

# Bhutan

## Investment Climate

## Assessment Report

*Vitalizing the Private Sector, Creating Jobs*

### VOLUME 1: SUMMARY REPORT

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The World Bank  
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## **Currency Equivalents**

Currency Unit = Bhutan Ngultrum

USD 1.00 = Nu. 48.41 (avg. exchange rate for calendar year 2009)

## **Fiscal Year**

July – June

## **Abbreviations and Acronyms**

AASBB	Accounting and Auditing Standards Board of Bhutan
BCCI	Bhutan Chamber of Commerce and Industry
BDFCL	Bhutan Development Finance Corporation Ltd.
BNB	Bhutan National Bank
BoB	Bank of Bhutan
BPC	Bhutan Power Corporation
BPO	Business Process Outsourcing
CIB	Credit Information Bureau
CPI	Corruption Perception Index
CRR	Cash Reserve Ratio
CSI	Cottage and Small Industries
DB	Doing Business
DHI	Druk Holding and Investments
DPR	Detailed Project Report
EDP	Economic Development Policy
FDI	Foreign Direct Investment
FI	Financial Institutions
FSA	Financial Service Act
GNH	Gross National Happiness
GNHC	The Gross National Happiness Commission
GTFP	Global Trade Finance Program
G2C	Government-to-Citizens
IC	Investment Climate
ICA	Investment Climate Assessment
ICT	Information and Communications Technology
IFC	International Finance Corporation
IMF	International Monetary Fund
IPSDS	Improving Public Service Delivery Systems
IT	Information Technology
ITES	Information Technology Enabled Services
MDG	Millennium Development Goal
MOE	Ministry of Education
MOEA	Ministry of Economic Affairs
MOF	Ministry of Finance
MOIC	Ministry of Information and Communications

MOLHR	Ministry of Labour and Human Resources
NSB	National Statistical Bureau
OPHI	Oxford Poverty and Human Development Initiative
PPD	Public Private Dialogue
PPP	Public Private Partnership
PSD	Private Sector Development
PSDC	Private Sector Development Committee
RGOB	Royal Government of Bhutan
RMA	Royal Monetary Authority
SEDF	South Asia Enterprise Development Facility
SME	Small and Medium Enterprise
SOE	State Owned Enterprise
TTICT	Trade, Transport and ICT
VET	Vocational Education and Training

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## **FOREWORD**

This investment climate assessment consists of two volumes. Volume 1 summarizes the main results. Volume 2 presents a more detailed analysis of each of the three main themes of the report: labor productivity and skills, access to finance, and business government relations, and is supplemented by a chapter on the gender dimensions of the investment climate. Volume 2 also includes the supporting econometric analysis of the enterprise survey data. The purpose of Volume 2 is to provide additional detail on the underlying data and analysis which supports the main results summarized in Volume 1.

## EXECUTIVE SUMMARY

### *Why is the Bhutan Investment Climate Assessment (ICA) important?*

**1. The objective of the Bhutan Investment Climate Assessment (ICA) is to evaluate the investment climate in Bhutan in all its operational dimensions and promote policies to strengthen the private sector.** The investment climate is made up of the many location specific factors that shape the opportunities and incentives for firms to invest productively, create jobs, and expand. These factors include macroeconomic and regulatory policies, the security of property rights and the rule of law, and the quality of supporting institutions such as physical and financial infrastructure.

**2. The main sources of information for the ICA are two surveys.** The first survey covered small, medium, and large enterprises with five or more employees in manufacturing and services. The second covered employees of the larger firms surveyed across sectors. Information from the survey is supplemented with information from other sources, including the *Doing Business Report*; analytical reports by the World Bank, the International Monetary Fund, other international organizations and the Royal Government of Bhutan (RGoB); and academic papers and reports.

**3. One of the advantages that the World Bank's Enterprise Surveys have over other firm-level surveys is that similar surveys have been conducted in a wide range of countries.** It is, therefore, possible to benchmark Bhutan against other countries with respect to both firm performance and measures of the investment climate. Throughout the report, firm performance and the investment climate in Bhutan are benchmarked against other South Asian countries and other economies with comparable factor endowments: Botswana, Mauritius, Costa Rica, Cape Verde, Lesotho, and Lao PDR.<sup>1</sup> As discussed in more detail in Volume 2, many aspects of the investment climate are favorable in Bhutan. Firms have few complaints about key areas of the investment climate, such as governance and infrastructure, and objective indicators of the investment climate suggest that Bhutan compares relatively well in many of these areas with the comparator countries. In other areas, such as access to finance, hiring workers, and regulations, firms report concerns.

### *What do ICA Survey results show? Diagnostic of the Investment Climate in Bhutan in 2010*

**4. This year's (ICA), a follow-up to the 2002 Private Sector Survey, shows that Bhutan continues to fare much better than the region on aspects of the investment climate that only long term policies can improve, while the main impediments that remain can be addressed in the short to medium term.**<sup>2</sup> Characterized by good progress in human development and good governance, Bhutan's unique advantages include a stable political and very low-corruption environment and good labor productivity. Extremely competitive electricity prices arising from large hydropower resources could give Bhutan a considerable advantage in power intensive

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<sup>1</sup> Defined as: the relative composition of natural resources, labor, human capital, and physical capital. See New Structural Economics: A Framework for Rethinking Development, Just Y. Lin, [World Bank Policy Research Working Paper No. 5197](#)

<sup>2</sup> Pilot Investment Climate Assessment, Challenges and Opportunities for Private Sector Development in Bhutan, 2002



industries; though access to electricity is likely to be constrained until new hydropower generation is available in 2015. Under a scenario of faster private sector development in Bhutan, sustained power generation for domestic companies will be a critical enabling factor. In addition, preferential access to the large Indian market and easy access to skilled and unskilled labor from India continue to offer unique advantages for the private sector in Bhutan.

**5. Against these unique advantages, challenges remain including access to finance, access to a skilled domestic labor force, and regulatory complexity.** The biggest impediments for the private sector come from factor markets: more than 20 percent of surveyed firms, mostly small and medium firms, listed access to finance as the main obstacle to their business. Equally, more than 20 percent of firms list skills issues or labor regulations as the main impediment, in particular, medium and large firms. Unsurprisingly, given the Kingdom's landlocked geography, transportation tops infrastructure/access to markets costs, in particular for large firms. These perceptions are corroborated by objective indicators. The time firms spend to comply with Government regulations and the associated costs are much higher compared to regional and international averages. The market would greatly benefit from the simplification of regulatory and licensing procedures.

#### *What next? A Vision for Private Sector Development*

**6. With its huge hydropower potential and seemingly assured demand from India, its large and booming neighbor, Bhutan has a proven and reliable source of growth** for many years to come. Therefore, Bhutan can further exploit its hydropower-wealth to create a more diversified economy and a broad-based growth generating process. Moving forward, Government focus should continue toward allocating some of Bhutan's hydropower resources to invest in human capital, in particular, in tertiary education and vocational training, a recurring constraint for firms in Bhutan. Better trained human capital would facilitate innovation, and the increased adoption of new technologies is likely to increase labor productivity of firms, an essential element to increase the competitiveness of the Bhutanese private sector. Easier access to FDI and opening up to more international markets could also encourage investments in technology, currently at low levels.

**7. Concurrently, to address the increase in unemployment rates despite its double-digit economic growth, Bhutan can encourage the growth of tradable sectors.** Bhutan can take advantage of its relatively well educated and productive workforce, inexpensive and reliable access to electricity and unique natural and political environment to continue to diversify its economy into services (tourism, ICT, education services) and niche sectors (for example niche organic products), in addition to existing power-intensive manufacturing industries. Reforms on simplifying regulatory procedures for businesses and FDI have been initiated, placing Bhutan above regional averages, and should continue to support private sector growth.

## KEY POLICY OPTIONS TO IMPROVE THE INVESTMENT CLIMATE

	<i>Investment Climate Constraint</i>	<i>Short Term Recommendations (less than 2 years)</i>	<i>Medium Term Recommendations (2-5 years)</i>
<b>Labor Productivity and Skills</b>			
<b>Skills</b>	<i>The shortage of skilled workers translates into high labor costs and attrition rates. Workers have little access to vocational or technical training up to market requirements.</i>	<ol style="list-style-type: none"> <li><b>1. Expand existing incentive programs to firms to train/employ semi-skilled and skilled workers [MOLHR]</b></li> <li><b>2. Facilitate access to expatriate workers</b> (unskilled, skilled) in FDI rules and regulations [MOEA]</li> <li><b>3. Ease salary ceilings</b> for classes of professionals in high demand (e.g. IT experts) in non registered companies [MOF]</li> <li><b>4. Conduct market assessment on Youth’s job expectations [MOLHR]</b></li> </ol>	<ol style="list-style-type: none"> <li><b>1. Improve the skill provision system, through supporting private sector vocational training and university-industry linkages</b> to increase the number and quality of Bhutanese trained as per market needs [MOLHR/MOE]</li> </ol>
<b>Productivity</b>	<i>Bhutan’s relatively good labor productivity is not yet coupled with investments in technology by firms.</i>	<ol style="list-style-type: none"> <li><b>5. Draft FDI rules and regulations to operationalize the new FDI Policy</b> and facilitate access to HR, capital, technology and global markets [MOEA]</li> </ol>	<ol style="list-style-type: none"> <li><b>2. Strengthen Certification and standards</b> to support high value niche product exports (e.g. eco-friendly, fair trade, organic). For service exports, <b>international recognition of qualifications</b> is key [MOLHR]</li> </ol>
<b>Institutional Framework</b>	<i>The private sector has been considered less attractive than the public sector.</i>	<ol style="list-style-type: none"> <li><b>6. Further implement Labour and Employment Act</b> consulting with firms and workers, for harmonious employer-employee relations [MOLHR]</li> </ol>	
<b>Women in Business</b>			
<b>Employment</b>	<i>While women have been established business owners, their participation as salaried workforce in the formal sector is low, in particular among skilled professionals.</i>	<ol style="list-style-type: none"> <li><b>7. Ensure that PSD Committee includes women’s voices and concerns [GNHC]</b></li> <li><b>8. Ensure systematic collection of gender data in Government statistics</b> for mainstreaming [NSB]</li> <li><b>9. Promote and monitor female participation in job placement programs [MOLHR]</b></li> </ol>	<ol style="list-style-type: none"> <li><b>3. Launch awareness campaigns for women on career options in skilled employment [MOLHR]</b></li> <li><b>4. Create government-funded scholarships for women [MOE]</b></li> </ol>

	<i>Investment Climate Constraint</i>	<i>Short Term Recommendations (less than 2 years)</i>	<i>Medium Term Recommendations (2-5 years)</i>
<b>Access to Finance</b>			
<b>Lending Practices</b>	<i>Almost all lending in Bhutan is collateral-based and does not take into account creditworthiness in determining loan terms and conditions.</i>	<p><b>10. Include 100 percent of account data into the Credit Bureau [RMA]</b></p> <p><b>11. Support Financial Institutions Association of Bhutan [MOEA]</b></p> <p><b>12. Review cash reserve ratio and statutory reserve ratio prudential requirements, with a view to increase lending [RMA]</b></p> <p><b>13. Consult private sector before finalizing External Commercial Borrowing regulations [MOF]</b></p> <p><b>14. Facilitate establishment of Code of Conduct</b> on disclosure of bank rates, prices, procedures and of bank <b>Customer Help Desks</b> to ensure availability of procedural guidelines [RMA]</p> <p><b>15. Increase awareness of the RMA’s “Grievance Cell” [RMA]</b></p> <p><b>16. Develop electronic payment systems</b> to stimulate commercial and financial transactions [RMA]</p>	<p><b>5. Support non registered firms in maintaining accounting and auditing standards [MOEA]</b></p> <p><b>6. Encourage new product development</b> e.g. loans for exports based on confirmed supply order or letter of credit. [RMA]</p>
<b>Access to Bank Services</b>	<i>Complex and time consuming loan procedures discourage firms from applying for bank financing.</i>	<p><b>13. Consult private sector before finalizing External Commercial Borrowing regulations [MOF]</b></p> <p><b>14. Facilitate establishment of Code of Conduct</b> on disclosure of bank rates, prices, procedures and of bank <b>Customer Help Desks</b> to ensure availability of procedural guidelines [RMA]</p> <p><b>15. Increase awareness of the RMA’s “Grievance Cell” [RMA]</b></p>	<b>7. Finalize Consumer Protection Act [MOEA]</b>
<b>Financial transactions</b>	<i>Heavy use of cash and paper-based instruments for payment transactions</i>	<p><b>16. Develop electronic payment systems</b> to stimulate commercial and financial transactions [RMA]</p>	<b>8. Facilitate development financial infrastructure including a national switch to support credit card transactions [RMA]</b>
<b>Financial inclusion</b>	<i>The anticipated increase in financial sector competition will be most prevalent in urban areas, and benefits may not be reaped in rural areas where smaller firms may be located.</i>	<p><b>17. Draft branchless banking/ business correspondents regulations</b> to encourage mobile banking (both low tech and high tech) and other innovative practices for reaching remote businesses [RMA]</p> <p><b>18. Strengthen enabling environment for financial inclusion and encourage partnerships between BDFCL, Bhutan’s development finance bank, and leading regional APEX institutions</b> to gain expertise on financial inclusion (e.g. SIDBI in India) [RMA]</p> <p><b>19. Expand awareness campaign on financial inclusion</b> and adapt to best practice [RMA]</p>	<p><b>9. Build capacity of banks to lend to MSMEs</b> (cash flow based lending, segmentation of borrowers by risk etc.) [MOF]</p> <p><b>10. Support access to finance for MSMEs through a combination of facilities</b> that may include, i) public-private partial loan guarantee schemes to banks to encourage MSME financing, ii) credit line facilities to financial institutions to encourage the provision of longer term financing to SMEs, iii) competition and innovation grants to businesses and iv) venture capital to encourage investments. [MOF]</p> <p><b>11. Establish “incubators” to promote entrepreneurship</b> and support and help commercialize innovation [MOEA/MOIC]</p>

	<i>Investment Climate Constraint</i>	<i>Short Term Recommendations (less than 2 years)</i>	<i>Medium Term Recommendations (2-5 years)</i>
<b>Business Government Relations</b>			
<b>Investment Climate Enabling Environment</b>	<i>Formal consultations between the private sector and the Government are nascent</i>	<p><b>20. Develop implementation blueprint for Economic Development Policy,</b> prioritizing needed amendments of relevant rules and regulations [GNHC-MOEA]</p> <p><b>21. Support Private Sector Development Committee to improve public private dialogue</b> and build confidence that the business environment is a priority in policy making [MOEA]</p> <p><b>22. Support BCCI</b> as APEX agency to represent private sector [MOEA]</p>	<p><b>12. Support public private investment promotion</b> to increase market access for Bhutanese private sector and attract leading strategic anchor investors [MOEA]</p>
<b>Time tax of licensing and regulatory compliance</b>	<i>Firms remain burdened with administrative costs caused by unclear and multiple licensing procedures</i>	<p><b>23. Adopt a licensing reform charter</b> as a base for the reform efforts [MOEA]</p> <p><b>24. Standardize and publish guidelines</b> on each regulation (including environmental) <b>centralized in electronic portal</b> , to be later phased into an application of the <b>one stop shop e-Government</b> initiative G2C [MOEA-GNHC]</p> <p><b>25. Eliminate ex-ante clearances without regulatory function,</b> amalgamate redundant license and permit requirements, streamline remaining licenses [MOEA-GNHC]</p>	<p><b>13. Draft Enterprise Registration Act</b> [MOEA]</p> <p><b>14. Create or amend the legal base</b> of ex-ante licensing requirements where updating is needed [MOEA-GNHC]</p> <p><b>15. Introduce Risk-based Inspection System</b> where possible (e.g. labor/ environment / statutory audits inspections, forest permits, food inspections) [MOEA-GNHC]</p>

GNHC: Gross National Happiness Commission

MOF: Ministry of Finance

MOEA: Ministry of Economic Affairs

MOLHR: Ministry of Labour and Human Resources

MOE: Ministry of Education

MOIC: Ministry of Information and Communications

RMA: Royal Monetary Authority

NSB: National Statistical Bureau

## 1. Introduction

**1.1 Bhutan has achieved impressive growth in recent years, driven by development of its large hydropower potential.** The Kingdom averaged over 7 percent real annual economic growth during the past decade as it started to effectively tap into its 23,760 MW hydropower potential. The economy is projected to be heavily dependent on hydropower development for its growth prospects in the medium term, as more new hydropower projects are expected to be launched. Bhutan's target is to tap 10,000 MW of its potential by 2020 — with significant assistance from India, the major donor contributing to hydropower development as well as the key buyer for electricity exports from Bhutan. Bhutan's per capita Gross National Income of US\$2020 in 2009 is the second highest in South Asia, after the Maldives. Moreover, Bhutan has already achieved or is on track to achieve most of its Millennium Development Goals (MDGs). With a Transparency International Corruption Perception Index of 5 in 2009, Bhutan is the least corrupt country in the region and is well positioned globally.

**1.2 Bhutan has been successfully using its natural resources to promote socio-economic development in the pursuit of gross national happiness.** Small economies relying on specific natural resources for its growth — like Bhutan depends on hydropower for 40 percent of its revenue — can potentially be affected by 'resource curse' symptoms. However, there is currently no evidence of this effect in Bhutan. Despite limitations in capacity, Bhutan is undertaking several relevant initiatives to promote environmentally sustainable development, reduce corruption before it becomes a major issue, use its vast hydropower resources to fund socio-economic development, strengthen fiscal management to counter the impacts of economic volatility, foster private sector development, and provide employment for its educated youth. The Gross National Happiness Index (GNH), Bhutan's homegrown development measurement tool, is aimed at measuring Bhutan's development vision beyond GDP growth and has raised interest from developed and emerging economies (Box 1).

### Box 1: Gross National Happiness (GNH)

The 4<sup>th</sup> King of Bhutan, HM Jigme Singye Wangchuck, coined the term 'gross national happiness' in 1972, declaring it to be more important than gross domestic product. Since then, GNH has "influenced Bhutan's economic and social policy" (OPHI 2010) and generated much interest outside the country. The four key areas of GNH are sustainable development, preservation of cultural values, conservation of the environment and good governance. (Thinley 2007)

In order to create a measurement tool "useful for policy making and resource allocation," (OPHI 2010) the GNH Index was launched in 2008. The GNH Index is comprised of nine dimensions, including, conventional measures in areas of health and education and less conventional measures including time use, culture and psychological well-being. The results of the first GNH index (2008) "showed that no surveyed Bhutanese person had achieved sufficiency in all of the indicators; however, most Bhutanese people had achieved sufficiency in six or more of the nine dimensions." (OPHI 2010)

The usefulness of the GNH Index as a policy tool includes aspects of Bhutan's investment climate. For example, a business is able to increase living standards, promote good governance, and can have implications on employees' psychological well-being.

#### The nine dimensions of the GNH Index:

- 1) Community Vitality
- 2) Culture
- 3) Education
- 4) Environmental Diversity
- 5) Governance
- 6) Health
- 7) Living Standard
- 8) Psychological Well-being
- 9) Time Use

Source: The Centre for Bhutan Studies (<http://www.grossnationalhappiness.com/>); Oxford Poverty and Human Development Initiative, OPHI (<http://www.ophi.org.uk/policy/national-policy/bhutan/>); Thinley, Lyonpo Jigmi Y., What Is Gross National Happiness? (2007)

**1.3 At the same time, Bhutan faces several policy challenges.** *Economic volatility* remains a concern for the small landlocked country. About 65 percent of the country's revenues are projected to come from electricity and budgetary grants until 2013, and the revenue stream is heavily dependent on the timing of hydropower projects coming onstream, and on external assistance materializing on schedule. *Private sector development* is constrained by factors including, limited access to finance, shortage of skilled / educated labor, and complexity of regulatory compliance. Unemployment among youth has risen from 2.2 percent in 1998 to 13 percent at present, and there are mismatches between skills and employment opportunities. *Underdeveloped infrastructure* constrains the delivery of public services as well as private sector growth, and access remains a problem in remote areas. Despite the rapid expansion of the road network, more than 50 percent of the population lives half a day's walk from the nearest motor road. With the urban population projected to reach 50 percent by 2020, urban development needs attention.

## 2. The Bhutan Enterprise Survey and Investment Climate Assessment

**2.1 The objective of the Bhutan Investment Climate Assessment (ICA) is to evaluate the investment climate in Bhutan in all its operational dimensions and promote policies to strengthen the private sector.** The investment climate is made up of the many location-specific factors that shape the opportunities and incentives for firms to invest productively, create jobs, and expand. These factors include macroeconomic and regulatory policies, the security of property rights and the rule of law, and the quality of supporting institutions such as physical and financial infrastructure.

### Box 2: Methodology

The main sources of information for the ICA are two surveys. **The World Bank Group (WBG) and local partners conducted from, mid-April to mid-June 2009, a nationally-representative Enterprise Survey** of approximately 250 small, medium and large establishments across the manufacturing and services sectors<sup>3</sup> in the following four regions of Bhutan: Thimphu/Paro, Phuentsholing, Gelephu/Sarpang, Samdrup Jongkhar. The survey follows a 2001 private sector survey along the Thimphu-Paro and Phuentsholing industrial areas, with expanded coverage. The second survey covered 486 employees sampled from the larger firms surveyed across sectors. Information from the surveys is supplemented with information from other sources, including the *Doing Business Report*; analytical reports by the World Bank, the International Monetary Fund, other international organizations, and the Royal Government of Bhutan; and academic papers and reports.

One of the advantages that the World Bank's Enterprise Surveys have over other firm-level surveys is that similar surveys have been conducted in a wide range of countries. It is, therefore, possible to benchmark Bhutan against other countries with respect to both firm performance and measures of the investment climate. Throughout the report, firm performance and the investment climate in Bhutan is benchmarked against other countries of the South Asia Region (SAR)<sup>4</sup> and other economies with comparable factor endowments: Botswana, Mauritius, Costa Rica, Cape Verde, Lesotho and Lao PDR. As discussed in more detail in Volume 2, many aspects of the investment climate are favorable in Bhutan. Subsequent to the completion of the Enterprise Survey, stakeholder workshops and focus group discussions were conducted throughout the drafting of the ICA to inform and validate the report's results.

<sup>3</sup> Enterprise surveys target formal companies with 5 or more employees. Firms with 100 percent government/state ownership or private firms in the mining sector are not eligible to participate.

<sup>4</sup> These include: Afghanistan, Bangladesh, India, Pakistan, the Maldives, Nepal, and Sri Lanka, in addition to Bhutan.

**2.2** The ICA complements work commissioned by the Royal Government to accelerate Bhutan's economic development (Box 3).

**Box 3: The Accelerating Bhutan's Socio-Economic Development Initiative**

The Royal Government of Bhutan (RGOB) engaged McKinsey & Company, a global management consulting firm, in July 2009 on a 23-month study to find ways to accelerate Bhutan's economic development. The associated project, called 'Accelerating Bhutan's Socio-Economic Development,' is being implemented by The Gross National Happiness Commission (GNHC) and has two key objectives:

1. Attracting investments and meeting the job gap by developing priority sectors identified for Bhutan's accelerated growth (e.g. **tourism, ICT, construction, cultural industries, agriculture, and cross-cutting factors which enable/inhibit growth**)
2. Improving the efficiency and effectiveness of public sector services (focusing in particular on **health care, education, vocational training and government-to-citizen services**)

In order to achieve these objectives, nine compacts that include time-bound performance targets, have been signed between the Prime Minister and various Ministries including the Ministry of Health; the Ministry of Information and Communications; the Tourism Council of Bhutan; the Ministry of Education; and the Ministry of Labour and Human Resources (MOLHR). For example, MOLHR has committed to improving the efficiency of vocational education and training (VET), increasing the number of VET graduates, and improving their employability. By 2013, Government expenditure on VET is targeted at below Nu. 85,000 per capita, the number of VET graduates is targeted to increase from 500 to 6,000, and the rate of employment of VET graduates is targeted to increase from 50 percent to 80 percent.

The newly formed Government-to-Citizens (G2C) implementation unit, with support from McKinsey, is currently involved in simplifying of up to 110 processes including some licenses commonly concerning micro and small businesses. The G2C mandate does not include policy or regulatory changes.

This ICA and its core chapters on labor and skills, access to finance, and business-government relations, provide a complement to the work commissioned by the Royal Government to McKinsey. The ICA's policy recommendations will inform RGOB's policy work on the investment climate, while the ICA's data analysis can substantiate McKinsey's diagnostic. The ICA report can also be used to inform choice of and baselines for key performance indicators to monitor the implementation of the existing compacts.

**2.3 The report presents a diagnostic of the investment climate based on the enterprise and employees surveys.** Firms have few complaints about key areas of the investment climate, such as governance and infrastructure, and objective indicators of the investment climate suggest that Bhutan compares relatively well in many of these areas with the comparator countries. In other areas such as access to finance, hiring workers, and regulations, firms report concerns. The summary below briefly presents the opportunities and challenges of the investment climate in Bhutan.

**2.4 This year's ICA, a follow-up to the 2002 Private Sector survey, shows that Bhutan continues to fare much better than the region on aspects of the investment climate that only long term policies can improve, while the main impediments that remain can be addressed in the short and medium term.**<sup>5</sup> Bhutan, in comparison to the South Asia region and lower middle income countries, has an outstanding advantage in terms of good governance, political

<sup>5</sup> Pilot Investment Climate Assessment, Challenges and Opportunities for Private Sector Development in Bhutan, 2002

stability, low levels of corruption and crime, theft and disorder, access to electricity, and customs and trade regulations. In addition, preferential access to the large Indian market and easy access to skilled and unskilled labor from India continue to offer unique advantages for the private sector in Bhutan. It is important to note that Bhutan has embarked on significant reforms over the last several years in its legal and regulatory environment helping to create a more business-friendly environment, including the Economic Development Policy (EDP). Some of these reforms and their impact were not captured in the Enterprise Survey as they were about to be introduced at the time the survey was implemented. The EDP aims at creating an enabling environment for investment, with a focus on increasing and diversifying exports with minimal ecological footprint within the framework of Gross National Happiness. Box 4 illustrates the Government strategy for supporting the IT enabled services.

**Box 4: A Niche Strategy for Jobs and Growth: Private Sector Development in IT Enabled Services**

In parallel with private sector development (PSD) policy reforms in cross-sectoral areas, the RGOB's PSD strategy, –now captured in the 2010 Economic Development Policy, has been to encourage the growth of *niche* sectors as potential sources of growth for economic development and employment generation. The Royal Government has begun facilitating the development of the nascent Information and Communications Technology (ICT) sector, in particular promoting export oriented Information Technology (IT) services, Information Technology Enabled Services (ITES), including Business Process Outsourcing (BPO), with support from the World Bank. Bhutan's unique selling proposition and comparative advantages include a disciplined, English speaking workforce, a relatively developed telecommunications network, its pristine natural environment, low cost abundant Green (Hydro) power, its safe and secure environment with high geopolitical stability, a stable political system, and a highly positive image (“Brand Bhutan”) conducive to making Bhutan an economic Shangri-La for green industries.

By promoting its comparative advantages, including proximity to India, the biggest player in the offshoring of ITES globally, the RGOB has attracted companies scouting locations for risk mitigation strategies and business continuity planning. The Thimphu TechPark<sup>6</sup>, (an IT Park) is the first public-private partnership (PPP) model of its kind in Bhutan, scheduled for inauguration in June 2011. RGOB has announced a set of incentives for ICT export-oriented companies to be located in the IT Park. It is expected that the FDI into the Park Investment will generate business opportunities for local companies and nurture a high-productivity ITES ecosystem based on global good practices. Experience around the world has shown that for every job created in an IT/ITES company, 2 to 5 jobs are created in support industries.

**2.5 Key findings of the 2010 ICA on the structure of industry in Bhutan highlight that the Private Sector has grown rapidly and is creating jobs (Figure 1).** The median Bhutanese firm reported an increase of 36 percent in sales and 25 percent in employment between 2006 and 2008. Large firms of 100 workers or more reported the fastest increases in sales and employment, while job creation was fastest in the Gelephu/Sarpang and Thimphu /Paro regions.

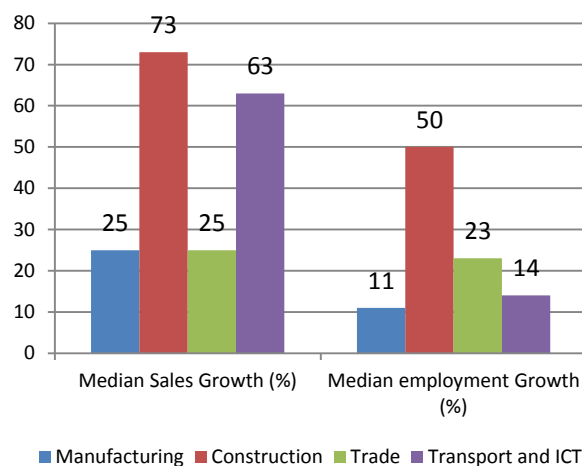
**2.6 In addition, Bhutanese firms are young and changing fast (Figure 2);** about 24 percent of enterprises surveyed are less than 5 years old. A quarter of these young firms are large, employing 100 workers or more (average 60 workers). The ICA also reveals that more than half of new enterprises are in manufacturing, in contrast to older firms, which tend to be more in the construction and trade sectors. In addition, the tourism, transport and ICT sectors are dominated by new firms. New firms are dynamic employment generators; they accounted for 34 percent of all net new jobs created by firms in the sample, an average of 21 new jobs per firm compared to 15 for more established firms fifteen years or older.

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<sup>6</sup> [www.thimphutechpark.com](http://www.thimphutechpark.com)

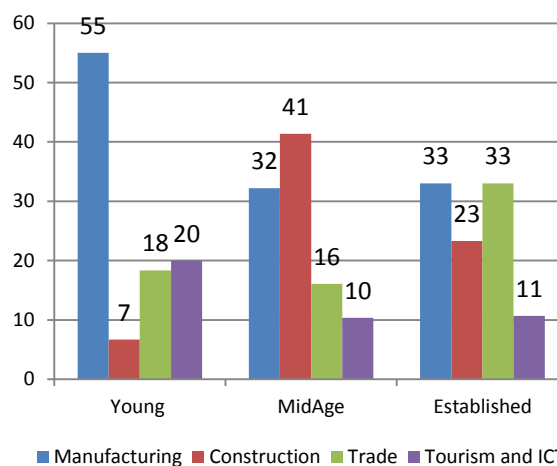


**Figure 1: The Private Sector has grown rapidly and is creating jobs (2006-2008)**



Source: Enterprise Survey data

**Figure 2: Sector-wise distribution of firms by age (%)**



Source: Enterprise Survey data

**2.7 The productivity of Bhutan’s labor force compares well with the region.**<sup>7</sup> While labor costs are higher in Bhutan than in neighboring countries, the ICA shows that these are offset by higher productivity, especially in the services sector. With competitive unit labor costs and cheap electricity, the ICA findings support the Royal Government of Bhutan’s vision, captured in the Economic Development Policy (EDP). The EDP promotes the expansion of niche services as potentially high growth sectors and supporting their expansion. The success of this productivity upgrading strategy will however crucially depend on improving connectivity via telecom and internet and bringing down associated costs.<sup>8</sup>

*Challenges: Access to capital and labor are the two main investment climate impediments*

**2.8 The biggest impediments for the private sector come from factors of production, in particular, access to capital and to labor.** Bhutan slipped from 124 to 126 out of 186 economies in Doing Business 2010 (on account of licensing and access to finance).<sup>9</sup>

**2.9 When asked to rank the severity of access to finance as a constraint, almost one third of firms report it is a major or very severe obstacle.** This is a paradox because Bhutan compares well to the region and the rest of the world in terms of firm linkages with the formal banking sector. The issue of access to finance is perceived to be particularly acute for younger firms and small and medium firms. Complex loan procedures, very high collateral requirements, little variety in external financing, and a restrictive policy and regulatory environment appear to be key reasons for inadequate access to finance relative to the needs of the private sector.

**2.10 Constraints linked to an inadequately skilled workforce are the single largest obstacle**

<sup>7</sup> The data collected through the indicator survey conducted does not permit total factor productivity calculations.

<sup>8</sup> See Box 1.2 in Volume 2 for a discussion of the status of telecommunications infrastructure and associated costs of bandwidth.

<sup>9</sup> World Bank (2009). Doing Business 2010 (www.doingbusiness.org)

**reported by medium and large firms and by established firms (10-19 year-old).** Almost one third of medium and large firms report the issue of hiring foreign workers and an inadequately educated workforce as major or very severe business environment constraints.

**2.11 Infrastructure presents a mixed picture in the business enabling environment.** In stark contrast with the region, electricity is not reported as a constraint to Bhutanese firms as of 2009.<sup>10</sup> Access to land, while reported as a major obstacle by only one tenth of firms, affects one fifth of medium or large firms and one fifth of firms located in industrial estates in a major way.<sup>11</sup> Transportation is the biggest infrastructure problem encountered by firms and the fifth largest business constraint, affecting large firms in particular. Forty percent of all firms – 70 percent of large firms - experienced losses due to ground transportation difficulties. While exporters are particularly hit, all firms are affected since domestic and export-led firms equally import a large part of their inputs. Transportation issues could be linked to the heavy regulations that currently govern movements of goods within Bhutan.

**2.12 In general, the time spent by firms to comply with Government regulations and associated costs are much higher compared to regional and international averages.** The complexity of regulatory procedures is a burden for older firms in particular.

**2.13 The data suggests that firms are not taking advantage of Bhutan’s open access to the large Indian market and of other important regional opportunities.** While trade flows are highly concentrated on imports from India, sales remain domestic. Enterprise Survey results highlight that imported inputs from India represent more than 80 percent of all imported inputs in Bhutan. However, over 93 percent of sales revenues are generated by domestic sales. Encouraging developments include the expansion of Bhutan’s preferential trade agreement with Bangladesh.<sup>12</sup>

### **3. Perceptions about the Investment Climate**

**3.1 In addition to collecting information on productivity, firms are also asked about the investment climate**—including competition from the informal sector, crime, taxation, worker education and skills, corruption, regulation, and infrastructure. Although most of the questions are quantitative (such as how many times did power go out in the previous month, how much the firms spend on security, and how much time do senior managers spend dealing with regulation), managers are also asked what they see as the biggest problem that they face. Although questions about firm perceptions have proven less robust than objective data collection, it is natural to include in the analysis of the investment climate, what firm managers perceived as the biggest problems they faced. Objective data on many of these issues are used later in this report, and in greater detail in Volume 2, to measure the cost of investment climate constraints to firms.

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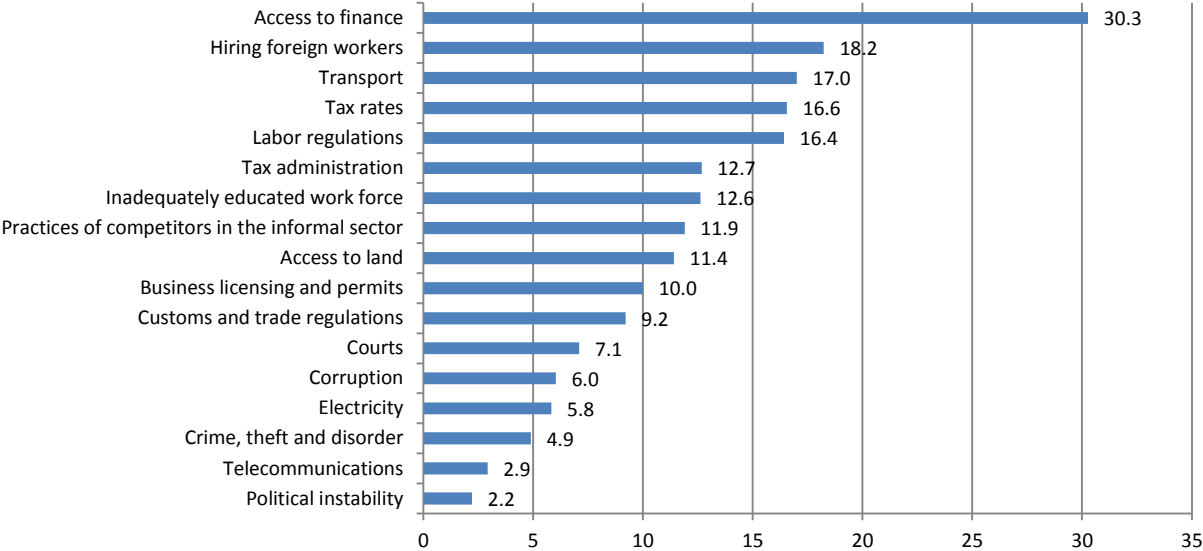
<sup>10</sup> An electricity deficit, however, is projected from 2010 until 2015, until the Dagachu power plant is built and operational.

<sup>11</sup> Land issues may be underreported due to the survey’s focus on existing firms, as opposed to new entrants.

<sup>12</sup> Bhutan and Bangladesh recently renewed their bilateral trade agreement, extending the list of tradable items from 27 to 90 and eliminating a 15 percent tariff on 18 major agricultural Bhutanese export products; therefore opening new markets for Bhutanese products.

**3.2 Perceptions and objective indicators do highlight that remaining challenges include access to finance, access to a domestic and foreign labor force, labor regulations, and transportation issues.** In addition, the market would greatly benefit from the simplification of regulatory and licensing procedures. Figure 3 presents perceptions of the most severe constraints as reported by firms.

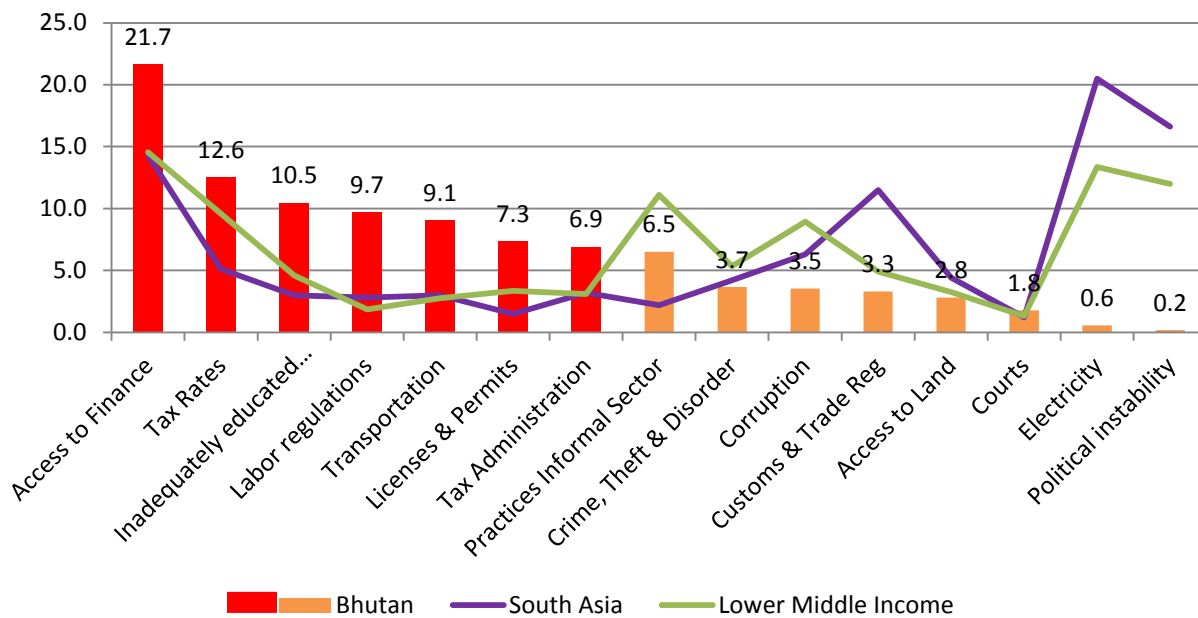
**Figure 3: Percentage of firms citing factor as a major or very severe constraint**



Source: Enterprise Survey data (2009)

**3.3 Figure 4 benchmarks the perception of investment climate constraints by Bhutanese firms against regional and lower middle income country averages.** The figure is based on a question that asks firms to choose the main business environment obstacle from a list of 15 obstacles.

Figure 4: Firm Perceptions of Business Constraints



Source: Enterprise Survey data (2009)

**3.4 The next sections of the report benchmark Bhutan with the comparator countries on both objective and perception data on the investment climate.** This volume focuses mostly on those areas of the investment climate that firms said were a serious problem or on areas where the objective data leads to a similar conclusion. Other areas of the investment climate, such as infrastructure and policy reforms, where Bhutan rates well with respect to both the objective and perception indicators, are discussed in Volume 2.

## 4. Labor Productivity and Skills

**4.1 The creation of good employment opportunities is one of the important goals of the RGOB.** The 10<sup>th</sup> Five Year Plan (10FYP) attaches high priority to tackling Bhutan's rising unemployment problem, particularly among youth. With public sector employment not expected to grow rapidly, it is the private sector that is expected to play an important role in creating these jobs. However, despite rapid economic growth and the relatively rapid development of the formal private sector over the past few years, the overall unemployment rate, albeit a low rate, rose to 4 percent in 2008, from 3.7 percent in the preceding year. Unemployment has risen especially rapidly among youth who represent a fifth of the population, from 2.2 percent in 1998 to 9.9 percent in 2007, and 13 percent in 2008.<sup>13</sup> At the same time, private sector firms report the unavailability of adequately trained workers. This is surprising given that Bhutan has one of the most highly educated workforces in the region.

**4.2 The survey shows that private formal firms in Bhutan are growing rapidly and**

<sup>13</sup> Labor Force Surveys

**creating jobs.** The median firm reported an increase of 36 percent in sales and 25 percent in employment between 2006 and 2008.<sup>14</sup> Most firms seem to be on a growth path and are optimistic about their short-term prospects. Seventy-five percent of all firms and 87 percent of manufacturing firms expect an increase in sales in fiscal year 2010.

#### **4.3 The private sector appears to have the potential of becoming an engine of job growth.**

The increased dynamism in the private formal sector, in terms of both the entry of new firms and the growth of existing ones, suggests that with a little support, the private sector has the potential to grow rapidly and create jobs. This report argues that the competitiveness of the private sector will depend critically on its ability to innovate and move up the productivity ladder. This will depend on raising the capacity of firms to absorb innovation, for which a growing, skilled, and happy workforce will be key. Currently, however, labor skills are emerging as a constraint.

### **Emerging Labor Market Constraints**

#### **4.4 The rapid growth of the private sector has created demands which the labor market in Bhutan has not yet been able to fully meet.**

The development of the private sector in such a major way is a recent development for Bhutan. The institutions for training workers and for regulating the employer-employee relationship, consequently, require support to change and sustain this development. In the meantime, however, workforce related issues have become a major constraint for business. The percentage of Bhutanese firms identifying labor skills as a major constraint remains relatively high at 13 percent.

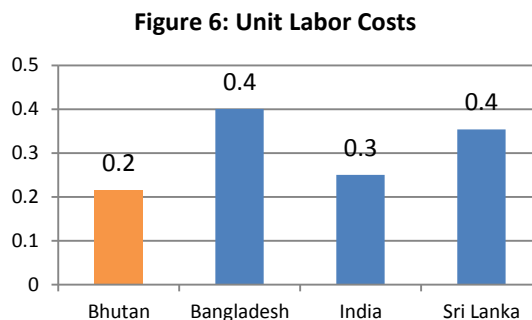
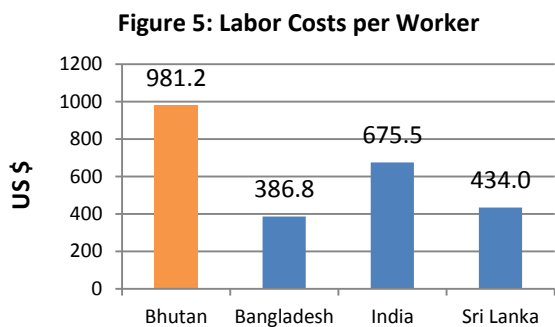
#### **4.5 Labor costs are higher in Bhutan than in neighboring countries, highlighting the need to raise productivity to remain competitive.**

Average labor costs in Bhutan work out to be almost 45 percent higher than in India (Figure 5). However, costs alone do not determine competitiveness: they need to be weighed against labor productivity. The survey results show that labor productivity is also high in Bhutan, and that the unit labor cost (the amount of value generated by a typical worker paid back to her as wages and salaries) is correspondingly lower than in many of its neighbors (Figure 6).<sup>15</sup> Disaggregating further, unit labor costs are significantly lower than in the rest of the region for service sector firms, and about the norm for manufacturing. The implication is that for Bhutan's current industrial structure, labor costs are competitive in general, especially in services. Another implication is that for Bhutan to become more competitive, firms have to move into higher productivity activities and adapt and innovate faster than its competitors. For this to happen, an educated and skilled workforce is a pre-requisite.

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<sup>14</sup> We used the median for analysis because there is wide variation in firm size, and using the average gives more weightage to outliers.

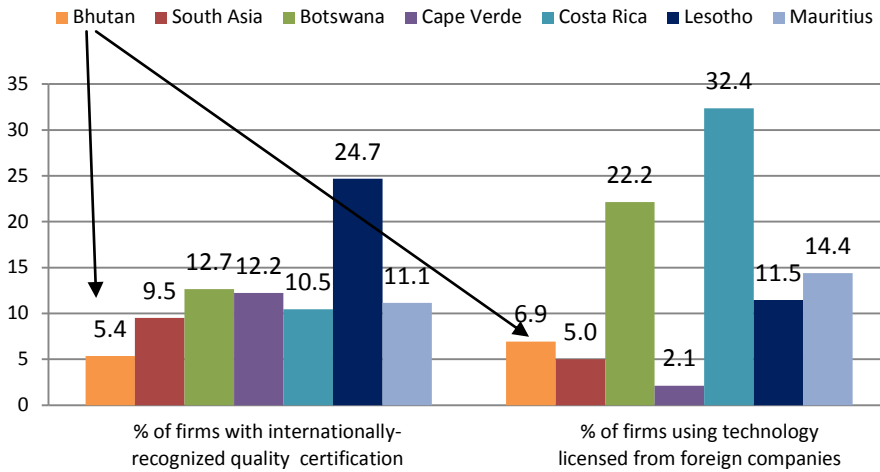
<sup>15</sup> Comparability to the larger set of comparator countries is limited by data availability



Source: Staff estimates based on Bhutan Indicator Survey (2009); India Investment Climate Survey (2004), Bangladesh Investment Climate Survey (2006), Sri Lanka Investment Climate Survey (2003).

**4.6 Increasing the capacity of private firms to absorb technology and innovate is critical.** Bhutanese firms currently have amongst the lowest levels of use of foreign technology, or internationally recognized quality certification (Figure 7). Only rarely do firms located in Bhutan license technology from a foreign-owned company and few Bhutanese firms have internationally recognized quality certification. International evidence supports that quality assurance standards such as ISO certification have a positive correlation with productivity levels. The Bhutanese market is therefore not taking advantage of foreign technology or international quality certification as a way to better compete in domestic or international markets. Facilitating FDI and encouraging trade can potentially improve firms' capacity to innovate. Another important determinant is the technological capacity of local industries in terms of skill levels of the workforce.

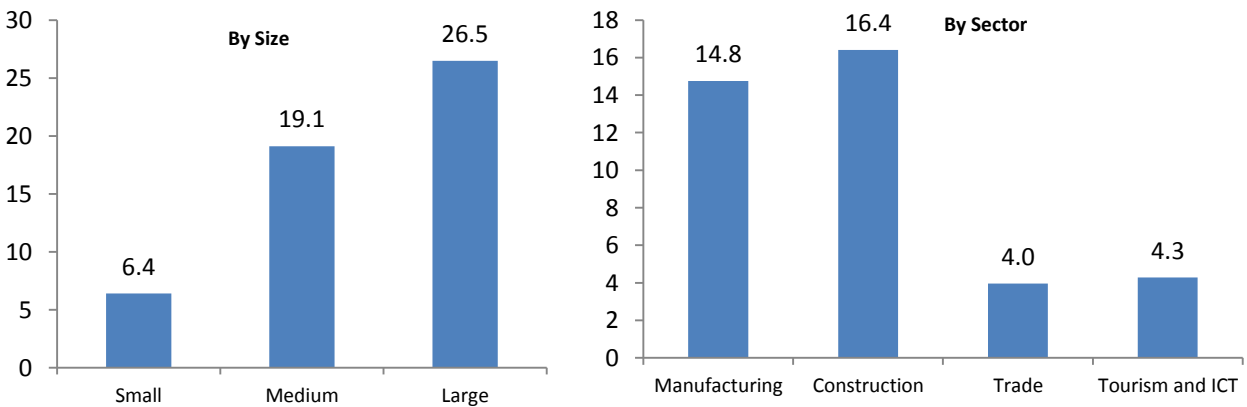
**Figure 7: Quality certification and technology**



Source: Enterprise Survey data

**4.7 An inadequately skilled labor force, however, remains a major constraint.** For businesses to remain competitive, they have to engage in high productivity activities, for which a skilled labor force is necessary. At the same time, one in ten firms in Bhutan feels that the low level of workforce skills is the biggest obstacle they face in their operations (Figure 8). These findings merit concern. Unless the issue of skills mismatch is understood and tackled head-on, it has the potential of becoming a binding constraint for the most dynamic segments of the private sector. This would warrant a reform of the education system to develop a more applied curriculum for the key skills required by the private sector.

**Figure 8: Percentage of Firms reporting Workforce Skills as Major Constraint**

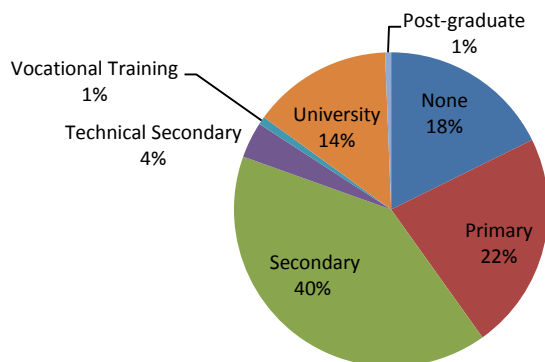


Source: Enterprise Survey data (2009)

**4.8 The paradox is that Bhutan’s workforce is by and large well educated – in particular women.** A survey of employees reveals that 40 percent of workers have completed secondary education. Another 15 percent have a university degree or higher (Figure 9). This is significantly better than regional standards, and indeed could be one of the big attractions for skilled labor

intensive businesses.<sup>16</sup> In India, for example, in 2004, just 16 percent of the population aged 15 or more had completed secondary education and 5.5 percent had attained higher degrees.<sup>17</sup> At the same time, however, a very small segment of the workforce has vocational or technical training. There is also a substantial mismatch between the education levels of jobseekers and the skills demanded by the market. This could represent a major constraint as the private sector grows and diversifies into new areas and few firms provide training for their workers. The lack of training and industry experience is likely to be behind the complaint of inadequate labor force skills identified by private firms.

**Figure 9: Workers' Completed Level of Education**



Source: Employee Survey (2009)

#### **4.9 Hiring foreign workers ranks as the second largest investment climate constraint.**

Foreign workers can help alleviate shortages of human resources. In Bhutan, foreign workers account for a fifth or more of all workers in half of the surveyed enterprises. Yet, almost one fifth of firms report difficult access to foreign workers as a major or very severe obstacle. In follow-up workshops to the Enterprise Survey, firms reported the lack of demand by the Bhutanese workforce for unskilled employment and the shortage of highly skilled Bhutanese experts in some disciplines. While a new online system for applying for permission to hire skilled foreign workers is working well, some regulations hinder access to both skilled and unskilled foreign labor. The required use of third party agents licensed by the government to hire unskilled foreign labor is reported as costly and offering businesses no real advantages. Establishing clear guidelines for hiring foreign workers, with a view to ensuring availability of human resources across the skills spectrum, could go a long way in meeting the Government's concerns along with those of the private sector.

#### **4.10 Bhutan leads its South Asian neighbors in the share of female business owners although, paradoxically the participation of women in the workforce lags.**

Participation of women as business owners and in the workforce is important to achieving the third MDG of gender equality and empowerment of women. With almost a third of firms owned by women, Bhutan is on par with OECD levels and performs remarkably well in terms of gender equality

<sup>16</sup> For more detailed discussion on women at the workplace, please see Chapter 6.

<sup>17</sup> This is not an exact comparison as we are comparing educational attainments among the workforce in Bhutan to those of the working age population in other south Asian countries.



compared to the rest of South Asia.<sup>18</sup> Bhutan's female entrepreneurs are not restricted to small firms and no less productive than men.<sup>19</sup> In fact, firms owned by women tend to be larger than firms owned by men and span across sectors.<sup>20</sup> While male and female business owners experience similar investment climate constraints, the reports suggest that female owners may be impacted more acutely by constraints including access to finance, hiring foreign workers, and transportation. While the 10 percent wage gap in the labor force compares favorably against the best OECD benchmarks, and despite the fact that employers provide similar non-wage benefits to male and female employees, women remain largely underrepresented – including compared to the region - as salaried, full time workers in non-agricultural sectors. These results warrant further research to understand if, indeed, female entrepreneurs experience key business constraints more acutely and what could explain the underrepresentation of women in the salaried labor force.

## **5. The Access to Finance Paradox**

**5.1 There is a noticeable discrepancy between the perceived level of access to finance and the actual level of financial outreach.** Bhutan is in a superior position to other South Asian countries in terms of financial outreach at the firm level. For example, it has a high ratio of firms with loans and bank accounts. However, firms in Bhutan perceived access to finance as a major constraint in both the 2001 and 2009 Enterprise Surveys. How can we explain why this constraint persists when Bhutanese firms have much better financial access than other comparable countries?

**5.2 The financial sector in Bhutan has experienced rapid growth in the provision of credit over the years but does not yet fully meet the needs of the real sector.** The financial system in Bhutan was, until January 2010, composed of a central bank, five financial institutions (FIs),<sup>21</sup> a pension fund, and a securities exchange. Two commercial banks dominate the financial sector, holding 78 percent of the sector's total assets as of December 2009. The total volume of credit provided by the financial sector increased from Nu.8.2 billion to Nu.27.5 billion between 2003 and 2009 (Figure 10). However, this rapid credit growth has not fully met the financial needs in the real sector. This could explain the continued and growing perception by firms of access to finance as a major obstacle.

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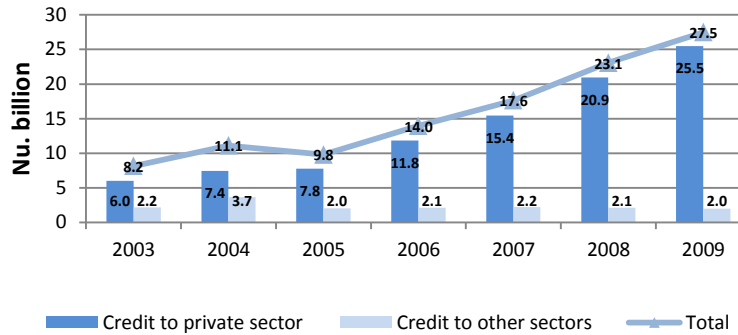
<sup>18</sup> The econometric analysis focused on sole proprietorships (more than 80 percent of the firms) to assess differences of men and women-owned firm, see Chapter 6 in Volume 2.

<sup>19</sup> The econometric analysis, through looking at labor productivity as a function of firm characteristics and investment climate variables, does not indicate that firms with female participation in ownership are less productive than male-owned firms

<sup>20</sup> Twelve percent of firms owned by women are large firms, while only 5 percent of firms owned by men are large.

<sup>21</sup> These include: two commercial banks; the Bank of Bhutan (BOB), and the Bhutan National Bank (BNB); the Royal Insurance Corporation of Bhutan (RICB); the Bhutan Insurance Limited (BIL); and Bhutan Development Financial Corporation (BDFC).

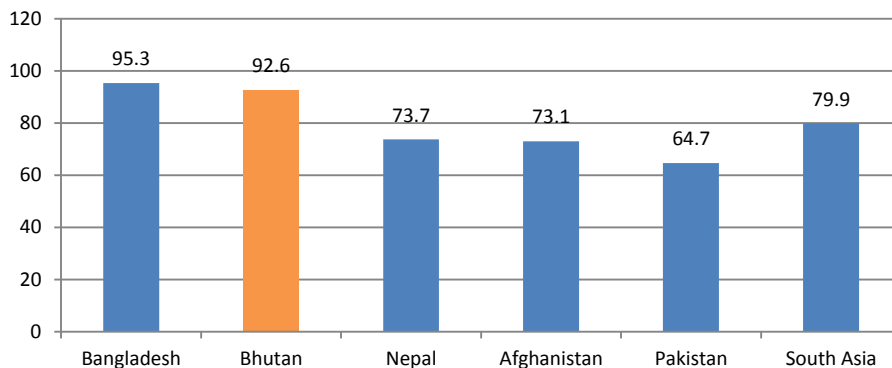
**Figure 10: Credit Growth Trend in Bhutan**



Source: World Bank analysis based on RMA data, July 2010

**5.3 Nonetheless, enterprise survey data shows that firms in Bhutan have much better access to banking services than other comparable countries in terms of access to a bank account.** It is noteworthy that 93 percent of the surveyed firms in Bhutan have a bank account, more than the regional average of 80 percent and more than any other country in the region except Bangladesh (Figure 11).<sup>22</sup>

**Figure 11: Percentage of Firms With a Checking or Savings Account**



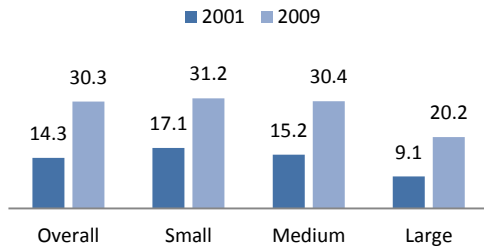
Source: Enterprise Survey data

**5.4 Despite relatively high levels of financial outreach compared to the rest of South Asia, firms in Bhutan have increasingly perceived access to finance as a major constraint from 2001 to 2009.** When asked to rank the severity of access to finance as a constraint, the percentage of firms responding that access to finance is a major obstacle more than doubled from 14.3 percent to 30.3 percent over this period, independently of firm size (Figure 12).<sup>23</sup> Similarly, a separate Enterprise Survey question indicates that 21.7 percent of surveyed firms identified access to finance as their biggest obstacle to doing business, more than all other obstacles in the Enterprise Survey (Figure 13). Among comparable countries, the access to finance obstacle in Bhutan is more acute.

<sup>22</sup> Does not include India and Sri Lanka for which Enterprise Survey data on this statistic is not available.

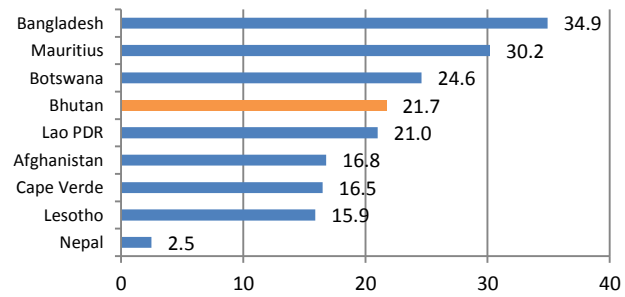
<sup>23</sup> This increase applies to all sizes of the firms: large firms from 9.1 percent to 20.2 percent, medium firms from 15.2 percent to 30.4 percent, and small firms from 17.1 percent to 31.2 percent.

**Figure 12: Access to Finance as a major obstacle**



Source: Enterprise Survey data

**Figure 13: Access to finance as biggest obstacle**

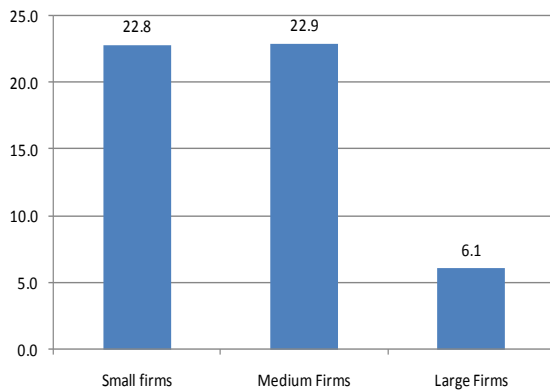


Source: Enterprise Survey data

**5.5 SMEs and firms in the trade sector are hit more severely by access to finance issues.**

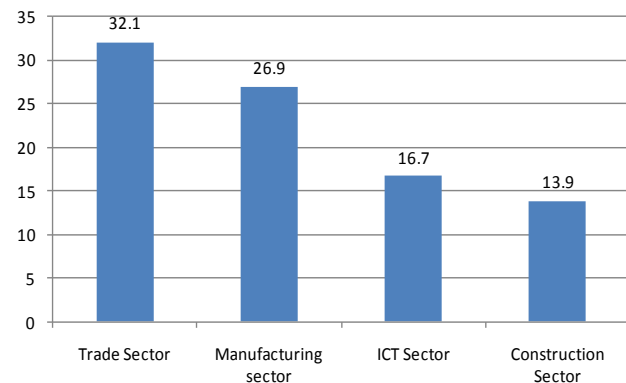
In particular, in Bhutan, small and medium firms and the trade sector consider access to finance their biggest obstacle (Figure 14). Twenty-three percent of small and medium sized firms cited inadequate access to finance as their biggest obstacle compared to all other business constraints. While lack of access to finance tends to hurt small firms the most in countries with underlying weaknesses in their institutional environment, empirical evidence also suggests that the benefit to small firms is disproportionately greater (in terms of having their constraints relaxed) as financial systems develop.<sup>24</sup> Across sectors, 32 percent of firms in the trade sector consider access to finance as the biggest obstacle to their business, compared to only 14 percent of firms in the construction sector (Figure 15). Although the Bhutanese economy is heavily dependent on trade, especially with India, provision of financial services to the trade sector has continued to remain minimal, with few financial instruments available.

**Figure 14: Access to Finance as Biggest Obstacle (across firm size)**



Source: Enterprise Survey data (2009)

**Figure 15: Access to Finance as Biggest Obstacle (across the sectors)**



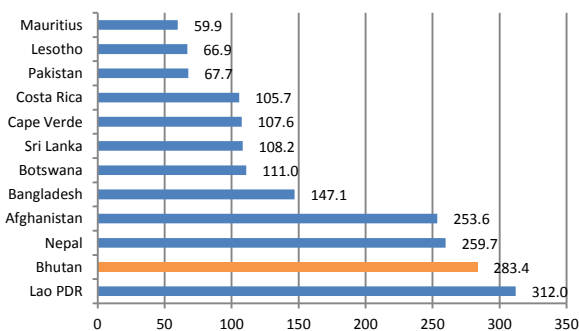
**5.6 While a relatively high percentage of firms are banked in Bhutan, firms see loan procedures as complex and lacking in transparency.** Financial inclusion literature has

<sup>24</sup> Beck, Thorsten, Asli Demirgüç-Kunt, and Vojislav Maksimovic (2005).

established that complexity of loan procedures, recurrence of costs and multiple fees, and lack of transparency tend to be associated with reduced access to banking services.<sup>25</sup> In Bhutan, 37 percent of surveyed firms responded that they had not applied for a loan in 2008, although they needed a loan for their businesses. Of these firms, 17 percent also revealed that they did not apply for a loan because application procedures for loans or lines of credit are complex and difficult to understand.

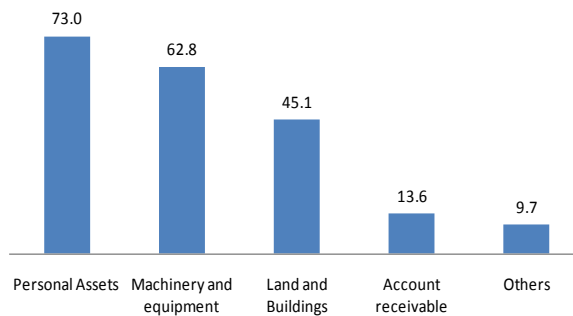
**5.7 Furthermore, the value of collateral needed for a loan is among the highest in the world.** The average value of collateral needed for a loan in Bhutan, as measured by a collateral-to-principal ratio, is 283 percent (Figure 16). Bhutan has the second highest collateral to principal ratio in the world, with only Lao PDR ranking higher at 312 percent.<sup>26</sup> Collateral currently acceptable by the banks is limited to movable and immovable assets under ownership of the borrowers; accounts receivable and inventories are not widely used. Personal assets, used 73 percent of the time, are the most frequently used collateral in Bhutan. Enabling firms to utilize a broader range of business assets (such as accounts receivable and inventory) to secure loans would help facilitate access to credit, as the recent World Bank “Banking the Poor” report demonstrates.<sup>27</sup>

**Figure 16: Value of collateral needed for a loan (as % of the loan amount)**



Source: Enterprise Survey data

**Form of collaterals (%)**



Source: Enterprise Survey data (2009)

**5.8 Banks attribute the wide use of collateral based lending to external constraints.** From the perspective of commercial lenders, the absence of financial statements, national accounting standards, and borrower credit histories make it difficult to carry out a proper loan appraisal of the borrowers’ credit worthiness. Commercial banks, therefore, require more collateral from borrowers.<sup>28</sup> Overall, only half of surveyed firms in Bhutan prepare certified financial statements. As one may expect, the smaller the firm, the less likely it prepares financial statements. Bhutan has a lower percentage of firms with annual financial statements reviewed by an external auditor compared to regional averages and comparator countries (Figure 17).

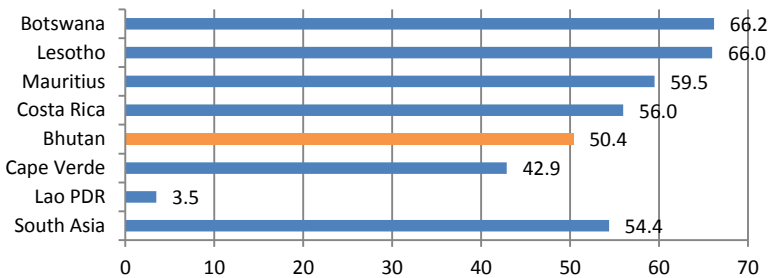
<sup>25</sup> World Bank (2009). Banking the Poor

<sup>26</sup> Enterprise survey benchmark analysis covers 125 countries across the world.

<sup>27</sup> World Bank (2009). Banking the Poor, p 53-60

<sup>28</sup> The January 2010 follow on survey included interviews with banks, which corroborated banks’ difficulty in evaluating creditworthiness of borrowers in the absence of financial statements; therefore requiring the use of collateral.

**Figure 17: Percentage of firms with annual financial statements reviewed by external auditor**



Source: Enterprise Survey data

**5.9 Increased competition is expected to expand the range of financial products and services available.** Until 2010, there were only two major banks and the financial sector lacked competition to drive innovation and new financial products. This is expected to change as three new financial institutions have entered the market. Like other large firms in Bhutan, commercial banks are also facing a lack of skilled workers in the expansion of their financial products. The need for capacity building of financial sector staff has become increasingly important to provide efficient and transparent banking services, particularly in an environment of increased competition among banks, due to the new entrants.

**5.10 In terms of the policy and regulatory environment, banks consider some prudential regulations limiting to the expansion of credit to industry.** Prudential regulations such as minimum capital requirements, single borrower limits, and required cash reserve ratio (CRR) have been successful in ensuring a sound and robust financial system. However, banks report that these regulations have impaired the level of access to finance. This feedback is shared by the private sector which is advocating a review of prudential regulations to meet the strong financial needs of the private sector. For example, because of the rapid increase of private sector credit, the Royal Monetary Authority of Bhutan (RMA) raised the CRR from 15 percent to 17 percent in the middle of the global financial crisis while other SAR countries loosened credit policies to provide more liquidity to industry. The private sector feels that the current CRR level, which is the highest in the region, limits the capacity of financial institutions to provide more loans to firms.<sup>29</sup> Finally, while an insolvency regulatory framework is in place in Bhutan, it is unclear whether it is being implemented. An insolvency regime, which is important for both entrepreneurship and access to credit, can give comfort to creditors in the form of a speedy recovery process in case of loan defaults and thereby, reduce the need for such high over-collateralization.

<sup>29</sup> CRR in other South Asian countries ranges from 5 to 8 percent, as compared to 17 percent in Bhutan. (Afghanistan, 8 percent; Bangladesh, 5 percent; India, 5%; Nepal, 5.5 percent; Pakistan, 5 percent; and Sri Lanka, 7 percent)

**5.11 Are access to finance constraints more severe for female entrepreneurs?** Finance appears a more acute constraint for female entrepreneurs, as their firms are less likely to use banks to finance investments (Table 1). This result warrants further research to better understand how financing constraints may differ between male and female entrepreneurs, especially given that the participation of women as business owners is not a recent phenomenon in Bhutan.

**Table 1: Finance constraints for women entrepreneurs**

	Male	Female		Male	Female
Access to finance	26%	37%	% firms using banks to finance investments	72%	61%
Hiring foreign workers	15%	25%	% firms using banks to finance expenses	59%	56%
Transport	13%	21%	% firms with loan/line of credit from financial institution	63%	47%
Labor regulations	13%	19%	Firm's recent loan/line of credit required collateral (%)	60%	47%
Practices of competitors in the informal sector	10%	13%	Value of collateral needed (% of the loan amount)	280%	292%

Source: Enterprise Survey data (2009)

## 6. Business Government Relations

**6.1 Bhutan’s government has prioritized facilitating the business environment, but much remains to be done for Bhutan’s private sector to reach its potential.** There have been substantial changes to the overall business environment, with major and important legislation introduced, regulations promulgated, and the civil service restructured to facilitate increased levels of private sector activity. Among various initiatives, the Improving Public Service Delivery Systems (IPSDS) Government team, hosted under the GNH Commission, is at the forefront of implementing an assessment of administrative burdens imposed on businesses, and their mandate under the Cabinet has recently been expanded to cover an ambitious regulatory reform agenda. In addition, the Ministry of Information and Communication has launched a vast e-government initiative. Other ministries, like the Ministry of Economic Affairs, are also playing a key role in regulatory reform initiatives, including a leading business licensing reform program.<sup>30</sup>

**6.2 The findings of the Enterprise Survey and the World Bank Group’s Doing Business Indicators show that some licensing and regulation issues still burden the private sector in Bhutan.** The findings highlight that Bhutan continues to fare much better than the region on aspects of the investment climate that only long term policies can improve such as peace and stability and good governance. However, firms remain burdened with administrative costs and the opportunity cost (in terms of lost business opportunities) caused by unclear and multiple licensing procedures, and lack of information on licensing requirements (Table 2).<sup>31</sup> The 2010 World Bank Doing Business survey concludes that, out of the 183 economies surveyed, Bhutan is ranked in the 126<sup>th</sup> place overall.<sup>32</sup>

**Table 2: Doing Business Rankings for Bhutan and Comparator Countries**

Economy	OVERALL RANK	Ease of starting RANK	Ease of licenses RANK	Ease of Employing RANK	Ease of Property RANK	Ease of Credit RANK	Ease of Investors RANK	Ease of Taxes RANK	Ease of Trading RANK	Ease of Contracts RANK	Ease of Closing RANK
Bhutan	126	80	127	12	41	177	132	90	153	33	183
Afghanistan	160	23	149	69	164	127	183	55	183	164	183
Bangladesh	119	98	118	124	176	71	20	89	107	180	108
Botswana	45	83	122	71	44	43	41	18	150	79	27
Cape Verde	146	136	83	167	126	150	132	110	58	38	183
Costa Rica	121	127	129	110	49	61	165	154	60	132	101
India	133	169	175	104	93	30	41	169	94	182	138
Lao PDR	167	89	115	107	161	150	182	113	168	111	183
Lesotho	130	131	155	67	142	113	147	63	143	105	72
Maldives	87	49	9	41	183	150	73	1	126	92	126
Mauritius	17	10	42	36	66	87	12	12	19	66	73
Nepal	123	87	131	148	26	113	73	124	161	122	105
Pakistan	85	63	105	146	119	61	27	143	78	158	56
Sri Lanka	105	41	168	96	148	71	73	166	65	137	45
		bottom third of all 183 countries, bottom half of Bhutan + 13 comparator countries									
		bottom third of all 183 countries, top half of Bhutan + 13 comparator countries									
		middle third of all 183 countries, bottom half of Bhutan + 13 comparator countries									
		middle third of all 183 countries, top half of Bhutan + 13 comparator countries									

Source: Doing Business (2010)

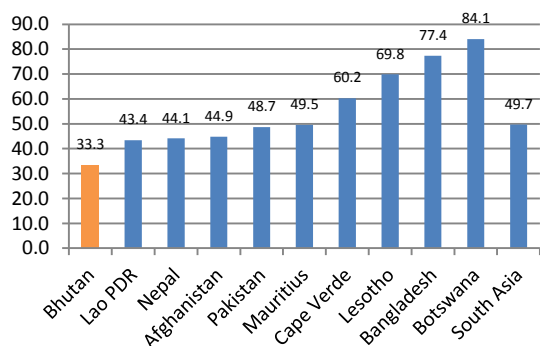
<sup>30</sup> This program was funded by the International Finance Corporation (IFC).

<sup>31</sup> Lack of transparency creates higher costs as firms deal with higher risks, and may deter new firms from entering the market due to information asymmetries that benefit market incumbents. See e.g. OECD, 2002: “Foreign direct investment for development.”

<sup>32</sup> <http://www.doingbusiness.org/>

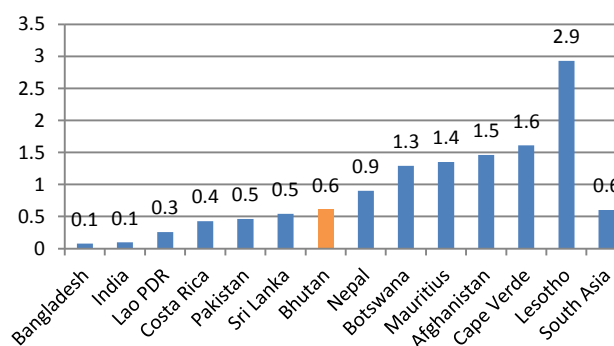
**6.3 Bhutan enjoys a very safe and stable environment compared to comparator countries, having the lowest percentage of firms paying for security and relatively low losses due to robbery and vandalism.**<sup>33</sup> Only 33 percent of firms reported paying for security, less than South Asia (50 percent) and all comparator countries (Figure 18). Losses due to robbery and vandalism amount on average to less than 1 percent of total annual sales which is on par with the region and lower than all comparator countries except Lao PDR and Costa Rica (Figure 19).

**Figure 18: Percentage of Firms Paying for Security<sup>34</sup>**



Source: Enterprise Survey data

**Figure 19: Losses Due to Theft, Robbery, Vandalism, and Arson Against the Firm (% of Sales)**



Source: Enterprise Survey data

**6.4 Perception data confirms that crime, theft, or disorder is generally not considered as a major obstacle.** Bhutanese firms have one of the lowest perceptions of crime, theft, and disorder as a constraint to doing business amongst the region and all comparator countries. Less than 5 percent of firms perceive this as major obstacle compared to 21 percent in the region and higher levels in the comparator countries.

**6.5 Bhutan fares extremely well against all comparator countries and the region in having the lowest levels of corruption, offering a significant advantage to market itself as a transparent country for foreign investors to conduct business in.** In terms of the reported percentage of firms required to pay informal payments to public officials, Bhutan ranks the lowest of the region at 10.1 percent and can be compared to corruption levels in Mauritius, Cape Verde, and Lesotho. The Enterprise Survey findings align with Bhutan's favorable ranking in Transparency International's 2009 Corruption Perception Index (CPI) compared to regional comparator countries (Figure 20).<sup>35</sup>

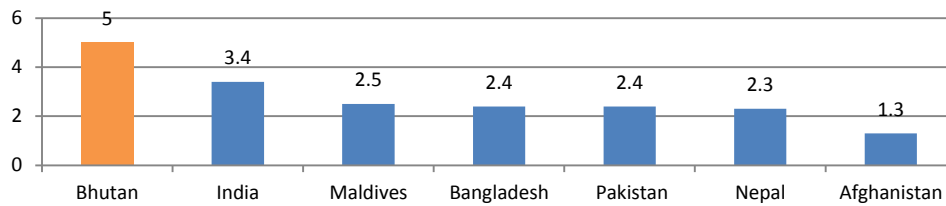
<sup>33</sup> See Box 1.4 in Volume 2 for an explanation of the selection of comparator countries.

<sup>34</sup> No data for India and Maldives.

<sup>35</sup> The Corruption Perceptions Index (CPI) measures the perceived level of public-sector corruption in 180 countries. The CPI is a "survey of surveys", based on 13 different expert and business surveys. The vast majority of the countries included in the 2009 CPI score below five on a scale from 0 (perceived to be highly corrupt) to 10 (perceived to have low levels of corruption). [http://www.transparency.org/policy\\_research/surveys\\_indices/cpi/2009](http://www.transparency.org/policy_research/surveys_indices/cpi/2009)



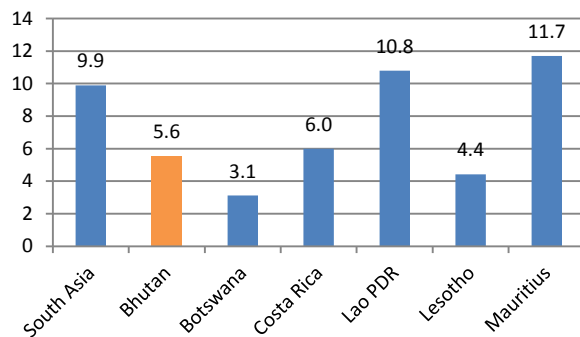
**Figure 20: Transparency International's 2009 Corruption Perceptions Index**



Source: Transparency International (2009)

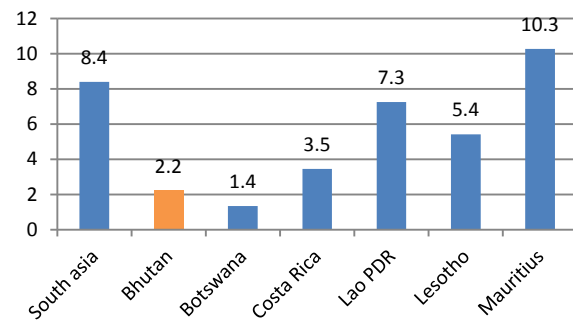
**6.6 In addition to a stable and low-corruption business climate, Bhutan's trade facilitation status, in terms of customs clearance delays, fares well. Bhutan ranks well in customs clearance delays in imports and particularly in exports.** On average, it takes businesses 6 days to clear imports, about half the regional average (Figure 21). Bhutan does exceptionally well in the time to clear exports: 2 days compared to the 8 day regional average and better than all comparator countries except for trade-friendly Botswana (Figure 22).

**Figure 21: Average time to clear imports from customs (days)**



Source: Enterprise Survey data

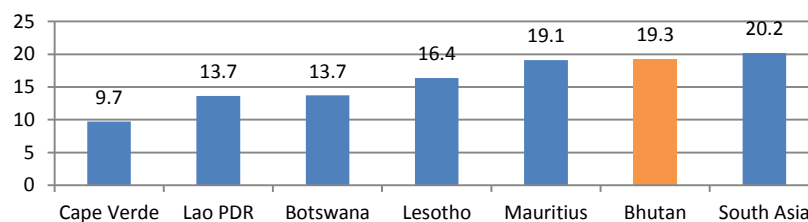
**Figure 22: Average time to clear direct exports through customs (days)**



Source: Enterprise Survey data

**6.7 Bhutan also fares well in terms of days to obtain a business license compared to the global average.** In Bhutan the processing time for an operating license (known as a “business license” in Bhutan) is higher than in most benchmark countries, on par with regional averages, and well below world averages. The results of the Enterprise Survey show that firms in operation waited on average 19 days to obtain an operating license compared to a global average of 27.4 days (Figure 23).

**Figure 23: Days to Obtain Operating License**

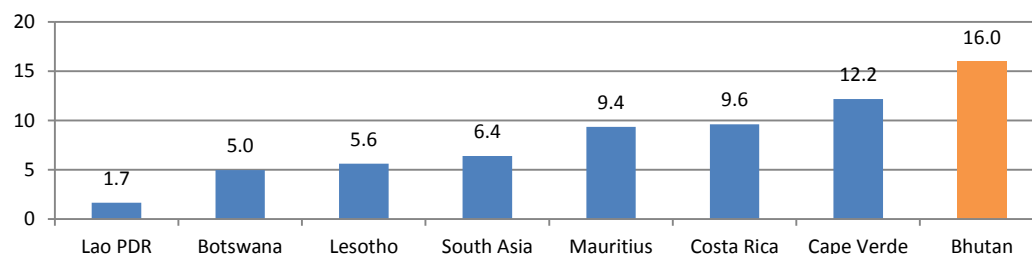


Source: Enterprise Survey data

**6.8** However, Enterprise Survey results show that while not ranked as a top business environment constraint, business licenses and permits are still ranked 6<sup>th</sup> out of 15 constraints and rank even higher in the trade sector. In many developing countries, licenses are the most important regulatory instrument used to ensure compliance with rules, and therefore, it is important to track the burden that they impose.

**6.9** Bhutanese firms have high regulatory compliance costs. A significant amount of senior management's time is spent dealing with regulations (16 percent) (Figure 24).<sup>36</sup> Senior management time spent dealing with regulations is an important overall indicator of the regulatory burden because it represents an opportunity cost or “time tax”—this “time-tax” can prevent the entrepreneur from focusing on the day-to-day matters involved with the operation and strategic decisions of his or her business. Heavy regulations on the transportation of goods within the country was also identified in focus group discussions as a major barrier, and likely a significant cause for the losses due to ground transportation experienced by a high proportion of firms in Bhutan.

**Figure 24: Management Time Spent in Dealing with Requirements of Government Regulation (%)**



Source: Enterprise Survey data

**6.10** Firms’ licensing procedures are unclear and firms lack information on licensing requirements. The high cost of compliance for firms is corroborated by a recent report that undertook an inventory of licensing requirements on firms in Bhutan.<sup>37</sup> Firms are subject to a total of 72 ex-ante licenses, issued by 23 different agencies, which use 11 different terms for “license”.<sup>38</sup> Of these 72 licenses, 13 have no legal basis. While many individual licenses can be processed relatively quickly, one of the reasons why procedures may be burdensome is that many licenses require multiple inputs or clearances from other agencies in addition to the application.

**6.11** Compared to the time to obtain an operating license, Bhutan fares worse in terms of starting a business according to Doing Business. Doing Business data shows that Bhutan has improved since 2007 in terms of time required to start a business and number of procedures to

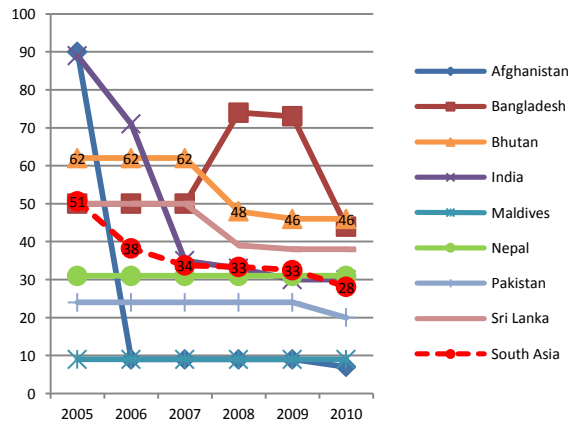
<sup>36</sup> Some of the time spent by senior management on meeting regulations could also be attributed to the fact that 83 percent of the firms sampled are sole proprietorships. Senior managers of small firms usually dedicate more time to these issues since they do not have staff to delegate the administrative work to.

<sup>37</sup> IFC SouthAsia Enterprise Development Facility (2010).

<sup>38</sup> It is worth noting that the 72 are ex-ante licenses (i.e., the inventory did not include post registration or operational licenses), and that not every company is required to obtain all 72 licenses to start operations.

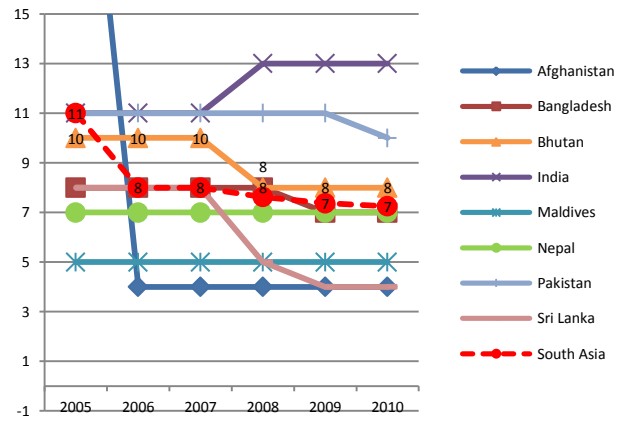
start a business. However, with an average of 46 days, Bhutan still ranks worse than the regional average of 28 days to start a business (Figure 25). Bhutan is close to the average in terms of the number of procedures required to start a business. This suggests that the highest potential for improvement in terms of efficiency of fulfilling the procedures by firms is to focus on procedural delays, since other countries have shorter times to start a business even though they are subject to similar numbers of procedures (Figure 26).

**Figure 25: Time in number of days required to start a business**



Source: Doing Business

**Figure 26: Number of procedures to start a business**



Source: Doing Business

**6.12 The recent reconstitution of a National Private Sector Development Committee, with expanded private sector participation, is a promising step towards the expansion of consultations between the private sector and the Government in order to improve the investment climate enabling environment.** While improvements to the business licensing environment are beneficial, alone, they are not enough to have a long term impact on private investment in Bhutan. It is also necessary to ensure that the business environment is a priority in future policy making. This can be achieved by building relationships between businesses and government through public private dialogue.

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