

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

Report No.: AB2045

Operation Name	First Development Policy Grant
Region	South Asia
Sector	General finance sector (40%); Other industry (20%); Primary education (15%); Health (15%); Central government administration (10%)
Project ID	P078807
Borrower(s)	Royal Government of Bhutan
Implementing Agency	The Department of Aid and Debt Management (DADM), Ministry of Finance
Date PID Prepared	December 12, 2005
Estimated Date of Appraisal Authorization	January 16, 2006
Estimated Date of Board Approval	May 2, 2006

1. Key development issues and rationale for Bank involvement

1. The Royal Government of Bhutan's (RGoB) ongoing medium-term policy and institutional reform program is anchored in its Ninth Five-Year Plan, which is also its Poverty Reduction Strategy Paper (PRSP). Reflecting the distinct vision of Gross National Happiness, the Ninth Five-Year Plan has five overall goals: (i) improving quality of the life and income, especially for the poor, (ii) ensuring good governance, (iii) promoting private sector growth and employment generation, (iv) preserving and promoting cultural heritage and environmental conservation, (v) achieving rapid economic growth and transformation. The strategies outlined to achieve these goals include infrastructure expansion, maintaining sound macroeconomic policy, ensuring good governance, and improving access and enhancing social services.

2. RGoB's policy and institutional reform program selectively supports these goals and strategies. The program is at an early stage and still gathering pace. It is, however, moving in the right direction and the government is committed to implementing the reform agenda. During the Bank's Country Assistance Strategy (CAS) consultations in early 2005, RGoB requested policy-based assistance in order to implement its poverty reduction strategy (PRS).¹ In view of the existing capacity constraints, PRS implementation in Bhutan is technically-demanding and requires long-term support from development partners. The Bank's development policy operation is an appropriate instrument in such a circumstance. Bhutan is a top performer among IDA countries; and its development progress and commitment to reform justify policy-based support to keep the reform momentum going.

3. The proposed Development Policy Grant (DPG) would be the first in a series of programmatic budget operations, and would seek to support key components of the government's program.² The grant would

¹ The Bhutan CAS (*World Bank: Country Assistance Strategy for the Kingdom of Bhutan for the period FY06-FY09*, Report No. 33704-BT, September 28, 2005) was discussed by the Board on November 1, 2005.

² An IDA only country, Bhutan's 2004 IDA allocation comes in the form of a grant. Bhutan qualifies for grants under IDA-14 based on: (i) the 2004 present value of external debt to GDP ratio of 64.7 % (where the threshold value has been set at 50%), and (ii) the 2004 present value of external debt to exports ratio of 225% (where the threshold value has been set at 200%). Bhutan's IDA allocation in FY06 is about US\$14.1 million. However, as a participant in the small states forum, with a population of less than 1.5 million, Bhutan can frontload up to 80% of the indicative FY07 and FY08 allocations. If Bhutan continues to receive 100 percent grant assistance from IDA, the indicative allocation for the rest of the CAS period—FY07 to FY09—would be about US\$44.0 million.

provide US\$15 million in budget support in FY06 to help RGoB meet its development goals. Given that the proposed DPG will be the first policy-based operation in Bhutan, it will entail a process of learning and deepening of the policy dialogue. A second operation, Development Policy Grant/Credit II, is planned to be processed in FY08, and would be linked to a strengthening of the reform program as well as to a quickening of the pace of implementation. These two operations are programmed in the current CAS period, FY06 to FY09. With maturity and deepening of the reform program; future operations could be annual and have broader coverage. They would also depend upon lessons learnt including the usefulness of this instrument in facilitating development in Bhutan.

2. Proposed objective(s)

4. In providing support for the reform program of RGoB, this operation recognizes progress to date and will facilitate the Kingdom's next steps towards achieving better socioeconomic outcomes and reducing poverty. More specifically, the objectives of the development policy program include: (a) improvement in the Kingdom's investment climate and greater labor market flexibility, leading to increased foreign direct investment and better job opportunities, (b) improved delivery of public services as a result of better public budget and financial management, (c) wider access to schooling services, helping raise enrollment and completion, particularly in previously under served areas, and (d) increased number of births delivered in health facilities leading to a reduction in maternal mortality.

3. Preliminary description

5. The Under the overarching themes of enhancing economic growth, reducing poverty and achieving the Millennium Development Goals (MDGs), the following four components of RGoB's interrelated developmental reform strategies are being supported by the DPG operation:

1. Ensuring the maintenance of a sound macroeconomic framework, strengthening fiscal policy, and bolstering financial management;
2. Enhancing the investment climate for private sector growth and employment generation;
3. Augmenting the quality of and access to education; and
4. Improving health care.

6. Specific government actions supported by the proposed DPG are described in Box 1 (see below). The Bank's program has two types of actions: (i) *up-front or prior actions* that are to be completed before the proposed DPG will be presented to the Bank's Executive Board; and (ii) *triggers* which are indicative for a second Development Policy Grant/Credit and would need to be largely met before it could go forward.

Box 1: Up-Front Actions and Key Triggers

I. Up-Front or Prior Actions for DPG I. There are seven up-front or prior actions that are to be completed prior to processing DPG I:

1. RGoB's MTFF will specify target ranges for key macroeconomic and fiscal indicators, including inflation, the current account balance, the overall balance (including grants), and total debt .It will be submitted to the Committee of the Council of Ministers (CCM) in January 2006 and CCM's endorsement of the Medium-Term Fiscal Framework (MTFF) as a basis for the preparation of the 2006-07 budget will be sought.
2. The draft Public Finance Act is submitted to the CCM.
3. (i) The draft Labor and Employment Act is submitted to the CCM, and (ii) the process for recruiting foreign workers is streamlined.
4. Foreign Direct Investment rules and regulations are approved.
5. As part of the implementation of its policy to expand education coverage through the establishment of new community primary schools (CPSs) in underserved areas, RGoB will establish 23 new CPSs in remote and/or underserved areas to increase enrollment and completion at the primary level, to support progress toward the achievement of the education-related MDG targets.
6. An English curriculum framework is developed for English from pre-primary (PP) to grade 12.
7. A draft strategy to increase institutional deliveries (child birth) is developed and two districts, where the strategy is to be piloted, are selected.

II. Key Triggers for a future DPG/DPC II. The following seven actions constitute key triggers for a future DPG/DPC II. These actions would need to be largely met before it could go forward.

1. The MTFE is circulated as a part of the annual budget preparation process in 2006-07 and 2007-08, and annual budget numbers (expenditure, revenue, deficits and debt) are developed in accordance with MTFE target. This will also involve implementing a strengthened debt management system.
2. The rules and regulations for the effective implementation of the Public Finance Act are issued.
3. The Labor and Employment Act is submitted to the National Assembly.
4. The business registration process is simplified, including the number of procedures, time taken and costs involved.
5. In continuing to implement its improved access to schooling policy, RGoB establishes an additional 20 community CPSs.
6. A reformed EMIS system is piloted, with a first version available for use as of the following academic year.
7. Recommendations on how to establish improved patient referral networks (for institutional deliveries) countrywide derived from the piloting of referral networks in two districts are drafted by June 2007.

4. Environment Aspects

7. Bhutan is rich in natural resources with an abundance of forests, biodiversity, water and hydro-power potential. These have provided a platform for sustaining agricultural growth and rural livelihoods. Bhutan's rich floral and faunal diversity have commanded scientific scrutiny, and much of the country forms part of a "global biodiversity hot-spot". Recognizing the significance of these natural assets, RGoB has committed to maintaining 60 percent of Bhutan's land under forest cover.

8. While Bhutan's environmental track record has been impressive, there are emerging challenges that could compromise its policy objectives in this area. A restricted supply of arable land, coupled with a growing population, have increased environmental pressures on forests and agricultural land. To provide employment opportunities for the growing labor force, there is a need to diversify the economy beyond agriculture. This is a key aim of this operation insofar as it seeks to stimulate employment and growth through improved macroeconomic management and private sector development. These policies can be expected to bring indirect environmental benefits in future by easing pressures on forests and agricultural land.

9. However, there are potential environmental risks associated with industrialization that could emerge from the proposed reforms. New industries are likely to be concentrated in the expanding urban centers. Experience in South Asia and elsewhere demonstrates that unmanaged urbanization can generate economic costs hindering growth through environmental health risks, reduced tourism potential, and sanitation problems. An integrated development and planning process is needed to address future externalities and accommodate potential trade-offs. RGoB plans to incorporate these features in the proposed White Paper on Private Sector Development in order that efficient, growth-enhancing mechanisms for addressing potential negative impacts are established as the economy develops. Other reforms supported in this operation address health and education issues, and are not expected to have any negative environmental impact.

5. Tentative financing

Source:	(US\$million.)
BORROWER/RECIPIENT	0
IDA Grant	15
Total	15

6. Contact point

Contact: Mr. Vinaya Swaroop

Title: Lead Economist

Tel: (202) 473-7688

Fax: (202)-522-0356

Email: Vswaroop@worldbank.org