 5). The act is expected to be submitted to the Committee of the Council of Ministers before end-2006. Once passed, the Act will require accompanying rules and regulations to make it fully operational. A range of reforms to streamline the process for recruiting foreign workers were implemented recently. In particular, an online recruitment system has cut the time to obtain foreign worker permits from 3 months to 3 weeks. A one stop service center was also established, allowing applicants to complete all the formalities required for foreign worker recruitment in one place.

126. Donors are providing outside advice on the draft as well as technical assistance on the preparation of accompanying rules and regulations. In general, the draft law is in line with international conventions, allowing for the formation of workers' councils and paternal leave, for example. Concomitantly, it maintains some flexibility, permitting temporary work agencies. Still, there are some areas where the proposed law may be overly prescriptive and may frustrate the RGoB's goal of fostering the expansion of income earning opportunities. For example, the Chief Labor Administrator is given wide discretion to alter contracts, notification of employment termination (by either side) is long by international standards, the percentages for night and overtime work are prescribed, the list of restrictive industries seems quite broad, the rules concerning the hiring and firing of foreign workers may be overly restrictive, and the immigration

service is to have broad powers to cancel work permits and repatriate foreigners at the employers expense (potentially discouraging FDI).

Box 5: Key Provisions of the draft Labor and Employment Act³²

- Prohibits forced labor, the worst forms of child labor, sexual harassment, and discrimination.
- Sets out the functions of the labor administration, including providing policies and programs in the areas of: (a) employment promotion, (b) labor protection, (c) labor relations, (d) vocational education and training, (e) occupational standards setting and certification.
- Specifies the circumstances under which an inspector might issue improvement or prohibition notices, and procedures of appeal.
- Describes the terms and conditions of contract employment, which applies to all labor except members of a family, and is to include written documentation on (a) the duration, (b) a specific task to be performed, (c) notice period for termination of the contract, and (d) wages, working hours, probation period and leave provisions. The section on contracts also specifies circumstances of contract termination, and unlawful reasons for termination, such as the employee's race, colour, sex, marital status, pregnancy, religion, political opinion, social origin, or absence from work on maternity leave or paternity leave. Finally, the section also sets down rules for making employees redundant, requiring consultations with workers, notification of the Chief Labor Administrator, and additional notice beyond what was specified in the contract.
- Sets out a series of benefits, including retirement, leave (including 9 public holidays), and maximum number of work hours.
- Gives the Ministry the power to fix a minimum wage.
- Covers occupational health and safety.
- Notes restrictions on the employment of workers between the ages 15-18, including barring them from night-work.
- Provides for the right to form worker's associations and engage in collective bargaining (in firms hiring more than 10 people). It also addresses dispute resolution.
- Specifies the circumstances under which foreigners may be employed. Foreign workers require a permit, and no Bhutanese is to be made redundant before all foreign workers performing similar tasks are made redundant first. The act gives notice that the government may establish quotas. The Department of Immigration may cancel a worker's permit at any time and immediately repatriate the worker at the employer's expense.
- Sets out penal provisions for violations that include fines or prison terms.

127. The RGoB is also working to alleviate skills issues by trying to raise retention rates of children through secondary school, as well as revising the curriculum to better target the skills sought by private sector employers. Boosting vocational training and job counseling is also an important aspect of the RGoB's strategy, again seeking to closely match job skills with what is demanded in the labor market. The MoLHR is attempting

³² The Labor and Employment Act does not apply to (a) the uniformed members of the Royal Body Guards, (b) the uniformed members of the Royal Bhutan Army, (c) the uniformed members of the Royal Bhutan Police.

to match labor supply and demand through job counseling, job information, though it is a new organization with limited capacity.

Sources of Employment Generation over the Medium-term

128. Given the large stream of revenue from hydropower sales and donors flowing through the government, the public sector will remain an important employment generator in the coming years, both directly by hiring and indirectly through public spending. Still, as noted above, hydropower expansion will bring very few jobs, and the RGoB will need to be mindful to avoid excessive increases in the public sector payroll, including through the SOEs, as Tala revenues lift government coffers. Hence, assuring a sound institutional framework, especially in avoiding overly cumbersome restrictions, will be critical to addressing employment concerns and facilitating employment generation in the private sector. In this regard, construction, tourism and related services, as well as the commercialized part of agriculture enjoy good prospects for expanding income earning opportunities.

8. Conclusion and Medium-Term Outlook

129. With continued hydropower development, donor support, and sound macro-fiscal management, the prospects for Bhutan are bright (Table 9). Growth will jump between 2006 and 2007 with the coming on-stream of the Tala hydropower project. Sustaining economic dynamism over the medium term, however, will depend on realizing the potential of the private sector in areas such as commercial services, agribusiness, and tourism. Together with the hiring associated with the expansion of public services, the private sector will become increasingly important in generating adequate employment opportunities.

Table 14: Selected Economic Indicators - Medium-Term Outlook

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
				<i>Projection</i>		
	<i>(Percentage Change)</i>					
Real GDP (1)	7.9	7.3	6.8	5.9	19.3	7.0
Consumer prices (1)	1.8	3.5	3.7	3.1	3.1	3.3
	<i>(In millions of U.S. dollars)</i>					
Balance of Payments (1)						
Current account balance	-67.0	-55.4	-189.8	-165.3	12.9	-10.9
Trade Balance	-76.8	-87.3	-224.5	-229.5	-67.7	-12.7
Exports, f.o.b.	112.8	157.6	186.0	234.2	400.1	455.1
Imports, f.o.b.	-189.6	-244.9	-410.6	-463.7	-467.8	-467.7
Services (net)	-16.7	-8.0	-10.1	-26.5	-45.1	-66.8
Receipts	24.9	31.3	46.4	53.0	58.3	64.0
Payments	-41.6	-39.3	-56.5	-79.5	-103.4	-130.7
External reserves (months of imports (c.i.f.) (2))	23.5	18.8	12.2	11.9	13.0	14.4
Exchange rate (ngultrum/US\$, period average) (2)	47.93	45.41	44.61	43.80	44.70	45.70
	<i>(In percent of GDP)</i>					
Central government (2)						
Total expenditure and net lending	35.5	31.5	35.9	40.6	36.5	33.3
Total revenue and grants	25.4	33.5	29.5	33.1	33.4	30.3
Overall balance (including grants)	-10.0	2.0	-6.4	-7.4	-3.2	-3.0
Total public debt (end of period)	76.9	76.2	81.7	84.2	71.6	67.7
Memorandum items (2):						
Nominal GDP (millions of ngultrum)	27,747.8	31,142.6	35,371.6	39,829.7	49,000.8	54,526.0

Note: Projections were prepared as part of the Medium Term Fiscal Framework, developed by the Macroeconomic Framework Coordination Committee of the RGoB, and presented to the Council of Ministers at the beginning of 2006.

130. It should be noted that even with the rapid growth in GDP, the expansion of the overall resource envelop will be moderated by a reduction in budgetary grants from India and high debt service payments associated with Tala. Hence, while spending will rise, it will be critical to manage expectations associated with the commissioning of Tala and pursue prudent fiscal policy, avoiding wasteful expenditures and an unproductive investment boom. The current MTFE envisages no significant fiscal surpluses over the medium term. This is of some concern, especially regarding the high volatility of revenues and expenditures. Generating surpluses in high revenue years to help lift spending in difficult years is a key part of any effort to mitigate volatility.

131. With such a high proportion of GDP flowing through the government (donor and hydropower revenues), every effort should be made to ensure that these are effectively applied towards sustained development progress. This means being vigilant to avoid the

natural resource curse, including continuing to strengthen governance arrangements, endeavoring to mitigate volatility, and carefully monitoring the real effective exchange rate to avoid any emerging signs of ‘Dutch disease.’ The RGoB should prepare a medium term strategy for divesting from the SOEs, and ensure that where government participation is to remain, that the goals of the public support, and the management of the companies are clearly defined and transparent.

132. Accelerating growth over the medium-term will require further progress in improving the investment climate. Addressing skills shortages and bureaucratic burdens stand out as key areas for government attention. Inviting more FDI will also play an important role in raising standards, transferring technology, and bringing much needed managerial capacity. The outlook for the private sector is bright, and increasingly it will develop a momentum of its own, though links with public spending will remain strong over the medium-term. The potential for autonomous dynamism is perhaps greatest in the expanding tourism sector and other services like the retail trade.

133. Generating adequate employment opportunities for the growing cohorts of school leavers and those seeking to move out of the agricultural sector will be a major challenge. Many continue to prefer government jobs to working in the private sector, and the RGoB will need to resist pressures to expand public sector employment unduly. Continued progress in improving the investment climate will be central to jobs growth that is broad-based.

134. Overall, the RGoB remains focused on poverty reduction and expanding the access and opportunities of the Bhutanese people. Continued and strong commitment to deepening the reforms will be essential to ensuring the effective intermediation of public resources, the vibrancy of the private sector, the adequate generation of employment, and the mitigation of vulnerability, for sustained development and GNH.

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Annex 1 – The Findings of the Private Sector Survey

Biggest Business Constraints of the Private Sector

The ICA was based on a survey of 100 private sector firms, which concluded with a question asking firms to identify their three biggest business problems and to rank them in order of importance (Table 8 above).

- *Skilled Labor* - By far the most important constraint felt by a majority of private firms was a lack of skilled labor. In addition there were concerns over labor policy and concerns about the future direction of policy on the employment of both skilled and non-skilled, and non-national labor. In this respect, training emerged as an area of considerable weakness in the survey. Virtually no firms undertook any serious staff training - despite their complaints over a lack of skills. Within the entire survey, only 3 percent of the employees had received training over the preceding 12- month period. Given the linkages between worker training, work productivity, and firm growth, it is important to ensure that a correct set of incentives are put in place to encourage firms to undertake more training.
- *Bureaucratic Burden - Public Policy and Regulations* - A surprising 26 percent of firms felt that the government was unpredictable - with this unpredictability exerting a negative impact on their business operations. A majority of firms (56 percent) feared that the government would make policy changes without consultation - again with negative effects on their businesses.
- *Technology (Lack of Demand)* - The third concern, lack of demand, presents somewhat of an anomaly. Demand in Bhutan is clearly not a constraint for an efficient and well-run business. Domestic demand is increasing rapidly as national income continues to rise - and regional demand for most products from India is well beyond Bhutan's production capacity. When most companies complain of a lack of demand, they are often referring to a lack of demand - at the price and quality offered by domestic producers. In other words, these companies are not cost competitive compared with imports or other domestic producers. Being able to produce goods competitively will depend, to a large degree, on a firm's ability to access technologies that will enable it to undertake its business in a cost effective manner.
- *Finance* - Firms in Bhutan complained about many aspects of the financial system and many of their concerns appear valid. Prevalent among these was the high and inflexible cost of finance. With real interest rates of between 7 to 10 percent, the cost of capital is exceedingly high in Bhutan. This has serious implications for any policy that seeks to promote increased capital intensity and mechanization in production processes. Another interesting feature of the financial sector was the large number of companies that were credit constrained (around 42 percent of the total sample). Although this was partly a result of a lack of financial sophistication among firms which did not wish to carry any debt - it is also a reflection of a lack of sophistication of the banking system which, despite access

to large amounts of liquid resources, did not (or could not) reach out to private-sector enterprises to help them develop bankable projects.

- *Infrastructure* - While firms were mostly complimentary about Bhutan's infrastructural base, the one big exception to this was road and air transport. Poor roads, which are slow and frequently cut off by land slides, make transport costly and unreliable. In the case of some timber products, the cost of transporting the timber is more than the value of the wood itself.

Main Recommendations

The report concluded with several key recommendations in support of private sector development, including:

- **TRAINING.** Establishment of a transparent system of tax relief and possibly a system of industry levies to support radically increased worker and management training - in an effort to increase overall productivity.
- **LABOR.** Develop a transparent, time-bound, policy for the recruitment of non-national workers with an eye to ensuring the ongoing cost competitiveness of Bhutanese industry.
- **FINANCE.** Encourage the development of innovative financial instruments and payment modalities - based upon the AsDB study - including, inter alia, ATM machines, greater use of lower-cost credit card transactions, introduction of leasing finance, extension of factoring services. Simultaneously make every effort to encourage greater financial-sector competition and greater interest-rate sensitivity.
- **TECHNOLOGY.** Support technology transfer mechanisms to enhance the private sector through, inter alia, the immediate establishment of a Matching-Grants System, use of retired executive schemes, etc. Incentivize technology transfer through the establishment of, for example, tax breaks on research and development.
- **FOREIGN DIRECT INVESTMENT.** Ensure that the new FDI Law is finalized and approved in the next session of the Assembly and that supporting regulations are put in place shortly thereafter. Actively encourage potentially high-impact FDI ventures in an early phase of implementation.
- **EXPORT INCENTIVES.** Immediately implement a system of duty drawback on imported raw materials used in the production of export products (including exports to India) and immediately begin a dialogue with the banks on the provision of pre-shipment and post-shipment finance to the private sector.

- **POLICY ENVIRONMENT.** Develop a clear, consistent, and transparent policy environment for the private sector, within the context of the NFYDP, which takes into account private sector views. Ensure proper and clear systematization, codification, and regulation of private sector strategy, laws and regulations.
- **AUDITING AND ACCOUNTING.** Increasingly include a wider group of private sector companies in the auditing net to encourage the greater use of financial management information as a tool of management information systems (MIS) for firms - as well as to assist the tax authorities.
- **INDUSTRIAL ESTATES AND DRY PORTS.** Further support private sector development through the establishment of strategically located (for the private sector) industrial estates as well as dry ports at strategic border locations.
- **DIALOGUE.** Immediately put in place support mechanisms for private sector industry interests such as the Bhutan Chamber of Commerce and Industry as well as sector associations - by bringing in experienced professionals from external chambers and the private sector.

Statistical Appendix

Table A.1: Key Economic Indicators

	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
<i>(Annual percentage change)</i>							
Growth and prices							
Real GDP	6.8	6.7	6.6	8.2	7.9	7.3	6.8
Consumer prices	4.6	4.5	4.4	2.7	1.8	3.5	3.7
<i>(Percent of GDP)</i>							
Central government							
Revenue and grants	41.0	40.9	40.0	35.9	25.4	33.5	29.5
Of which: Grants	0.0	0.0	0.0	7.5	5.8	7.2	5.5
Expenditure and net lending	11.5	11.5	11.9	10.3	3.3	7.3	6.7
Of which capital spending	19.0	19.5	20.6	18.1	16.5	16.5	17.4
Current balance	-0.4	1.5	2.1	0.5	-0.2	0.0	-0.2
Overall balance (excluding grants)	2.5	4.2	2.1	2.6	0.7	-0.3	-0.3
Overall balance (including grants)	-21.7	-21.7	-29.2	-19.5	-18.2	-15.2	-18.7
Financing	-2.2	-4.4	-12.0	-4.3	-10.0	2.0	-6.4
Foreign financing	3.3	3.2	4.9	5.7	5.5	3.0	4.0
Domestic financing	-1.1	1.2	7.1	-1.4	4.5	-5.0	2.4
<i>(In millions of ngultrum)</i>							
Monetary Survey							
Foreign assets (net)	11,341.6	13,250.6	12,779.1	14,352.2	17,507.4	16,452.4	18,615.4
Domestic credit	374.9	746.9	2,012.2	2,275.4	3,810.1	4,287.7	5,996.1
Central government, net	-1,485.3	-1,110.3	-455.7	-744.5	-109.8	-746.0	-760.8
Non-financial public enterprises	391.0	353.6	332.7	292.3	257.2	268.5	234.8
Private sector	1,469.2	1,503.6	2,135.2	2,727.5	3,662.7	4,765.3	6,522.2
Broad money	7,176.2	8,823.0	9,314.8	10,971.2	14,255.1	14,832.3	16,848.6
Money	2,685.4	3,584.2	4,372.8	4,913.8	6,793.8	7,737.0	8,088.3
Quasimoney	4,490.8	5,238.9	4,942.0	6,057.5	7,461.3	7,095.3	8,760.3
<i>(In millions of US dollars)</i>							
Balance of payments							
Current account balance	9.0	-43.3	-26.4	-48.3	-67.0	-55.4	-189.8
(In percent of GDP)	2.3	-10.0	-5.7	-9.4	-11.6	-8.1	-23.9
Trade balance	-57.6	-70.7	-70.3	-82.9	-76.8	-87.3	-224.5
Exports, f.o.b.	104.7	114.3	99.5	103.6	112.8	157.6	186.0
Of which to India	98.2	109.3	94.4	97.5	106.3	149.1	169.8
Imports, c.i.f.	-162.3	-185.0	-169.8	-186.5	-189.6	-244.9	-410.6
Of which from India	-115.5	-139.0	-160.9	-145.0	-171.2	-215.6	-226.9
Of which related to Tala	-26.2	-33.9	-29.4	-11.8	-37.3	-45.7	-37.1
Services (net)	-0.3	-11.4	-4.0	-4.5	-16.7	-8.0	-10.1
Income (net)	9.6	-3.9	2.6	-4.9	-11.4	-16.3	-16.6
Current transfers (net)	57.3	42.7	45.3	44.1	37.9	56.2	61.5
Of which grants	120.8	83.3	80.0	85.6	84.7	94.4	122.7
Of which India	89.5	58.4	55.0	59.3	30.1	50.9	68.8
Non-monetary capital (net)	27.0	41.1	30.8	103.1	225.9	178.9	214.7
Of which foreign aid (loans, net)	33.0	41.1	49.8	59.0	94.5	102.8	77.7
Net errors/omissions.	7.3	37.4	0.7	-29.0	-104.4	-115.3	7.7
Overall balance (change in reserves)	43.4	35.1	5.1	25.8	54.5	8.1	32.7
Gross official reserves	259.0	292.7	293.6	316.5	371.5	383.5	417.9
(In months of imports of goods and NFS)	19.2	19.0	20.8	20.4	23.5	18.8	12.2
External debt (year-end)	150.3	173.8	236.9	290.9	413.1	515.4	608.7
(In percent of GDP)	38.3	39.9	51.1	56.9	71.4	75.2	76.8
Debt service	14.1	6.5	6.2	6.1	7.6	9.8	12.0
(In percent of exports of goods and NFS)	11.5	4.9	4.7	4.6	5.5	5.2	5.2
Exchange rate (ngultrum/US\$ period average, year to June)	42.6	43.6	46.4	48.2	47.9	45.4	44.6
Memorandum items:							
Nominal GDP at factor cost (millions of nu)	16,703	19,005	21,521	24,636	27,748	31,143	35,372
Nominal GDP (millions of U.S. dollars)	392.2	435.5	463.9	511.0	578.9	685.8	793.0

Source: Statistical Year Book, 2004, NSB and Selected Economic Indicators, June 2005, RMA, International Financial Statistics, IMF, and staff estimates.

Table A.2: Gross Domestic Product at Factor Cost by Sectoral Origin

	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
	<i>(Millions of ngultrum, constant 2000 prices)</i>							
Gross domestic product	17149.8	18316.2	19550.6	20834.2	22538.7	24327.1	26110.0	27879.4
Primary	5184.0	5283.6	5446.0	5709.1	5941.3	6115.7	6274.9	6422.5
Agriculture (Crops)	2296.1	2360.9	2459.7	2566.5	2653.3	2729.7	2798.0	2854.5
Livestock	1630.0	1652.9	1705.4	1817.6	1915.2	1962.4	1999.8	2037.6
Forestry	1257.9	1269.8	1280.9	1324.9	1372.8	1423.6	1477.1	1530.4
Secondary	5564.7	6114.2	6719.5	7352.0	8440.1	9244.6	9769.8	10451.8
Mining	315.5	309.6	305.8	326.9	370.8	400.4	393.8	389.0
Manufacturing	1530.5	1561.0	1624.5	1678.4	1714.6	1790.2	1890.9	1981.3
Electricity	2288.4	2396.8	2378.2	2274.7	2414.8	2528.1	2645.7	2788.1
Construction	1430.4	1846.9	2411.1	3072.1	3940.0	4525.9	4839.5	5293.5
Tertiary	6401.1	6918.3	7385.1	7773.2	8157.4	8966.8	10065.3	11005.1
Trade & services	915.2	955.6	1059.2	1218.4	1355.2	1564.6	1898.0	2174.7
Transport, storage, and communication	1569.0	1716.7	1828.2	1950.3	2065.6	2160.6	2418.2	2758.1
Financial, insurance and real estate	1020.7	1168.1	1266.6	1382.8	1309.3	1353.3	1521.9	1600.4
Government services	2431.5	2626.7	2839.8	2936.4	3109.6	3379.0	3510.4	3624.7
Taxes Net of Subsidies	611.9	626.8	569.1	512.0	590.3	817.6	1109.0	1273.9
Less: imputed bank service charges	-147.2	-175.6	-177.8	-226.6	-272.5	-308.2	-392.2	-426.6
	<i>(Annual percentage change)</i>							
Gross domestic product		6.8	6.7	6.6	8.2	7.9	7.3	6.8
Primary		1.9	3.1	4.8	4.1	2.9	2.6	2.4
Agriculture (Crops)		2.8	4.2	4.3	3.4	2.9	2.5	2.0
Livestock		1.4	3.2	6.6	5.4	2.5	1.9	1.9
Forestry		0.9	0.9	3.4	3.6	3.7	3.8	3.6
Secondary		9.9	9.9	9.4	14.8	9.5	5.7	7.0
Mining		-1.9	-1.2	6.9	13.4	8.0	-1.7	-1.2
Manufacturing		2.0	4.1	3.3	2.2	4.4	5.6	4.8
Electricity		4.7	-0.8	-4.4	6.2	4.7	4.6	5.4
Construction		29.1	30.5	27.4	28.3	14.9	6.9	9.4
Tertiary		8.1	6.7	5.3	4.9	9.9	12.2	9.3
Trade & services		4.4	10.8	15.0	11.2	15.5	21.3	14.6
Transport, storage, and communication		9.4	6.5	6.7	5.9	4.6	11.9	14.1
Financial, insurance and real estate		14.4	8.4	9.2	-5.3	3.4	12.5	5.2
Government services		8.0	8.1	3.4	5.9	8.7	3.9	3.3
Taxes Net of Subsidies		2.4	-9.2	-10.0	15.3	38.5	35.6	14.9
	<i>(Percent of GDP)</i>							
Primary	30.2	28.8	27.9	27.4	26.4	25.1	24.0	23.0
Agriculture (Crops)	13.4	12.9	12.6	12.3	11.8	11.2	10.7	10.2
Livestock	9.5	9.0	8.7	8.7	8.5	8.1	7.7	7.3
Forestry	7.3	6.9	6.6	6.4	6.1	5.9	5.7	5.5
Secondary	32.4	33.4	34.4	35.3	37.4	38.0	37.4	37.5
Mining	1.8	1.7	1.6	1.6	1.6	1.6	1.5	1.4
Manufacturing	8.9	8.5	8.3	8.1	7.6	7.4	7.2	7.1
Electricity	13.3	13.1	12.2	10.9	10.7	10.4	10.1	10.0
Construction	8.3	10.1	12.3	14.7	17.5	18.6	18.5	19.0
Tertiary	37.3	37.8	37.8	37.3	36.2	36.9	38.5	39.5
Trade & services	5.3	5.2	5.4	5.8	6.0	6.4	7.3	7.8
Transport, storage, and communication	9.1	9.4	9.4	9.4	9.2	8.9	9.3	9.9
Financial, insurance and real estate	6.0	6.4	6.5	6.6	5.8	5.6	5.8	5.7
Government services	14.2	14.3	14.5	14.1	13.8	13.9	13.4	13.0
Taxes Net of Subsidies	3.6	3.4	2.9	2.5	2.6	3.4	4.2	4.6
Less: imputed bank service charges	-0.9	-1.0	-0.9	-1.1	-1.2	-1.3	-1.5	-1.5
Memorandum items:								
Nominal GDP (millions of ngultrum)	14401.8	16702.9	19004.8	21520.6	24635.7	27747.8	31142.6	35371.6
Nominal GDP (millions of US\$)	375.1	392.2	435.5	463.9	511.0	578.9	685.8	793.0
Implicit GDP deflator (percent change)		8.6	6.6	6.3	5.8	4.4	4.6	6.4
CPI (percent change)		4.6	4.5	4.4	2.7	1.8	3.5	3.7

Source: Statistical Year Book, 2004, NSB, Selected Economic Indicators, December 2005, RMA, and staff estimates.

Table A.3: Key Tourism Indicators

	2000	2001	2002	2003	2004	2005
Total arrivals	7559	6,393	5,599	6,261	9,249	13,626
(percentage change)		-15.4	-12.4	11.8	47.7	47.3
Country of residence						
North and South America	3024	2,367	2,142	1,928	3,496	
Asia & Pacific	1556	1,462	1,332	1,152	1,452	
Europe	2948	2,450	2,015	2,473	3,478	
Africa	7	27	17	20	20	
Others	24	87	93	687	803	
Seasons						
Winter (November - January)	1274	874	849	986	1,240	
Spring (February - April)	2284	2,540	1,814	1,967	2,493	
Summer (May - July)	764	551	489	685	1,037	
Autumn (August - October)	3237	2,428	2,447	2,266	3,987	
Purpose						
Tour, holiday and recreation	6633	5,925	5,242	5,823	8,742	
Trekking & mountaineering	926	468	357	438	507	
Total tourism receipts (US\$ millions)	10.5	9.2	8.0	8.3	12.5	18.5
(percentage change)		-12.4	-13.3	4.0	50.6	48.0
Tourism contribution to GDP (in percent)	2.3	1.9	1.5	1.3	1.7	2.2

Source: Statistical Yearbook, 2003, NSB, and Monthly Statistical Bulletin, December 2005, RMA.

Table A.5: Balance of Payments

	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
	<i>(In millions of US dollars)</i>						
Current account balance	9.0	-43.3	-26.4	-48.3	-67.0	-55.4	-189.8
Trade balance	-57.6	-70.7	-70.3	-82.9	-76.8	-87.3	-224.5
Exports, f.o.b.	104.7	114.3	99.5	103.6	112.8	157.6	186.0
Of which to India	98.2	109.3	94.4	97.5	106.3	149.1	169.8
Imports, c.i.f.	-162.3	-185.0	-169.8	-186.5	-189.6	-244.9	-410.6
Of which from India	-115.5	-139.0	-160.9	-145.0	-171.2	-215.6	-226.9
Of which related to Tala	-26.2	-33.9	-29.4	-11.8	-37.3	-45.7	-37.1
Services (net)	-0.3	-11.4	-4.0	-4.5	-16.7	-8.0	-10.1
Credit	17.8	17.7	31.1	29.4	24.9	31.3	46.4
Debit	-18.1	-29.1	-35.1	-33.9	-41.6	-39.3	-56.5
Income (net)	9.6	-3.9	2.6	-4.9	-11.4	-16.3	-16.6
Credit	12.0	13.9	17.3	10.9	11.7	9.6	12.0
Debit	-2.4	-17.8	-14.8	-15.8	-23.1	-25.9	-28.6
Current transfers (net)	57.3	42.7	45.3	44.1	37.9	56.2	61.5
Credit	121.3	88.1	87.2	91.7	91.1	107.1	135.8
Of which Grants	120.8	83.3	80.0	85.6	84.7	94.4	122.7
Of which India	89.5	58.4	55.0	59.3	30.1	50.9	68.8
Of which budgetary grants	45.3	50.1	55.0	52.5	18.5	50.4	58.9
Debit	-64.0	-45.3	-41.9	-47.7	-53.2	-50.9	-74.3
Non-monetary capital (net)	27.0	41.1	30.8	103.1	225.9	178.9	214.7
Capital transfers				41.9	121.4	102.8	93.3
Foreign direct investment	1.1	-	-	2.1	2.5	3.5	9.0
Portfolio investment	-	-	-19.0	-	-	-	-
Foreign aid (loans, net)	33.0	41.1	49.8	59.0	94.5	102.8	77.7
Other loans	-7.0	0.0	-	0.0	7.6	2.0	2.0
Other investment				0.0	0.0	-32.1	32.7
Net errors/omissions.	7.3	37.4	0.7	-29.0	-104.4	-115.3	7.7
Overall balance (change in reserves)	43.4	35.1	5.1	25.8	54.5	8.1	32.7
Monetary movements	43.4	35.1	5.1	25.8	54.5	8.1	32.7
Royal Monetary Authority	-	-	-	-	-	-	-
Commercial banks	-	-	-	-	-	-	-
Memorandum items:							
Export growth (value, percent)	-5.9	9.2	-12.9	4.1	8.9	39.7	18.0
Import growth (value, percent)	0.3	14.0	-8.3	9.8	1.7	29.2	67.6
Current account balance (in % of GDP)	2.3	-10.0	-5.7	-9.4	-11.6	-8.1	-23.9
Gross official reserves (millions of US\$)	259.0	292.7	293.6	316.5	371.5	383.5	417.9
Rupee reserves (millions)	2519.3	3106.6	3551.9	3663.9	3330.2	4362.8	3578.3
(in millions of US\$)	59.1	71.2	76.6	76.0	69.5	96.1	80.2
Convertible currency reserves (millions of US\$)	199.9	221.5	217.0	240.5	302.0	287.4	337.7
Months of imports	19.2	19.0	20.8	20.4	23.5	18.8	12.2
External debt (millions of US\$)	150.3	173.8	236.9	290.9	413.1	515.4	608.7
External debt (percent of GDP)	38.3	39.9	51.1	56.9	71.4	75.2	77.8
Debt service (millions of US\$)	14.1	6.5	6.2	6.1	7.6	9.8	12.0
Debt service (% exports, goods, NFS)	11.5	4.9	4.7	4.6	5.5	5.2	5.2
Exchange rate (ngultrum/US\$)	42.6	43.6	46.4	48.2	47.9	45.4	44.6
Nominal GDP (millions of US\$)	392.2	435.5	463.9	511.0	578.9	685.8	793.0

Source: Statistical Year Book 2004, NSB, Selected Economic Indicators, December 2005, RMA, Annual Financial Statements 2003-04 and staff

Table A.6: Debt and Debt Service

	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
	<i>(In millions of U.S. dollars)</i>						
Total debt	150.3	173.8	236.9	307.9	459.1	529.4	674.6
Total domestic debt	-	-	-	17.1	46.0	13.9	65.8
Bonds	-	-	-	11.3	17.2	40.8	53.2
Ways and Means	-	-	-	5.8	28.8	(26.9)	12.6
Total external debt outstanding & disbursed	150.3	173.8	236.9	290.9	413.1	515.4	608.7
Medium- and long-term (DOD)	150.3	173.8	236.9	290.9	413.1	515.4	608.7
Official creditors	150.3	173.8	236.9	290.9	413.1	515.4	608.7
Multilateral	88.3	88.3	94.4	107.7	142.0	152.5	169.2
Asian Development Bank	43.2	43.2	47.4	55.4	75.8	79.2	88.0
EFIC (Australia)	0.5	0.5	0.4	0.3	0.2	0.1	0.0
IFAD	12.7	12.7	12.5	13.7	19.6	20.0	20.2
KFAED	7.9	7.9	6.5	5.1	3.6	2.5	1.8
World Bank (IDA)	24.0	24.0	27.6	33.2	42.9	50.7	59.1
Bilateral	62.0	85.5	142.5	183.2	271.1	363.0	439.5
Government of Austria	10.4	10.4	12.6	23.0	34.7	47.3	54.9
Government of India	51.6	75.1	129.9	160.2	236.3	315.6	379.6
of which Tala		33.7	76.3	108.1	178.2	259.4	328.0
Government of Denmark				-	-	-	5.0
Private creditors	-	-	-	-	-	-	-
Short-term debt	-	-	-	-	-	-	-
External debt service	14.1	6.5	6.2	6.1	7.6	9.8	12.0
Amortization	11.8	4.6	4.5	4.9	5.9	6.9	9.0
Interest payments	2.3	1.8	1.7	1.1	1.7	2.8	3.0
	<i>(Percent of GDP)</i>						
Total debt				60.3	79.3	77.2	85.1
Total domestic debt				3.3	7.9	2.0	8.3
Bonds				0.0	0.0	(0.0)	0.0
Ways and Means							
Total external debt, % of GDP	38.3	39.9	51.1	56.9	71.4	75.2	77.8
Medium- and long-term debt/GDP	38.3	39.9	51.1	56.9	71.4	75.2	76.8
Short-term debt/GDP	-	-	-	-	-	-	1.0
Debt service ratio							
(In percent of exports of goods and NFS)	11.5	4.9	4.7	4.6	5.5	5.2	5.2
Memorandum items:							
Nominal GDP (millions of U.S. dollars)	392.2	435.5	463.9	511.0	578.9	685.8	793.0
Exchange rate (ngultrum/U.S. \$)	42.6	43.6	46.4	48.2	47.9	45.4	44.6
Exports of goods & nonfactor services	122.5	132.0	130.6	133.0	137.7	188.9	232.4

Source: Selected Economic Indicators, December 2005, RMA and Annual Financial Statements of RGoB for the year ended 30 June, 2005.

Table A.7: Summary of Central Government Finance and Medium Term Fiscal Framework

	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
					<i>Prov. Est.</i>	<i>Budget</i>	<i>Proj.</i>
<i>(In millions of ngultrum)</i>							
Total revenue and grants	8848.5	7054.3	10422.6	10439.2	13191.3	16356.7	16526.8
Total revenue	5100.0	4785.3	5055.2	6066.1	6805.7	10122.0	11344.2
Tax revenue (Current Revenue)	2035.9	2403.9	2113.7	2826.8	3007.8	4149.7	3193.7
Non-tax revenue (Capital Revenue)	1223.3	760.1	713.4	1286.8	1197.7	1250.5	2408.4
Other revenue	1840.8	1621.3	2228.1	1952.6	2600.2	4721.8	5742.0
Grants	3748.5	2269.1	5367.4	4373.1	6385.6	6234.7	5182.6
Of which India	2531.8	929.3	2287.2	2370.5	3835.2	4174.8	3000.0
Expenditure and net lending	9910.2	9842.1	9795.8	12697.8	16151.8	17901.7	18162.6
Total expenditure	9780.4	9890.5	9802.3	12785.9	16102.8	17776.0	19445.6
Current expenditure	4467.9	4580.9	5149.2	6170.6	7198.6	7962.0	8710.0
Capital expenditure	5312.6	5309.6	4653.1	6615.3	8904.2	9814.0	10735.6
Net lending	129.8	-48.4	-6.5	-88.1	49.0	125.6	-1283.0
Current balance	632.1	204.4	-94.0	-104.5	-393.0	2159.9	2634.2
Overall balance (excluding grants)	-4810.2	-5056.9	-4740.6	-6631.7	-9346.1	-7779.7	-6818.4
Overall balance (including grants)	-1061.7	-2787.8	626.8	-2258.6	-2960.5	-1545.0	-1635.8
Financing	1061.7	2787.8	-626.8	2258.6	2960.5	1545.0	1635.8
Foreign	1396.7	1537.3	932.1	1414.8	1054.4	-702.5	-273.7
Domestic	-334.9	1250.4	-1558.9	843.9	1906.1	2247.4	1909.5
Total public debt (end of period)	15049.1	21342.0	23737.5	28893.7	33529.7	35108.2	36937.1
Foreign	14215.7	19205.0	23112.4	26515.6	29776.6	30732.9	30709.4
Domestic	833.4	2137.0	625.1	2378.1	3753.1	4375.3	6227.7
<i>(Percent of GDP)</i>							
Total revenue and grants	35.9	25.4	33.5	29.5	33.1	33.4	30.3
Total revenue	20.7	17.2	16.2	17.1	17.1	20.7	20.8
Tax revenue (Current Revenue)	8.3	8.7	6.8	8.0	7.6	8.5	5.9
Non-tax revenue (Capital Revenue)	5.0	2.7	2.3	3.6	3.0	2.6	4.4
Other revenue	7.5	5.8	7.2	5.5	6.5	9.6	10.5
Grants	15.2	8.2	17.2	12.4	16.0	12.7	9.5
Of which India	10.3	3.3	7.3	6.7	9.6	8.5	5.5
Expenditure and net lending	40.2	35.5	31.5	35.9	40.6	36.5	33.3
Total expenditure	39.7	35.6	31.5	36.1	40.4	36.3	35.7
Current expenditure	18.1	16.5	16.5	17.4	18.1	16.2	16.0
Capital expenditure	21.6	19.1	14.9	18.7	22.4	20.0	19.7
Net lending	0.5	-0.2	0.0	-0.2	0.1	0.3	-2.4
Current balance	2.6	0.7	-0.3	-0.3	-1.0	4.4	4.8
Overall balance (excluding grants)	-19.5	-18.2	-15.2	-18.7	-23.5	-15.9	-12.5
Overall balance (including grants)	-4.3	-10.0	2.0	-6.4	-7.4	-3.2	-3.0
Financing	4.3	10.0	-2.0	6.4	7.4	3.2	3.0
Foreign	5.7	5.5	3.0	4.0	2.6	-1.4	-0.5
Domestic	-1.4	4.5	-5.0	2.4	4.8	4.6	3.5
Total public debt (end of period)	61.1	76.9	76.2	81.7	84.2	71.6	67.7
Foreign	57.7	69.2	74.2	75.0	74.8	62.7	56.3
Domestic	3.4	7.7	2.0	6.7	9.4	8.9	11.4
Memorandum item:							
Nominal GDP (millions of ngultrum)	24,636	27,748	31,143	35,372	39,830	49,001	54,526

Source: RGoB Annual Financial Statements 2003-04, Selected Economic Indicators, September 2005, RMA, National Budget - Financial Year 2005-06, June 2005 and staff estimates. The projections of the Medium Term Fiscal Framework were developed by the Macroeconomic Framework Coordination Committee of the RGoB.

Table A.8: Government Revenue and Grants

	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
					<i>Prov. Est.</i>	<i>Budget</i>
	<i>(In millions of ngultrum)</i>					
Total Revenue and grants	8,848.5	7,054.3	10,422.6	10,439.2	13,191.3	16,356.7
Total Revenue	5,100.0	4,785.3	5,055.2	6,066.1	6,805.7	10,122.0
Tax revenue	2,035.9	2,403.9	2,113.7	2,826.8	3,007.8	4,149.7
Direct Tax	1,119.7	1,191.6	1,331.8	1,458.0	1,532.2	1,623.9
Corporate Income Tax	394.9	383.7	419.1	447.9	538.4	551.1
Business Income Tax	317.2	350.2	404.0	423.2	325.1	341.0
Tax on Payroll/PIT	73.6	100.5	113.5	84.6	131.7	146.4
Other direct taxes	333.9	357.2	395.2	502.4	536.9	585.3
o/w Royalties	214.3	214.7	243.3	332.2	288.3	397.0
Indirect Tax	916.2	1,212.3	781.9	1,368.7	1,475.6	2,525.8
Bhutan Sales Tax	360.0	435.0	495.5	567.9	673.4	781.0
Export Tax	12.3	0.8	0.5	0.9	0.7	0.9
Excise Duty	444.9	657.8	129.3	565.6	631.0	1,516.4
Import Duty	94.5	115.2	153.3	230.8	166.6	223.2
Other Indirect Tax Revenue	4.5	3.5	3.3	3.6	3.9	4.3
Nontax Revenue	1,223.3	760.1	713.4	1,286.8	1,197.7	1,250.5
Administrative Fees and Charges	137.0	148.4	128.9	169.0	204.1	215.3
Capital Revenue	34.7	25.0	73.5	232.6	174.8	217.6
Revenue from Government Departments	500.0	34.1	40.6	78.7	79.3	86.6
Dividends	179.0	205.5	121.3	172.1	168.2	176.2
Transfer of Profits	315.4	317.2	198.4	384.5	279.7	271.7
Interest Receipts from Corporations	..	..	..	242.3	283.9	275.0
Other Non-Tax Revenue	57.3	29.8	150.6	7.5	7.6	8.2
Other Revenue	1,840.8	1,621.3	2,228.1	1,952.6	2,600.2	4,721.8
KHPC	..	..	..	..	..	..
CHPC	1,840.8	1,621.3	2,205.8	1,924.3	2,528.2	2,550.0
Tala	..	..	..	..	..	2,092.4
Basochu	..	..	22.3	28.3	72.0	79.4
Grants	3,748.5	2,269.1	5,367.4	4,373.1	6,385.6	6,234.7
Of which India	2,531.8	929.3	2,287.2	2,370.5	3,835.2	4,174.8
	<i>(Percent of GDP)</i>					
Total Revenue and grants	35.9	25.4	33.5	29.5	33.1	33.4
Total Revenue	20.7	17.2	16.2	17.1	17.1	20.7
Tax revenue	8.3	8.7	6.8	8.0	7.6	8.5
Direct Tax	4.5	4.3	4.3	4.1	3.8	3.3
Corporate Income Tax	1.6	1.4	1.3	1.3	1.4	1.1
Business Income Tax	1.3	1.3	1.3	1.2	0.8	0.7
Tax on Payroll/PIT	0.3	0.4	0.4	0.2	0.3	0.3
Other direct taxes	1.4	1.3	1.3	1.4	1.3	1.2
o/w Royalties	0.9	0.8	0.8	0.9	0.7	0.8
Indirect Tax	3.7	4.4	2.5	3.9	3.7	5.2
Bhutan Sales Tax	1.5	1.6	1.6	1.6	1.7	1.6
Export Tax	0.0	0.0	0.0	0.0	0.0	0.0
Excise Duty	1.8	2.4	0.4	1.6	1.6	3.1
Import Duty	0.4	0.4	0.5	0.7	0.4	0.5
Other Indirect Tax Revenue	0.0	0.0	0.0	0.0	0.0	0.0
Nontax Revenue	5.0	2.7	2.3	3.6	3.0	2.6
Administrative Fees and Charges	0.6	0.5	0.4	0.5	0.5	0.4
Capital Revenue	0.1	0.1	0.2	0.7	0.4	0.4
Revenue from Government Departments	2.0	0.1	0.1	0.2	0.2	0.2
Dividends	0.7	0.7	0.4	0.5	0.4	0.4
Transfer of Profits	1.3	1.1	0.6	1.1	0.7	0.6
Interest Receipts from Corporations	..	..	..	0.7	0.7	0.6
Other Non-Tax Revenue	0.2	0.1	0.5	0.0	0.0	0.0
Other Revenue	7.5	5.8	7.2	5.5	6.5	9.6
KHPC	..	..	..	..	..	..
CHPC	7.5	5.8	7.1	5.4	6.3	5.2
Tala	..	..	..	..	..	4.3
Basochu	..	..	0.1	0.1	0.2	0.2
Grants	15.2	8.2	17.2	12.4	16.0	12.7
Of which India	10.3	3.3	7.3	6.7	9.6	8.5
Memorandum item:						
Nominal GDP (millions of ngultrum)	24,636	27,748	31,143	35,372	39,830	49,001

Source: RGoB Annual Financial Statements 2004-05, Selected Economic Indicators, March 2006, RMA, National Budget - Financial Year 2006-07, June 2006 and staff estimates. The projections of the Medium Term Fiscal Framework were developed by the Macroeconomic Framework Coordination Committee of the RGoB.

Table A.9: Economic Classification of Central Government Expenditure and Net Lending

	2001-02	2002-03	2003-04	2004-05	2005-06 <i>Prov. Est.</i>	2006-07 <i>Budget</i>
	<i>(In millions of ngultrum)</i>					
Expenditure and net lending	9910.2	9842.1	9795.8	12697.8	16151.8	17901.7
Total Expenditure	9780.4	9890.5	9802.3	12785.9	16102.8	17776.0
Current expenditure	4467.9	4580.9	5149.2	6170.6	7198.6	7962.0
Pay & Allowances	1563.9	1615.7	1726.1	2128.7	2524.5	3076.5
Other Personnel Emoluments	181.9	229.1	253.6	268.9	304.5	326.1
Medical Benefits	26.7	39.1	86.0	111.2	107.2	97.2
Special Allowance	30.8	30.5	29.0	29.8	38.9	40.0
Stipends	124.7	134.0	139.1	157.7	184.1	184.0
Travel	592.3	604.6	677.9	767.4	887.5	970.7
Utilities	130.7	142.3	163.4	181.7	239.7	266.1
Rental of Properties	50.0	56.5	48.6	45.4	66.0	70.4
S & M	462.3	493.7	635.3	751.0	848.7	895.8
Maintenance of Property	351.9	338.8	357.1	399.2	459.1	525.6
Op. Exp.	281.2	153.9	172.8	238.9	300.7	330.8
Hospitality & Entertainment	41.6	42.7	45.1	46.3	46.7	52.5
Write Off - Stocks, Loss of Cash/Goods	0.4	9.5	0.0	0.1	0.0	0.1
Current Grants	293.8	347.8	393.9	462.5	462.2	470.5
Subscriptions to International Organisation	21.0	19.1	61.6	23.5	38.9	34.3
Contributions	151.4	107.1	107.2	114.9	134.3	143.6
Retirement Benefits	47.7	47.7	32.3	38.1	24.5	30.0
Interest Payment	115.8	168.9	220.3	405.4	531.2	448.0
Interest Payment - Internal	37.9	68.0	98.0	66.6	174.8	105.6
Interest Payment - External	77.8	100.9	122.3	338.8	356.4	342.4
Other	0.0	0.0	0.0	0.0	0.0	0.0
Capital expenditure	5312.6	5309.6	4653.1	6615.3	8904.2	9814.0
Acquisition	38.3	76.7	16.3	14.9	38.3	30.2
Training	385.8	471.8	493.5	571.4	1041.9	1056.5
Exp. on Structure	2552.8	1940.1	2221.2	2844.8	5239.3	6085.5
Plant & Equipt.	1179.7	484.4	461.8	450.9	857.3	667.7
Purchase of Vehicles	85.0	50.4	116.8	67.2	62.5	11.8
Furniture	61.8	48.1	76.4	99.0	130.9	161.0
Office Equipment	46.8	29.1	54.8	77.8	110.7	128.3
Computers & Peripherals	73.1	70.5	92.1	106.7	200.6	140.8
Professional Services	220.8	356.7	169.0	154.8	415.7	517.5
Capital Grants	359.2	792.3	260.0	237.5	357.9	387.2
Acquisition of Equities/Shares	309.2	989.4	691.3	1990.3	449.1	627.6
Net lending	129.8	-48.4	-6.5	-88.1	49.0	125.6
Loans	249.3	99.4	662.5	379.1	360.5	502.3
Recoveries	119.4	147.8	669.0	467.1	311.5	376.6
	<i>(Percent of GDP)</i>					
Expenditure and net lending	40.2	35.5	31.5	35.9	40.6	36.5
Total Expenditure	39.7	35.6	31.5	36.1	40.4	36.3
Current expenditure	18.1	16.5	16.5	17.4	18.1	16.2
Pay & Allowances	6.3	5.8	5.5	6.0	6.3	6.3
Other Personnel Emoluments	0.7	0.8	0.8	0.8	0.8	0.7
Interest Payment	0.5	0.6	0.7	1.1	1.3	0.9
Interest Payment - Internal	0.2	0.2	0.3	0.2	0.4	0.2
Interest Payment - External	0.3	0.4	0.4	1.0	0.9	0.7
Capital expenditure	21.6	19.1	14.9	18.7	22.4	20.0
Acquisition	0.2	0.3	0.1	0.0	0.1	0.1
Training	1.6	1.7	1.6	1.6	2.6	2.2
Exp. on Structure	10.4	7.0	7.1	8.0	13.2	12.4
Plant & Equipt.	4.8	1.7	1.5	1.3	2.2	1.4
Net lending	0.5	-0.2	0.0	-0.2	0.1	0.3
Loans	1.0	0.4	2.1	1.1	0.9	1.0
Recoveries	0.5	0.5	2.1	1.3	0.8	0.8

Memorandum item:

Nominal GDP (millions of ngultrum)	24,636	27,748	31,143	35,372	39,830	49,001
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Source: RGoB Annual Financial Statements 2004-05, Selected Economic Indicators, March 2006, RMA, National Budget - Financial Year 2006-07, June 2006 and staff estimates. The projections of the Medium Term Fiscal Framework were developed by the Macroeconomic Framework Coordination Committee of the RGoB.