Report Number : ICRR0021777

1. Project Data

Country
Bhutan

Practice Area(Lead)
Macroeconomics, Trade and Investment

Programmatic DPL
Planned Operations: 2
Approved Operations: 2

Operation ID
P147806

Operation Name
BT: 2nd DPC Series

L/C/TF Number(s)
IDA-56470

Closing Date (Original)
31-Mar-2016

Total Financing (USD)
20,068,048.00

Bank Approval Date
17-Jun-2015

Closing Date (Actual)
31-Mar-2016

	IBRD/IDA (USD)	Co-financing (USD)
Original Commitment	20,000,000.00	0.00
Revised Commitment	20,000,000.00	0.00
Actual	20,068,048.00	0.00

Prepared by	Reviewed by	ICR Review Coordinator	Group
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Operation ID
P157469

Operation Name
Development Policy Credit 2 (P157469)

L/C/TF Number(s)	Closing Date (Original)	Total Financing (USD)
IDA-56470,IDA-59230	30-Jun-2018	23,832,724.89
Bank Approval Date	**Closing Date (Actual)**	
21-Dec-2016	30-Jun-2018	

	IBRD/IDA (USD)	Co-financing (USD)
Original Commitment	24,000,000.00	0.00
Revised Commitment	24,000,000.00	0.00
Actual	23,832,724.89	0.00

2. Program Objectives and Policy Areas

a. Objectives

The program documents defined the objectives for the development policy credits (DPCs) as: “to promote fiscal discipline, improve access to finance for enterprises, and improve the climate for business entry and investment in Bhutan” (DPC2, par. 29). There was an equivalent statement in DPC1 (para. 34).

b. Pillars/Policy Areas

The two credits were structured around three pillars: I. Fiscal measures- strengthening fiscal sustainability and self-reliance; II. Fostering financial sector development: improving access to finance; and III. Private sector development – improving the investment climate and increasing domestic and foreign investment. Pillar I covered policy reforms on debt, taxes and credit for housing and vehicles. Pillar II supported a new strategy and implementation plan for the financial sector and reforms on the rules governing collateral, insolvency, credit information, and movable and immovable property. Pillar III supported reforms on laws (Acts) and regulations covering licensing, foreign investment, registering property, and starting and registering a business. Reforms in customs administration and regulations on construction permits were dropped because (a) of technical problems (customs) and (b) Thimphu Thromde (City) could not develop and deploy the registry within the DPC2 time frame.

c. Comments on Program Cost, Financing, and Dates

The program consisted of credits DPC1 (P147806) for US$20 million and DPC2 (P157469) for US$24 million. Disbursements were US$20.70 million and US$23.83 million because of fluctuations in the exchange rate of the SDR (the currency of the credits) and the US dollar.

The DPC1 credit was approved on June 17, 2015 and DPC2 on December 21, 2016; they were closed on March 31st, 2016 and June 30th, 2018 as planned.

3. Relevance of Objectives & Design

a. Relevance of Objectives

Hydropower construction spurred Bhutan’s high growth rates and its rapid India-financed public debt buildup. As this source of growth wanes, the private sector has to drive Bhutan’s future growth, for which the authorities need to remove barriers to private sector development from financial constraints and an inadequate climate for private investment. To achieve the overarching objective of Gross National Happiness the government issued its Economic Development Policy (EDP) 2010, which identified some 14 constraints, of which the program supported actions on the high fiscal deficit, mounting public debt, difficult access to finance, a small domestic market, inadequate infrastructure and high transport cost. The Pillars of DPC1 and DPC2 were aligned with the Economic Development Policy of 2010 and 2016. Pillar 1, fiscal measures, was aligned with the problems of the fiscal deficit and public debt; Pillar 2, fostering financial sector development, was aligned with difficult access to finance and Pillar 3, private sector development, was aligned with the small domestic market due to the small population, an inadequate investment climate and an insufficient foreign investment.

The objectives were also aligned with IDA and IFC's Country Partnership Strategy (CPS) for FY 2015–2019, including Results Area 1, improving fiscal and spending efficiency, and Results Area 2, increasing private sector growth and competitiveness.

Rating
Substantial

b. Relevance of Design

Design of the DPC series had strengths and shortcomings. Development partners supported the design of the DPC program, the Asian Development Bank being important in the areas of public sector management, financial sector development and private sector development. The program documents explained, in varying detail, the rationale for selecting the actions supported under the program and how they would contribute to the objectives. The results chain is clear for the fiscal measures in pillar 1 but it was not always clear for the reforms and actions under pillar 2 on the fostering financial sector development. The results chain for private sector development had two elements that should be looked at separately: investment flows and investment climate. New and clear rules for foreign direct investment (FDI) were required since minimum investment requirements and restrictions on the repatriation of profits discouraged larger investment flows into the country. The new rules facilitated those inflows, and the results chain between actions and expected results was clear. On the investment climate, the program implicitly assumes that private sector growth is restricted in terms of the entry of new companies, an assumption that the evidence in Bhutan does not support. The non-electricity sector in Bhutan (sectors 1-3 and 5-9 of national accounts) grew at 7.2 percent per year between 2011 and 2014, a fast rate by any standards (NSB, National Accounts 2018, Table 5). It is not clear how the specific actions of the program would promote the growth of new companies by an amount large enough to accelerate private sector growth. It is also unclear the importance of some of the actions the program supported. Companies ranked licensing and permits as number 12th in the list of obstacles identified by enterprises in the World Bank's 2015 Enterprise Survey for Bhutan. There was insufficient attention paid to solving potential implementation problems arising from the lack of capacity in the country--a deficiency the World Bank Group (WBG) knew beforehand .

Macroeconomic framework. During the program period (2015/16-2017/18) the country's economic performance was strong. Real GDP grew 7 percent per year, annual inflation averaged 6 percent and government expenditure averaged 31 percent of GDP. Total revenue and grants averaged about 29.2 percent of GDP, with an overall deficit (cash basis) of 1.8 percent of GDP. The current account deficit reached 22.8 percent of GDP in FY2017, down from an average of 26 percent of GDP over FY2012-16. International reserves cover 13 months of imports. Key medium-term policy challenges include the mobilization of domestic revenues and prudent management of anticipated hydro power revenues. According to the IMF (press release 18/401) over the medium-term, the three new hydro power projects expected to come on stream could boost growth to around 7 – 7½ percent, along with improvements in the current account, the fiscal position and international reserves. Improving macroeconomic conditions would support the authorities' plans to diversify the economy.

Rating
Modest

4. Achievement of Objectives (Efficacy)

Objective 1

Objective
Promote fiscal discipline

Rationale
DPC1 supported actions to eliminate restrictions on loans for housing and imported vehicles and to raise taxes and customs duties on selected products. The second credit supported broadening the tax base through limits on public debt and regulations on fiscal incentives. With these actions, the program sought to increase revenue, and in turn improve macroeconomic and fiscal discipline and sustainability.

Tax revenue and fiscal deficit. The program supported actions to generate more tax revenues in an efficient manner. To do so the program supported lifting the restrictions on providing loans for housing and the purchase of vehicles, raising customs duties, sales taxes and green taxes of selected goods (DPC1), and revising rules and regulations on fiscal incentives to broaden the tax base (DPC2). By lifting credit restrictions it was expected that the demand for housing and vehicles would increase, and by raising tax rates and customs duties it was expected that tax revenues would increase. The program's expected result was to increase tax revenues from a baseline of 18.4 billion ngultrum (Nu) in FY2014/15 to 23.2 billion Nu in FY2017/18. DPC2 abandoned "the ratio [revenue/GDP] for an increase in nominal revenues .... to capture the impact of reforms and exclude the impact of fluctuations in GDP." (notes of meeting with the ICR team leader). Tax revenue in FY2017/18 reached 27.1 billion Nu., exceeding the program's target. The indicator, adopted in DPC2, replaced two indicators defined in DPC1 for FY16/17: fiscal deficit of 3% or less of GDP and tax revenues equal to or higher than 15% of GDP. The result can be attributed to the reforms supported by the series, along with complementary reforms including the introduction of the goods and services tax (GST), procurement reforms and work on fiscal rules, all supported by technical assistance from another World Bank project.

Public Debt. To improve fiscal sustainability the program supported putting a limit on government debt. The expected result was to reduce the government's non-hydropower debt from 27 percent of GDP in FY2014/15 to 25 percent or less in FY 2017/18. The rationale for using non-hydro debt was to isolate it from the other debt, given the outsized role of the hydro power sector in Bhutan's debt dynamics.; There is a better reason for this treatment. The IMF considers Bhutan's hydropower debt to be like FDI due to the explicit guarantees from India that cover financial and construction risks for all hydropower projects. This exceptional treatment is justified by a strong track record of project implementation, commercial viability and close economic and political ties with India, the main provider of financing for hydropower projects and the key consumer of Bhutanese electricity (see 2016 IMF article IV report). Given these reasons, the decision to use reduction in non-hydro debt as a target for the series seems reasonable, and achievement was substantial. The 2018 Article IV report estimates the ratio of total debt/GDP peaked at 114% in 2015/16, and then came down to 103% in 2017/18, a trend also confirmed by the fall in the ratio of non-hydro debt/GDP to 22.3 percent by 2017/18..
In summary, the fiscal and debt situations improved as measured by tax/GDP, deficit/GDP and debt/GDP.

Rating
Substantial

Objective 2
Objective
To improve access to finance for enterprises

Rationale

The first credit supported measures to make it easier for small and medium enterprises to access credit by using movable assets as collateral and by having the utility companies (Tashi Cell, Bhutan Telecom and Bhutan Power Co) share credit information with the Credit Information Bureau (CIB). The second credit sought to have (a) the Cabinet approve the Financial Sector Development Action Plan and an insolvency bill that would be submitted to Parliament; (b) the regulators BEA (Bhutan Electricity Authority) and BICMA (Bhutan InfoComm and Media Authority) issue a directive obliging utility companies to share information with the Credit Information Bureau; and (c) the Credit Bureau confirm that its system has been enabled to share credit information with the utility companies. The results of the program are examined below. The review groups them in three categories: (a) movable assets, insolvency and collateral, (b) credit information, and (c) financial sector strategy and action plan.

- *Movable assets, insolvency and collateral.* Under this category the program expected an improvement in the legal rights for getting credit –as measured by a Legal Rights Index–and more loans registered in the collateral registry. The ICR reports that by the end of 2018: (a) the Legal Rights Index remained unchanged at 4/12, missing the target value of 6/12; and (b) the number of micro, small and medium-sized enterprise (MSME) loans in the collateral registry had increased 487 percent, exceeding the 40 percent target. While the legal rights index did not change, credit to MSMEs loans in the collateral registry increased, supporting the presumption that credit to enterprises increased and access to finance improved. It is a presumption because the numbers reported do not break out the change in registered loans by new and old loans.
- *Credit information.* Under this category the program expected that the Credit Information Bureau would increase its coverage of information of individuals *and* firms as percent of the population. The indicator combines two different groups that cannot be put together to assess access to credit; program documents and the ICR do not have separate values for firms and individuals. The ICR reports the Credit Information Bureau increased its coverage of the adult population (15 years or older) from a baseline of 15.9 percent to 35.9 percent by the end of 2018, exceeding the target of 30 percent; the coverage for males and female reached 22.7 and 17.8 percent, exceeding the targets of 19.5 and 10.5 percent. The ICR and the Bureau's web site do not report on the number of firms covered (see https://www.cib.bt/index.aspx). The percent of adult population covered does not inform about enterprises, at which the program was aiming.
- *Financial sector strategy and action plan.* The program expected an improvement in financial inclusion. The ICR reports that by the end of 2017 some 64 percent of the population aged 15 or older had a bank account, while 44 percent of women had an account. The actual values exceed the target values of 40 percent for total population and 37 percent for women. The Bhutan Central Bank reports that in terms of access to financial products "64 percent of adults in Bhutan had a savings account, while only 16 percent have access to credit, followed by 18 percent holding life insurance as of December 2018" (RMA Annual Report 2018, p. 83); the Central Bank also reports that lending to the cottage and small industry sector accounted for 14 percent of total loans in 2017 (Ibid). None of these indicators informs about access to finance by enterprises. The program document and the ICR do not separate individuals from firms and do not explain the link between access to finance by individuals and access to finance by enterprises. In a meeting with IEG, Bank staff involved in the credits explained that cottage and small industry enterprises

in Bhutan account for more than 90% of the total number of industrial enterprises, and most of them are run by individuals. Therefore, there is no big distinction between micro-enterprises and individuals.

Summarizing, individuals have more access to financial products and the CIB has more credit information about individuals and firms. Also, per the number of loans registered in the collateral registry there is a presumption that credit to MSME increased. On the other hand, the legal rights index did not improve. The review concludes that overall access to financial services improved.

Rating
Substantial

Objective 3

Objective
To improve the climate for business entry and investment in Bhutan.

Rationale
DPC1 supported the objective of improving the climate for business by (a) making it easier to start a business; (b) revising the licensing policy; (c) reducing the threshold for authorizing foreign direct investment; and (d) making it easier to pay taxes. Under DPC2, actions were taken to register businesses online, to improve the electronic property and land registration system in the capital, to have a policy for Private-Public-Partnerships (PPP) and to issue rules and regulations concerning PPP. The expected results were to improve the climate for business, to reduce the time for registering property, and to increase foreign investment; they are examined below.

- *Improve the climate for business*. Four indicators were to measure improvement.
  - Time to start a business. It fell from 32 to 12 days; the result represents a significant improvement over the baseline value despite falling short of the 10 days target.
  - Number of procedures for starting a business. It remained unchanged at 8 procedures, missing the target of 4.
  - Cost of starting a business. It fell from 5 to 3.5 percent of income per capita, improving over the target of 4 percent.
  - Number of tax payments. They remained unchanged at 18, missing the target of 6 payments.
- *Reduce the time [days] needed to register property*. The number of days fell from 92 to 77, an improvement over the baseline but still far from the target of 47 days.
- *Increase foreign investment*. Over the period 2014-2017 the cumulative level of foreign direct investment reached US$146 million, a bit short of the target of US$150 million. The government also prepared a PPP pipeline and presented it to the PPP Steering Committee in March 2018, outside the deadline date. Its late delivery prevented the Committee from reviewing the pipeline of projects by the end of 2017, as planned in the program.

Summarizing, the climate for business improved partially (as per the indicators selected) and the flow of foreign investment almost reached the target level set in the program.

Rating
Modest

5. Outcome

The program had substantial relevance in its objectives but its design was modest. Efficacy was substantial in achieving objectives 1 (promote fiscal discipline), 2 (improving access to finance) and 3 (improve the climate for business entry and investment).
The program made progress in improving tax revenues and reducing the fiscal deficit, in containing the external debt, in promoting access to finance for enterprises and in improving the flow of foreign direct investment into the country. The program partially succeeded in improving the business climate.
The review rates the outcome satisfactory.

a. **Outcome Rating**
Satisfactory

6. Rationale for Risk to Development Outcome Rating

The Bhutan government has delivered political stability, rapid growth, sound macroeconomic policies and steady improvements in social welfare. The results demonstrate the government's ownership of the policies behind the success. While political and social risks are likely to be moderate, economic, financial and technical risks are likely to be substantial. The country faces some macroeconomic risks arising from delays in implementing the goods and services taxes, volatility in global oil prices, completing hydro power projects and lower electricity exports resulting from lower growth in India, Bhutan's main developing and trading partner. If the risks materialize tax revenues are likely to suffer, debt management will become more difficult, the business environment might deteriorate, and domestic and foreign investment could fall. These risks may be amplified by the limited capacity of some agencies to implement and coordinate reforms with other agencies.

a. **Risk to Development Outcome Rating**
Substantial

7. Assessment of Bank Performance

a. Quality-at-Entry

The WBG selected relevant problems to address with the program .The program covered three policy areas of substantial relevance and was aligned with the government's development plan and the WBG's CPS. In most instances, the prior actions could ensure achievement of the objectives. Some of the actions, however, could not guarantee the achievement of objectives; for example, approving draft bills for presentation to Parliament to amend the companies and the property acts do not guarantee their amendments and their intended impacts. The relevance of design was modest. The WBG and the government missed the opportunity to revise the results framework when designing the second credit. The implementation arrangements, the implementing agencies and the monitoring and evaluation (M&E) arrangements were appropriate when the credits were approved.
The execution showed the government had limited technical and implementation capacity in some areas supported by the DPCs. Weak capacity may be caused by a combination of actual skill shortages in the country and/or government, and contrived skill shortages due to the influence of vested interests working to frustrate reforms. Given the WBG's knowledge of the country, this was a predictable problem beforehand, which raises the possibility of a mismatch between means (e.g., execution capacity) and ends (e.g., reforms and objectives) and calls into question the adequacy of the program's design, both of its policy reforms and its implementation arrangements.

Quality-at-Entry Rating

Moderately Satisfactory

b. Quality of supervision

Supervision took place during the preparation of the second development credit (ICR, p. 27), with Bank staff in the country carrying out most of it. The WBG correctly realized that two triggers for DPC2 had to be dropped because one could not be implemented and the other their implementation would extend beyond the execution of the program. The WGB also realized that some indicators could not properly measure the achievement of program outcomes; the WBG tried to solve the problem by changing some indicators, but that did not help to improve the design. In other instances, a change that could have improved the results framework was not done.

Quality of Supervision Rating

Moderately Satisfactory

Overall Bank Performance Rating

Moderately Satisfactory

8. Assessment of Borrower Performance

a. Government Performance

The review assesses government and implementing agency performance under a single heading because the Ministry of Finance oversaw the two credits and two of its units were responsible for implementing it: The Department of Public Accounts until 2017 and the newly created Department of Macroeconomic Affairs thereafter.
The government's ownership of the program translated in carrying out important actions in fiscal and debt policy, ensuring macroeconomic stability, in pushing reforms in the financial sector that improved access to finance and in setting new rules for foreign direct investment that eased constraints on investment inflows to the country. That ownership, however,did not translate into timely execution by the agencies of the tasks they had to implement. Performance varied across line agencies. The ICR attributes the slow response of some agencies to limitations in their technical and implementation capacity and to the switch of the implementing unit within the Ministry of Finance.
The government glossed over the potential conflict between capacity constraints and program implementation. Weak capacity and weakening government ownership over time contributed to undermine implementation. The ICR notes that "in the run up to the 2018 elections, the previous government did not push for major reforms which impacted reform implementation in certain areas" (par. 23).

Government Performance Rating

Moderately Satisfactory

b. Implementing Agency Performance

Assessment of implementing agency performance is included in the assessment of government performance.

Implementing Agency Performance Rating

Overall Borrower Performance Rating

Moderately Satisfactory

9. M&E Design, Implementation, & Utilization

a. M&E Design

The program document envisaged M&E as a continuous dialogue between the WBG and the government. The program also established a feedback mechanism from business–to–government over the online property and land registration system in Thimphu and the operation of the single window for online business registration. It was expected the set up would permit adequate monitoring of the program.
A comment on the indicator for fiscal performance is warranted. The rationale for changing the indicators was that "Due to the projected increase in the size of the economy from hydropower projects, which does not yield proportionate contributions to tax revenues, the tax to total GDP ratio can be misleading." (DPC2 program document, par. 36). The new indicator is inadequate to measure tax effort. Some inflation is enough to generate

a larger revenue between mid-2015 and mid-2018; for example, if revenues for 2018 had been extrapolated using the CPI inflation rate for mid-2013 to mid-2016 total revenue would have been 31 percent higher, exceeding the program's implicit target of 27 percent. A better indicator would have been non-hydro power tax revenues as percent of non-hydropower GDP, a feasible separation since the data are readily available (see Statistical Yearbook 2018 Table 15.1 and IMF cr18300, table 2). For the record, in FY2017/18 tax revenue was 15.5 percent of GDP (Ministry of Finance, National Revenue Report, Fiscal Year 2017-2018, p. 7) and the fiscal deficit was one percent of GDP (IMF, Country Report 18/300, p. 21). The targets set in DPC1 would have been met.

b. M&E Implementation

The WBG dialogue with the authorities took place almost continuously, a result of working in the file with the agencies implementing the program and from its work on Advisory Services and Analytics (ASA). M&E suffered as in 2017 the Ministry of Finance made the newly created Department of Macroeconomic Affairs the agency responsible for implementing the program instead of the more experienced Department of Public Accounts. The new department had limited capacity to coordinate the implementing agencies and in obtaining the data required to assess the progress of the program. Eventually, the information was collected, but not on a timely manner.

Changes in some indicators introduced precision to the results framework but changes in others (e.g., taxes and debt) weakened it, making it difficult to evaluate achievement of objective. Other indicators remained unchanged when it would have been advisable to change them to better evaluate the achievement of objectives (e.g., in access to finance, firms instead of individuals).

The ICR does not report on what happened with the business-to-government feedback mechanism for online business registration.

c. M&E Utilization

The WBG and the government agreed that two triggers for DPC2 could not be carried out because of technical problems and the inability to deploy an electronic registry of building permits during the duration of the program. Some results indicators were changed seeking to provide evidence on achievement of outcomes.

M&E Quality Rating

Modest

10. Other Issues

a. Environmental and Social Effects

None

b. Fiduciary Compliance

None

c. Unintended impacts (Positive or Negative)

None

d. Other

None

11. Ratings

Ratings	ICR	IEG	Reason for Disagreements/Comment
Outcome	Satisfactory	Satisfactory	---
Risk to Development Outcome	Substantial	Substantial	---
Bank Performance	Satisfactory	Moderately Satisfactory	The WBG did not take sufficient actions beforehand to improve the implementation problems related to lack of capacity in the country, which affected the program.
Borrower Performance	Moderately Satisfactory	Moderately Satisfactory	---
Quality of ICR		Substantial	---

Note

When insufficient information is provided by the Bank for IEG to arrive at a clear rating, IEG will downgrade the relevant ratings as warranted beginning July 1, 2006.

The "Reason for Disagreement/Comments" column could cross-reference other sections of the ICR Review, as appropriate.

12. Lessons

The ICR has five lessons with which the review agrees. Three of the lessons are summarized below as examples.

- Focusing on enacting legislative reforms rather than endorsing them for submission to Parliament would support implementation better, and lead to achieving results;
- Strengthening the government's technical capacity would support reform implementation. Therefore, the WBG needs to focus on institutional strengthening and tailor future operations to existing capacity;
- Focusing on few key areas of reforms would help achieve better results given the government's weak implementation capacity.

The review adds the following lessons:

- Strengthening capacity alone will not solve the problems nor will better agency coordination. To design better programs and correct ones that do not function well, the WBG and the government must know what went wrong, why and how to improve program performance.
- A mismatch between means (e.g., implementation) and ends (e.g., objectives and results) calls into question the adequacy of policy design and of implementation arrangements. Because implementation is the only source of experience that can guide managers to test and improve programs, policy design and implementation must be looked at simultaneously.

13. Assessment Recommended?

Yes

Please explain

To examine the contribution of the program to the country's development outcomes, to examine in depth the implementation problems and to evaluate policies in terms of their worth and the likelihood of implementing them.

14. Comments on Quality of ICR

The ICR reviews the program in a succinct, complete and clear manner. The ICR presents adequate evidence to assess the achievements of the program and links the evidence to findings. It derives lessons based on the information presented. The ICR falls short of connecting the results indicators to achievement of objectives, conflating targets met with objectives achieved in instances when the indicator is inappropriate to measure the achievement of objectives. The ICR follows the path of many other ICRs: it identifies lack of capacity as the source of implementation problems but does not examine what went wrong, why and how to improve program performance.

a. Quality of ICR Rating
Substantial