



DEVELOPMENT EFFECTIVENESS COUNTRY BRIEF

# Bhutan

## Selected Country Indicators

Country Indicators	Comparison year	Most recent year
Gross domestic product per capita (constant year 2000 in US\$)	\$587 (1997)	\$870 (2005)
Poverty headcount ratio (% of population below poverty line)	–	31.7 (2004)
School enrolment, primary (% gross)	–	102.1 (2006)
School enrolment, secondary (% gross)	–	83.5 (2006)
Ratio of girls to boys in primary and secondary education (%)	–	95 (2004)
Under-5 child mortality (per 1,000 live births)	97 (1994)	75 (2005)
Maternal mortality ratio (per 100,000 live births)	560 (1990)	255 (2000)
Births attended by skilled health staff (% of total)	24 (2000)	50.9 (2005)
Prevalence of HIV/AIDS (% , 15–49 years)	–	0.1 (2005)
Population with access to an improved water source (%)	–	62 (2005)
Fixed line and mobile phone subscribers (per 1,000 people)	25.3 (1995)	110.8 (2005)
Access to an all-season road (% of rural population)	30 (1995)	45 (2005)
Household electrification rate (% of households)	35 (1995)	43 (2005)
Cost required for business start-up (% of GNI per capita)	–	16.6 (2006)
Time required for business start-up (days)	–	62 (2006)

GNI = gross national income.

# COUNTRY DEVELOPMENT SETTING

## Overview of Country Achievements and Development Challenges

1. In 2006, the then King of Bhutan had announced that he would abdicate the throne in 2008, when the two-party democratic system would come into effect. However, in December 2006, the King abdicated the throne in favor of the Crown Prince to allow him to gain experience in matters of the State. There is no change in the scheduled transformation to a two-party democratic system with effect from mid-2008.
2. **Millennium Development Goal Achievements with Persistent Poverty and Physical Isolation.** Bhutan was among the first countries to publish its first Millennium Development Goals (MDG) Progress Report. The report provides an update of Bhutan's progress in meeting the seven MDG targets, and highlights challenges in meeting these goals. According to the second report, published in December 2005, Bhutan is well on track to achieve the MDGs. The targets pertaining to lowering the percentage of under-weight children (under 5 years of age), and to halving the proportion of the population without sustainable access to an improved water source and to improved sanitation have already been achieved. Eighty-one percent of all children of primary school age are enrolled in school, and Bhutan intends to achieve universal primary education some 8 years before the MDG target date. Good progress is also being made in achieving infant mortality, nutrition, maternal mortality, gender equality, and environmental targets.
3. Prior to the 1960s, Bhutan was effectively a closed society. Most of the population worked as subsistence farmers, and markets played little role in economic affairs. Tremendous accomplishments have been registered particularly in the last two decades of development, but institutions are new and fragile, and the challenges remaining are substantial. Once it opened to the outside world from its self-imposed isolation in the 1960s, Bhutan embarked on a far-reaching development strategy based on the goal of boosting gross national happiness—a concept defined in the Government's Vision 2020 document and repeated in various national development plans. This has led to significant improvement in the economic and social situation of the country. Real economic growth has averaged around 7% a year since the 1970s, resulting in an increase in gross domestic product (GDP) per capita from \$51 in 1961, then the lowest in the world, to \$830 by 2004. Starting from a virtual absence of economic infrastructure and social services in the early 1960s, tremendous achievements have been registered in delivering basic services—the result of which is most clearly reflected in steady progress toward the MDGs. The infant mortality rate has been halved, the primary education enrollment rates have increased fivefold, and life expectancy doubled between 1970 and 2000. Yet, Bhutan remains a poor country. About a third of the population has an income below the national poverty line. Income inequity is among the highest in Asia,

and a large segment of the population continues to draw livelihoods from subsistence agriculture. In addition, poverty is readily passed on from one generation to the next. At 2.1% per annum, the population growth rate is among the highest in Asia; 42% of the population is below the age of 15.

4. **Narrow Economic Base and High Degree of Dependence on Hydropower (90% Exported to India).** Bhutan's economic base remains quite narrow, with the main support for economic growth coming from the exploitation of hydropower and establishment of natural resource-based industries that make use of cheap power. Hydropower accounted for 12% of GDP in 2003, and its exports accounted for about 45% of government revenues. With the Tala project and several large hydropower projects in various stages of preparation, hydropower is bound to remain a vital engine of economic growth. But hydropower and its related industries generate very few jobs, and during the Ninth Five-Year Plan period (2002–2007), some 50,000 youth are expected to enter the labor market, and another 20,000 are expected to migrate from rural to urban areas. Most youth prefer public sector employment, but very few will find jobs in Government. Diversifying the base of economic activity by enabling greater private sector participation in the development process is central to the Government's growth, employment generation, and poverty reduction strategy.
5. **Limited Involvement of Private Sector in Economic Development.** A combination of deficiencies in the enabling environment and a dearth of entrepreneurial capacity have restricted the growth of the private sector. Despite the structural changes experienced by the economy, it remains largely rural and non-monetized, with

bartering prevailing in many areas. Although 84.8% of the labor force is in the private sector, 63% is engaged in small-scale agriculture, and the balance is primarily in tertiary sector activities.<sup>1</sup> An estimated 15.2% of the labor force works in the public sector, but Government and state-owned enterprises account for nearly 60% of GDP.<sup>2</sup> Only about 100 medium-sized companies dominate the private sector, and most enterprises are cottage or mini-enterprises with fewer than 10 employees and invested capital of less than \$10,500. Restrictive labor and tax policies, difficult access to land, inadequate infrastructure, high cost of finance, and lack of skilled labor are among the key policy problems cited by Bhutanese enterprises in a recent private sector assessment. To create greater scope for private sector development, the Government has gradually privatized several state-owned enterprises, deregulated the licensing for tour operators, introduced new financial institutions, and contracted out a major part of its public works program. In recent years, the Government has taken additional measures to improve the private sector enabling environment, the most important of which includes (i) adopting a foreign direct investment policy; (ii) rationalizing the tariff structure and lowering the maximum tariff rate; (iii) introducing personal income tax and eliminating interest rate regulations; (iv) streamlining industrial licensing procedures; and (v) passing legislation such as the Bankruptcy Act, Movable and Immovable Property Act, Negotiable Instruments Act, Companies Act, Copyright Act, Industrial Property Act, and Commercial Sales of Goods Act. In addition, to facilitate private sector development, some tax holidays incentives were announced as part of the national budget for FY2002/03.<sup>3</sup> While tax holidays to date have had little tangible effect, a

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1 Central Statistical Office. 2004. *Labor Force Survey 2004*. Thimphu.

2 Interpreted from the Central Statistics Office. 2004. *(Draft) National Accounts*. Thimphu.

3 These include tax holidays for (i) 3 years for manufacturing industries; (ii) 3 years for information technology and vocational institutes; (iii) 5 years for hotels, schools, and automechanical workshops established in rural areas; and (iv) 7 years for manufacturing industries established in rural areas.

decade of private sector development effort is starting to pay off—almost 3,000 private individuals are registered as contractors, three major international hotel chains have entered the Bhutanese tourist market, residential and commercial construction

is booming, urban wholesale and retail establishments are recording double-digit growth, and the number of Internet cafes and Internet-related businesses has increased from a handful in 1990 to several hundred in 2004.

## ADB'S CONTRIBUTIONS TO DEVELOPMENT RESULTS

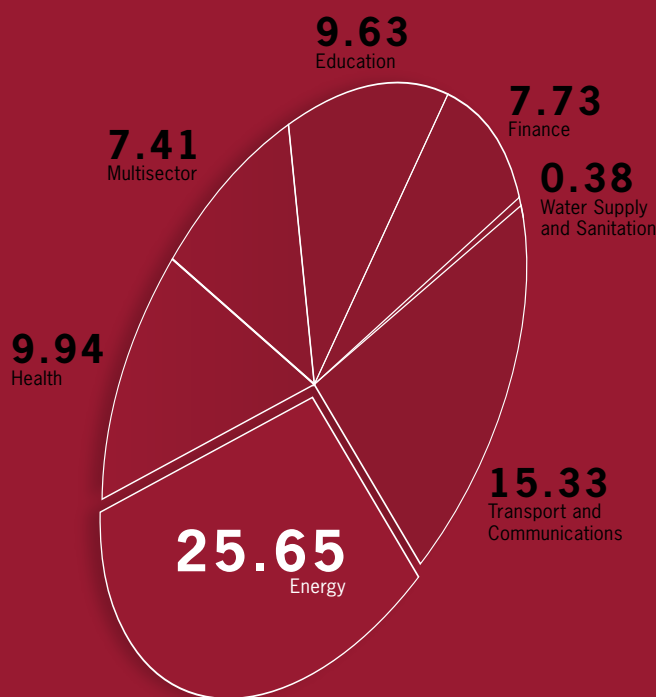
### Volume and Performance of ADB Operations

- Energy (rural electrification) and transport (roads) sectors have been the main beneficiaries of ADB assistance to Bhutan. This is in recognition of the fact that remoteness and isolation are among the major causes of poverty, and that

any poverty alleviation strategy must address the constraints to making access easier. Rural electrification is necessary to deepen opportunities for income generation. ADB also supported health and education development. The sector mix of ADB assistance (see figures 1 and 2) aims at alleviating rural poverty in Bhutan. All ADB projects completed had a satisfactory rating (see figure 3 and 4).

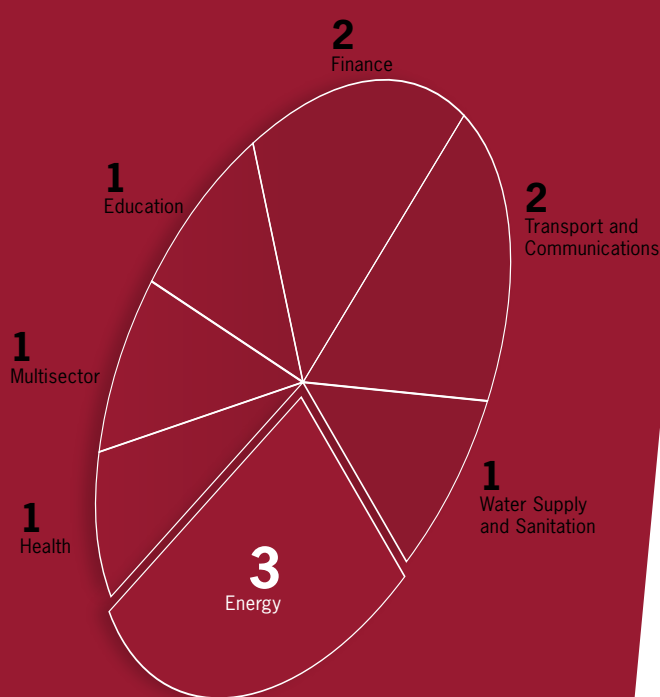
**Figure 1**

Asian Development Fund Loans and Grants Approved, 1995–2006 (\$ million)



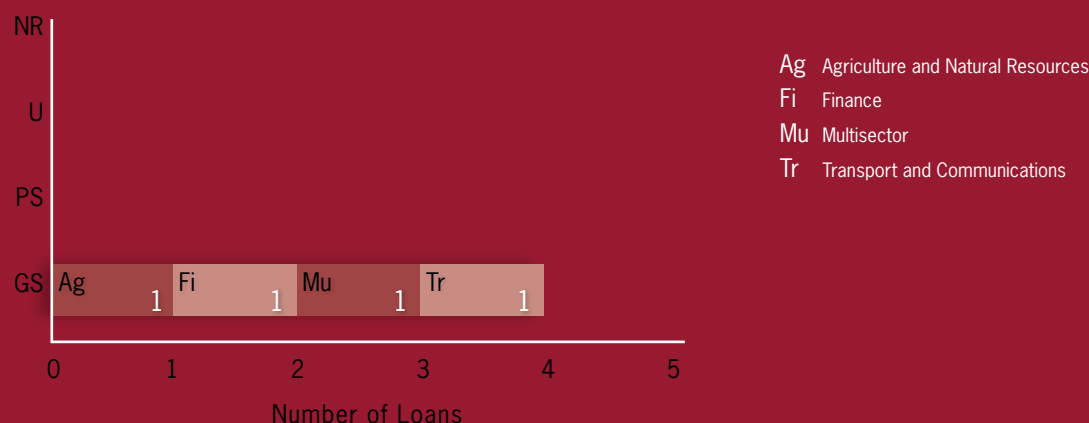
**Figure 2**

Asian Development Fund Loans and Grants Approved, 1995–2006 (number of projects)



**Figure 3**

Project Completion Report Ratings, 1995–2000 (prepared under old guidelines)

**Figure 4**

Project Completion Report Ratings, 2001–2006 (prepared under new guidelines)



## Highlights of ADB Results

7. **Roads.** Geographic isolation is a major cause of poverty and underdevelopment in Bhutan. A large segment of the rural population has limited access to markets and modern services because of the harsh geography and the limited reach of the domestic transport system. ADB commitments to the sector have reached \$28.63 million to date, making roads one of the largest recipients of ADB assistance, in terms of both policy support and investments (see top box on the next page). Within the sector, ADB has provided three loans, totaling \$23.6 million; six advisory technical

assistance (TAs) projects, totaling \$3.36 million; and five project preparatory TAs, totaling \$1.63 million. Since 1991, several of these initiatives have directly supported the Government's successive 5-year plans by contributing to the resurfacing of the road network. The projects included the East-West Highway Maintenance Project and the Road Improvement Project. In addition, the projects funded the construction of 34 kilometers of roads between Samchi and Dorokha, as well as 73 kilometers of forest roads and 10 suspension bridges.

8. **Energy.** ADB is the main development partner involved in power sector restructuring, distribution reforms, and rural electrification expansion. To date, ADB has provided three loans for rural electrification to help the Government meet its objective of 100% electrification by 2020. ADB's support to rural electrification has contributed to poverty reduction in different ways (see bottom box). A second plank of ADB's assistance strategy for the power sector has been to reform the sector to improve its efficiency. Starting in 1998, the Government and ADB agreed to implement a series of sequenced TA grants that together would restructure and strengthen the power sector over a period of 8 years. The TAs have contributed to strengthening the institutional capacity of the former Department of Power, established the strategic framework for power sector development, and outlined the timing for sector reforms. In July 2002, after 3 years of ADB-assisted preparatory work, the Department of Power was deregulated, giving birth to the Department of Energy, the Bhutan Electricity Authority, and the now commercially-oriented Bhutan Power Corporation. This was a significant step to improving sector efficiency and delivery of service.

### **ADB's Strategic Thrust in the Road Sector in Bhutan**

An ADB TA for Road Planning and Management Strengthening contributed to improvements in sector governance and in the road policy and management system which facilitated efficient budget allocations. The TA also supported the preparation of a road sector master plan, which became the basis of the Government's 9th Five-Year Plan (2002–2008).

ADB lending and nonlending activities in the sector have aimed at reducing rural poverty through, among others, road network expansion. As a result, ADB assistance has focused on rehabilitation and maintenance of the main highway network, as well as transport network planning and management.

The assistance to the sector has provided and will continue to provide a number of benefits through the following strategic sector objectives: (i) continue to enhance the main road network, (ii) ensure adequate maintenance of the existing road network, (iii) improve rural accessibility, (iv) support institutional strengthening, (v) promote private sector participation, (vi) improve road technology and productivity, and (vii) support subregional linkages.

### **Benefits of ADB Assistance for Rural Electrification in Bhutan**

ADB's assistance for rural electrification has improved the standard of living of poor households through the use of electric lighting and other appliances. Electrification has generated additional income-generating opportunities through several means: establishing small-scale cottage industries; engaging in food processing; increasing efficiency in small trades such as carpentry and tailoring; and creating small shops, bars, and restaurants. It also improved health standards due to a cleaner environment without kerosene lamps, with less cooking over smoky cooking fires in case of houses with electric cooking appliances, and better preservation of food for houses with refrigerators.

Other benefits of rural electrification include increased useful hours for leisure or housekeeping in the evenings, improved access to modern communications and entertainment facilities such as radio and television, and a better overall quality of life.

# ADB'S AGENDA FOR ENHANCING PARTNERSHIPS AND AID EFFECTIVENESS

## Current ADB Portfolio and Assistance Pipeline

9. The Bhutan Country Partnership Strategy (CSP) for 2006–2010 envisages a focus on four sectors: transport; power, including rural electrification and renewable energy; urban infrastructure development; and financial and private sector development (figures 5–8). The business plans for 2007 and for 2008–2010 are fully consistent with these CSP priority areas. In 2007, ADB will provide assistance for the development of micro, small, and medium-sized enterprises. One project/program per year has been programmed for the 3-year period 2008–2010: a power sector development project for 2008, a road network project for 2009, and an urban infrastructure development project for 2010.

### 10. **Lessons Learned from Past Assistance.**

While all loans under implementation are rated satisfactory or highly satisfactory (figure 9), a number of recurrent factors tend to affect project implementation. Some of the key lessons on project implementation from self- and independent evaluations of past operations include the following: (i) frequent turnover of project managers adversely affects project implementation, (ii) problems with land acquisition can result in project delays, (iii) a solid assessment of the existing policy framework is needed to phase and sequence sector reforms, (iv) inadequate financial resources for road operation and maintenance have resulted in infrastructure deterioration and deferred maintenance, (v) close cooperation

between technical personnel involved in previous projects and international consultants should be secured to impart lessons learned, and (vi) capacity building of key implementation staff should take place prior to project commencement or in its early phases to avoid unnecessary implementation delays. These lessons have been the subject of continuous ADB-Government dialogue, and are being addressed in the context of annual country portfolio review action plans.

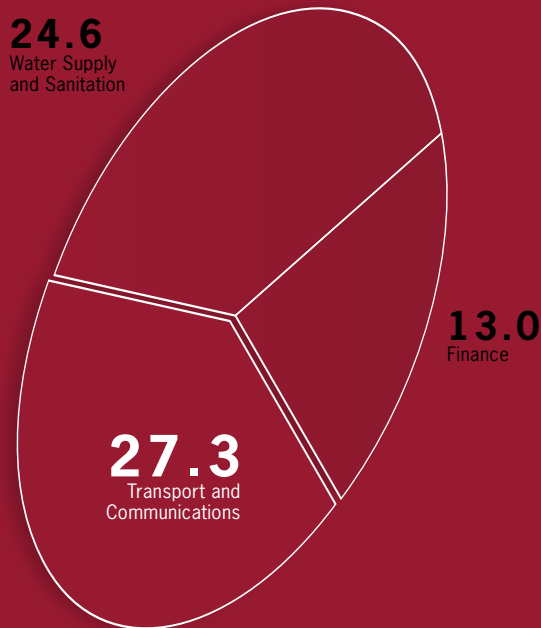
## Ownership, Alignment, and Managing for Results in ADB Operations

### 11. **Alignment of ADB's Operational Strategy.**

A full results-based Country Strategy and Program (CSP) was endorsed by the Board with poverty reduction through economic diversification as its overarching goal. This is motivated by the economy's heavy reliance on the capital intensive power sector to finance public expenditures, the need to address the employment challenge for growing numbers of educated youth, and the required effort to reduce Bhutan's high level of dependence on external funding for financing development initiatives. The CSP has two strategic thrusts: (i) assistance for programs and projects in four core sectors (consistent with national priorities, ADB's track record and competitive advantage, evaluation of the Government's development strategy, and knowledge gained from lessons learned), and (ii) institutional capacity development in the sectors of ADB intervention and for overall development

**Figure 5**

Approvals, 2005–2006 (\$ million)



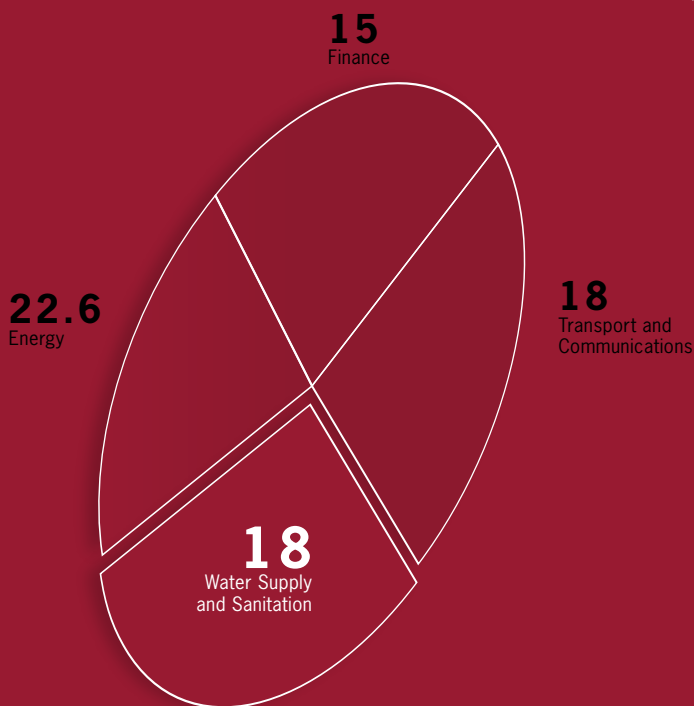
**Figure 6**

Approvals, 2005–2006 (number of projects)



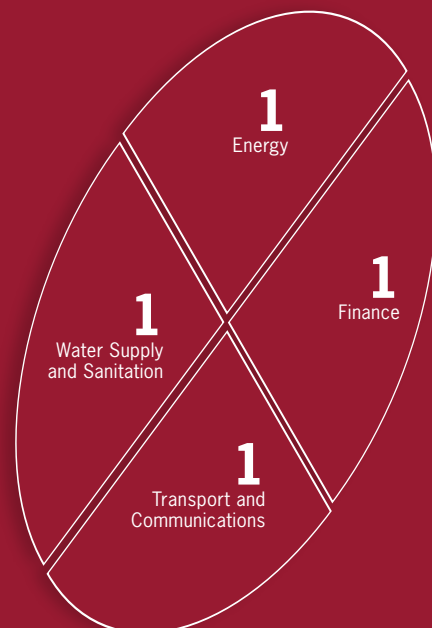
**Figure 7**

Projected Approvals, 2007–2010 (\$ million)



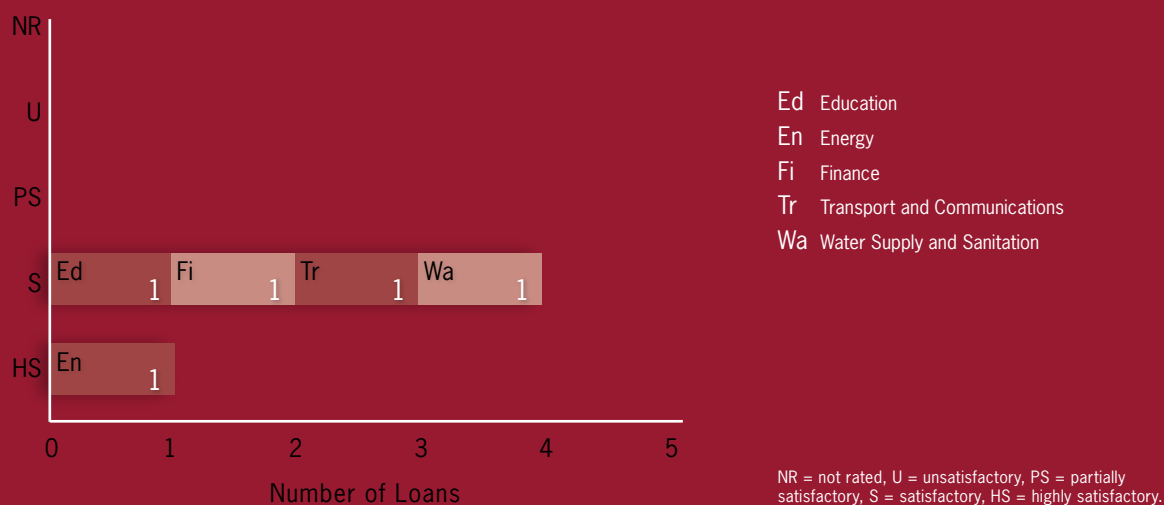
**Figure 8**

Projected Approvals, 2007–2010 (number of projects)



**Figure 9**

Project Performance Report Ratings, (current)



management. ADB has validated that assistance for the four core sectors is vital if Bhutan is to continue its socioeconomic progress, diversify its economic base, and reduce poverty. In each of these areas, ADB will combine investment support with measures to build the institutional, policy, and regulatory capacity of the sector policy making and executing agencies.

12. ADB support constitutes an integral part of the national agenda for poverty reduction. It responds to the preference of national authorities for the use and management of external assistance, and is informed by the guidance received from the ADB Management and Board during the CSP formulation. ADB's assistance strategy benefited from seven background diagnostic studies and in-depth consultations with communities, the Government, the private sector, and

development partners. It was designed to minimize the transaction costs of future ADB assistance for a small but capable Government, and, given vulnerabilities, makes careful assessments of the Government's absorptive capacity and debt sustainability.

13. **Support to Managing for Development Results.** The CSP is designed to be managed for key national development results (MDGs and sector-specific commitments) with the identification of specific goals, targets, and indicators to which ADB assistance will contribute. In addition to monitoring and actively managing a CSP-linked results framework, ADB will provide assistance for the implementation of a national monitoring and evaluation system to help improve national capacity to manage for development results.

## ADB's Role in Donor Coordination and Harmonization Initiatives

14. **Cofinancing Context.** The Government has been careful to ensure that external aid is carefully planned, coordinated, and prioritized. Cofinancing activities have diminished in recent years because the Government has had very clear areas identified for different development partners with the principal objective of avoiding duplication of activities. Moreover, given the Government's strong preferences for using loan funds for infrastructure and private sector development, and grant funds for agriculture, rural development, and the social sectors, opportunities for cofinancing have been limited.
15. **Joint Work.** In this context, ADB developed excellent project collaboration with development partners even without formal cofinancing arrangements. Examples include ADB's rural electrification loans following the Rural Electrification Master Plan developed with assistance from the Government of Japan. Similarly, other development partners use the Road Sector Master Plan formulated with ADB support. ADB has maintained close cooperation with other multilateral and bilateral funding agencies to support capacity development initiatives. One of the most significant examples of this is the Bhutan Living Standard Survey 2003 funded by ADB. Subsequent assistance for analyzing the survey and building statistical and analytical capacities was provided by the United Nations Development Programme (UNDP).
16. ADB closely cooperates with all major development partners during the preparation of CSPs and CSP updates and at different stages of project financing. At least twice a year, ADB staff meets with all the development partners at a joint aid meeting at the UNDP office in Thimphu. To help foster more cohesive and coherent assistance, ADB has played a lead role in the preparation of master plans for transport, and will support similar, comprehensive planning to underpin urban development, small and medium-sized enterprises, and financial sector reform. Close coordination is maintained through regular contact and dialogue with major development partners, and a special effort is being made to involve development partners in sector-wide capacity building initiatives.

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