

**D R A F T**  
(8 February 2000)

**ASIAN DEVELOPMENT BANK**

**COUNTRY OPERATIONAL STRATEGY**

**FOR**

**BHUTAN**

**January 2000**

## CONTENTS

	<b>Page</b>
EXECUTIVE SUMMARY	ii
I. BACKGROUND	1
II. SUMMARY OF DEVELOPMENT ISSUES AND OUTLOOK	2
A. Economic Performance	2
B. Human and Social Development	5
C. Environment	10
D. Governance	11
III. DEVELOPMENT ASSISTANCE EXPERIENCE AND OUTLOOK	12
A. Background	12
B. ADB Assistance	13
C. ADB's 1991 Operational Strategy	14
D. Lessons from ADB's Project Implementation Experience	16
E. Aid Coordination and Cofinancing	17
F. Outlook for Future Resource Inflows	18
IV. ADB's FUTURE ROLE IN BHUTAN	18
A. General Considerations	18
B. ADB's Strategic Focus	19
C. Emergence of Private Sector Development as a Government Priority	20
D. Relation of the Current Strategy to the Previous Strategy	23
E. Sector Strategies	24
F. Gender Dimensions	30
G. Governance	30
H. Subregional Cooperation	30
V. INSTRUMENTS OF ADB SUPPORT AND OPERATIONAL IMPLICATIONS	31
A. Lending Operations	31
B. Technical Assistance Operations	32
C. Economic and Sector Work	33
D. Risks	33
APPENDIXES	35

## CURRENCY EQUIVALENTS

(as of 14 January 2000)

Currency Unit	–	Ngultrum (Nu)
Nu1.00	=	\$0.0230
\$1.00	=	Nu43.45

## ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
Danida	–	Danish International Development Agency
DFI	–	development finance institution
DOP	–	Division of Power
EIA	–	environmental impact assessment
GDP	–	gross domestic product
GEF	–	Global Environment Facility
GNP	–	gross national product
HDI	–	human development index
IFAD	–	International Fund for Agricultural Development
ILO	–	International Labour Organisation
IMF	–	International Monetary Fund
IPF	–	indicative planning figure
JICA	–	Japan International Cooperation Agency
MW	–	megawatts
NEC	–	National Environment Commission
NES	–	National Environment Strategy
NGO	–	nongovernment organization
RMA	–	Royal Monetary Authority
SAARC	–	South Asia Association for Regional Cooperation
TA	–	technical assistance
UN	–	United Nations
UNCDF	–	United Nations Capital Development Fund
UNDP	–	United Nations Development Programme
UNFPA	–	United Nations Fund for Population Activities
UNICEF	–	United Nations International Children's Emergency Fund
WFP	–	World Food Programme
WHO	–	World Health Organization

## NOTES

- (i) The fiscal year (FY) of the Government ends on 30 June. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY1998 ends on 30 June 1998.
- (ii) In this report, "\$" refers to US dollars.

## EXECUTIVE SUMMARY

Since Bhutan's emergence from isolation in the early 1960s, the country has witnessed considerable growth, diversification, and modernization, with major improvements in social indicators, communications, governance, and the standard of living. The changes have occurred with relatively few adverse effects on the environment or the country's cultural heritage. The gross domestic product (GDP) grew by nearly 8 percent a year in real terms during the second half of the 1980s and, while it has slowed somewhat since, real GDP growth averaged 5.6 percent a year during 1990-1995 and 6-7 percent annually in 1996-1998 (the latest year for which data are available). These recent rates, while relatively good in themselves, should accelerate over the medium term with the scheduled completion of a cement plant and a number of large hydropower projects, which will generate increased export earnings. Currently, India receives over 90 percent of Bhutan's exports and supplies some 70 percent of its imports.

The economy has also become more diversified: the share of agriculture in GDP declined from 53 percent in 1981 to 38 percent in 1998; that of industry, led by manufacturing, electricity, and construction growth, rose from 17 percent to over 36 percent; and that of the services sector fluctuated in the range of 27-33 percent, being some 29 percent in 1998. Even the agriculture sector, which is still dominated by subsistence production, has become more diversified, with a wider range of crops being grown for domestic use, and export crops – fruit, medicinal plants, cardamom, lemongrass, and mushrooms – gaining significance.

The growth of industry has slowed in recent years, particularly in the electricity subsector, although the rate of growth in manufacturing remains buoyant. The sector is dominated by a few large firms – mostly State-owned or recently privatized – and supported by myriad small and cottage enterprises, and some medium-size firms in handicrafts, handmade paper, food processing, wood products, and construction activities. Currently, most manufacturing output and exports are from a narrow range of products – cement, ferro-alloys, calcium carbide, processed foods, and particle board – which benefit from local hydropower but are dependent on skilled and unskilled expatriate labor, largely from India.

In common with its approach to development policy generally, the Government has managed the economy prudently. In practice, it is fiscal policy rather than monetary policy that has to play the key role in macroeconomic management because interest rates and price movements closely reflect those of India. The Government's prudence in fiscal policy is evidenced by its attempt to cover its current expenditures with domestic revenue and to finance capital expenditures with grants and soft loans. While current budget deficits (excluding grants) have occurred in most of the past 20 years, generous grant assistance – mainly from the Government of India – has bolstered limited domestic resources and served to finance the domestic deficits. Current revenues now finance current expenditure, but capital expenditure is still heavily dependent on external assistance. This assistance has been more than adequate to cover capital expenditures in most years, thus contributing to rising exchange reserves that would currently finance some 18-19 months of merchandise imports.

In the financial sector, the key questions for the Government are how to address the buildup of excess liquidity in the financial system, and how to improve financial intermediation so as to encourage private sector operations. Despite the general prudence of the country's fiscal management, fiscal issues and risks remain: (i) the dependence of government revenues on the export of energy to India and thus on the volume of sales and the negotiated export price; (ii) the narrowness of the domestic revenue base in the context of rising recurrent

expenditures associated with the maintenance of physical and social infrastructure; and (iii) the country's large and increasing foreign exchange reserves, which could serve to slow further inflows of aid or to lead to a hardening in their terms.

Both the debt-to-GDP ratio and the debt service ratio remain manageable. The debt-to-GDP ratio has been falling in recent years with the repayment of some commercial and concessional loans. This trend will reverse in the coming years, as the new power projects being constructed will have a greater share of loan financing than some earlier investments. Moreover, convertible currency debt is beginning to rise as a result of increased lending from multilateral agencies, including the Asian Development Bank (ADB). At the same time, the debt service ratio stands at about 11 percent of merchandise exports, mostly to service convertible debt obligations.

In parallel with an impressive performance in economic growth and diversification, major strides have also been made in human development indicators, although from depressingly poor initial levels and to levels that have to be improved further. In the case of health indicators, life expectancy rose from 35 years in 1961 to 66 years in 1998. Similarly, between the mid-1980s and the mid-1990s, the infant mortality rate and the maternal mortality rate were reduced from 142 to 71 per 1,000 live births and from 7.7 to 3.8 per 1,000 live births, respectively, while the under-5 mortality rate fell from 162 to 97 per 1,000 live births. In addition, major advances in immunization to 90 percent of children have virtually eliminated neonatal tetanus, polio, and diphtheria.

These positive developments were achieved by providing increased access to health facilities, boosting the number of doctors and health personnel, as well as by improving access to potable water and safe sanitation. By the mid-1990s, 90 percent of the population had access to free basic health care (up from 65 percent in 1987); 58 percent of the rural population had access to safe water supplies (a proportion that had increased from 31 percent in 1987 and that is expected to reach 95-100 percent in the next five years); and 80 percent of the rural population had access to means for safe excreta disposal.

The main issues facing the country's health authorities are the scarcity of skilled personnel for service delivery and for undertaking promotional and preventive programs, and finance to support a highly dispersed and expanding health care system that seeks to provide improved services to widely scattered communities. Difficulties faced on both fronts, as indeed in many other areas of national development, will become more acute if the rate of population growth is not brought under more control. The success achieved in reducing the mortality rate between the mid-1980s and mid-1990s was not matched by a similar decline in fertility, with the result that the population growth rate by the mid-1990s had actually increased from 2 percent in 1984. A population growth rate of 2.1 percent is projected for 2002.

As in health, considerable progress has been made in education over the past 20 or more years. Considering that fewer than 450 children attended primary schools in the late 1950s and that the country had no secondary schools at that time, educational achievements in Bhutan have been impressive. The education system in 1999 consisted of 253 primary and community schools, 51 junior high schools, 21 high schools, 7 private schools, and 10 institutions providing specialized education as well as tertiary and vocational training (including one degree college). Since 1977 alone, the number of teachers has trebled, and the number of educational establishments has doubled.

The Government provides nine years of free basic education up to junior high school. The primary school enrollment ratio had reached 72 percent (nearly 80,000 children) by 1997 – up from 12 percent in 1980 and from 25 percent as recently as 1990 – which suggests that a 95 percent ratio may be reached in 2002 and universal primary enrollment soon after. Girls now comprise some 45 percent of primary schoolchildren, or over 60 percent of the gross enrollment ratio. As a result of these improvements, the adult literacy rate rose from 17 percent in 1977 to 54 percent in 1998, although the adult rate is only 28 percent for women, and particularly low – even 10 percent – in the more remote rural areas. For women, this position is made more difficult by the continuing high rates of fertility, maternal mortality, and infant and child mortality.

Secondary education has also expanded rapidly, although a shortage of trained, competent teachers at these higher levels remains a major constraint to faster growth. Even so, the Government has built new secondary schools, recruited expatriate teachers (mainly from India) and, importantly, expanded boarding facilities (now covering some 5,000 students) as an inducement to rural students generally and to girls in particular. The gender balance is about 53:47 in favor of boys in junior high schools, 57:43 in high schools, and 52:48 in private schools. At tertiary and vocational levels, males dominate.

Notwithstanding the major improvements in basic education facilities, the country faces an acute shortage of skilled and semiskilled workers. The problems thus far are that the technical and vocational training system has not been demand-driven, the quality of training provided has been poor, the institutions offering training have been weak, and the job seekers with even basic educational qualifications have been reluctant to accept training for many vocational occupations or trades.

Translating ADB's overarching goal of poverty reduction into a strategy and operational program that reflect the reality of Bhutan's development context requires that five main considerations be noted: (i) the nature and degree of poverty in Bhutan; (ii) the effectiveness of the Government's economic and social development programs in addressing basic human needs; (iii) the country's access to grant funds from India, United Nations, and other bilateral sources; (iv) the country's debt-servicing and project implementation capacities; and (v) the likely initiatives of other aid agencies. A sixth consideration is that, in making a small program effective, ADB has to be selective and not try to spread available resources too thinly, or to dissipate them by supporting too many objectives.

With an estimated gross national product (GNP) of \$480 per head in 1996, average Bhutanese incomes are low – some \$1.30 per head a day – indicating that income poverty is widespread. Even then, the kind of abject poverty seen in some parts of Asia as a result of such low incomes is not evident, as the Government's social welfare policies over many years have resulted in high levels of human capital and relatively widespread social well-being. Addressing poverty in Bhutan has to reflect the situation: first, by addressing the income dimension of poverty; and second, by supporting further progress in its nonincome, social dimension.

Reducing poverty in these circumstances requires continued economic growth, together with the continued spread of health, education, and other facilities to encourage the inclusion of all groups in its potential benefits, supported by targeting special assistance at those groups regarded as particularly vulnerable or disadvantaged. ADB would seem to be better equipped to support poverty reduction in Bhutan by promoting economic growth and social inclusiveness through interventions in physical and social infrastructure, private sector development, employment creation, and improved economic management rather than simply targeting the especially vulnerable groups, many of whom live in very remote areas.

Given the Government's determination to see the private sector play the main role in the future growth of incomes and employment opportunities, ADB's strategy should

- ?? strengthen the capacity of government agencies for macroeconomic management, governance, and development administration, largely through policy dialogue and technical assistance activities;
- ?? improve the physical and social infrastructure, through both lending and technical assistance activities;
- ?? promote private sector development, through the various lending and technical assistance activities associated with physical infrastructure development, skills training, financial sector strengthening, and legislative reform;
- ?? improve the efficiency of public service delivery and cost recovery through policy dialogue and lending and technical assistance activities; and
- ?? protect the environment, largely through ensuring the environmental compatibility of ADB-sponsored projects.

ADB's concern for poverty reduction will be addressed through the income and employment generation impact of private-sector-led development, brought about by an improved policy setting and more efficient financial intermediation. This will be complemented more specifically by ADB interventions to

- ?? reduce physical infrastructure constraints, particularly in road transport and rural energy, to widen access to more productive, higher income occupations;
- ?? develop the domestic skills base, to provide Bhutanese labor with increasing opportunities to take up more rewarding occupations;
- ?? address the increasing stress on housing and urban infrastructure due to rural-urban migration, to improve the urban environment generally and provide added support for the low-income urban groups in particular; and
- ?? support the strengthening of the management and cost recovery of social services so that higher levels of government revenue are generated to expand the delivery of traditional social services and the targeting of vulnerable groups.

Thus, the strategy is to address some of the major constraints to increased incomes and improved public service delivery, and to weaken the effects of the mutually reinforcing nature of these constraints. Government officials already show a commitment to the development of Bhutan and there is a general congruence of thought behind the Government's development philosophy and that of ADB. What ADB should bring is financial resources and ideas to enable government commitment to be realized, and to support the strategic theme of improving the quality of life for all.

This strategy does not differ fundamentally from the previous one; in fact, it seeks to maintain continuity with it, especially with those thrusts that are considered to have had – or

seem likely to have – a positive development impact. It thus represents a fine-tuning of the previous strategy, something that has evolved from the regular consultations among the Government, ADB and the funding agencies as well as from the changing dimensions and/or pressures of Bhutan's development process. While maintaining continuity, partnership with the Government in poverty reduction will be strengthened with the undertaking of a joint poverty assessment so as to establish a benchmark for formulating, monitoring, and evaluating future interventions in poverty reduction. In addition, the strategy (i) places more explicit emphasis on the need to support private-sector-led growth as a means of creating employment opportunities and underpinning GDP and income growth; (ii) highlights the importance of raising the Government's revenue base as a means of preserving social achievements, expanding access to social facilities, and improving social indicators; (iii) emphasizes the importance of governance and public sector management; and (iv) proposes more strongly that, given the country's past performance in meeting basic needs, ADB's interventions in social development should be more narrowly focused on addressing the continuing shortage of skills and on improving the efficiency of public service delivery.

As in the past, it is envisaged that ADB's operational program in Bhutan will consist of about one or two loan projects per year, with technical assistance projects in support of the loan projects and ADB's broad strategic thrust more generally. To maintain continuity and to allow ADB to revisit a sector every 4-5 years to maintain the reform momentum, it is envisaged that ADB's program will be limited to five sectors: energy, road transport, finance, human resources, and urban development.

This sectoral focus omits the agriculture sector and the environment, and thus differs from the previous strategy. But it includes the health sector, which was not included previously. In the case of agriculture and the environment, several other aid agencies are providing grant resources, which the Government would prefer to maintain. The inclusion of health rests on its importance as an avenue for supporting social progress and the further reduction in nonincome manifestations of poverty.

## I. BACKGROUND

1. The Kingdom of Bhutan, a small country of some 46,500 square kilometers, is located in the eastern Himalayas. It is rugged and mountainous, with difficult land communications often made even more difficult by the interruptions caused by landslides in the rainy season and by snowfall in winter. It has few opportunities to develop domestic air transport, but those are being explored. The population is officially estimated at about 650,000, increasing at 3.1 percent per year. Gross national product (GNP) per head is estimated to be about \$480.

2. Prior to the early 1960s, Bhutan was isolated from the rest of the world – without electricity, telephones, or motor vehicles – and heavily dependent on subsistence agriculture, livestock, forest products, and barter for daily survival. There were only two trained doctors in the entire country, fewer than 450 children in secular primary schools, no secondary schools, very high mortality and morbidity rates, and little or no access to piped water or sanitation facilities. Life, which had continued largely unchanged for decades, was harsh, and domestic travel and trade restricted by the absence of a road network and by the mountainous terrain.

3. Since the early 1960s, Bhutan has witnessed considerable modernization and change, with significant improvements in the main social indicators, communications, governance, and the standard of living. The abject poverty prevalent in other parts of the region is not evident; income and gender disparities for the mass of people are less pronounced than in many countries; and the Government is staffed by dedicated, honest, professional, and caring officers who administer the country's modernization process cautiously and prudently. In many ways, the process of development in Bhutan provides a model for a country in adverse circumstances, which certain others may emulate.

4. It is critical to any understanding of development policy in the country to recognize that the modernizing process has been guided at a pace and in a form that have minimized disruption to the country's cultural heritage and environment, two central tenets of government policy for many years. Distinctive features of the Government's development philosophy are the importance explicitly attached to (i) encouraging growing national self-reliance; (ii) preserving the cultural heritage; (iii) promoting spiritual and nonmaterial human progress; (iv) ensuring stability and economic, environmental, and social sustainability; and (v) dispersing the benefits of socioeconomic progress widely and equitably. These objectives are well integrated into the developments proposed under the Eighth Plan (1997-2002) and in the longer-term document, *Bhutan 2020: A Vision for Peace, Prosperity and Happiness*, both published by the Planning Commission. Moreover, they are similar to those of the Asian Development Bank's (ADB's) *Medium-Term Strategic Framework*, some predating those of ADB by several years.

5. Accordingly, the pursuit of more narrowly defined economic goals has thus to be tempered by these wider considerations, and any strategy to support the attainment of the Government's longer-term development objectives has to accommodate them. While some of these concerns, and the cautious approach to structural transformation which they inspire, might slow the rate of growth in terms of economic aggregates per se, it is a price that the Government is determined to pay to maintain national harmony and equity, and to preserve the country's distinctive cultural and environmental heritage.

## II. SUMMARY OF DEVELOPMENT ISSUES AND OUTLOOK

### A. Economic Performance<sup>1</sup>

#### 1. Growth and Diversification

6. Assessing economic performance in Bhutan is complicated by its weak database. Nevertheless, the country's emergence from isolation and almost total dependence on subsistence agriculture began in 1961 with the initiation of its First Five-Year Development Plan (1961-1966). Together with the Second Plan (1966-1971), the First Plan concentrated on the construction of roads and the creation of a technical and administrative framework for governance. The third and fourth plans (1971-1981) witnessed the beginning of sectoral developments, notably in agriculture, forestry, electricity, mining and public health. The Fifth Plan (1981-1986) reflected wider developmental considerations, namely: (i) the country needed economic growth to increase domestic self-reliance, (ii) the developmental administration would be more effective if it were decentralized, and (iii) the benefits of economic progress had to be widely dispersed.

7. While these plans laid the basis for subsequent developments, it was not until the Sixth Plan (1986-1991) and the commissioning of the Chukha hydropower plant (336 megawatts [MW]) in 1986 that the diversification of the economy – largely based on the exploitation of the country's natural resources – might be said to have begun to take shape. It has been continued to the present day under the seventh and eighth plans. Chukha also paved the way for increased exports of surplus energy to India and for increased government revenues.

8. With the arrival of local hydropower and the stimulus it provided to the domestic manufacturing and services industries, together with the relative size of the Chukha plant itself, the gross domestic product (GDP) rose by nearly 8 percent in real terms annually during the second half of the 1980s. However, with no hydropower and few new major manufacturing projects commissioned in the 1990s, real GDP growth has slowed since the late 1980s, but it averaged 5.6 percent annually during 1990-1995 and 6-7 percent per year in 1996-1998 (Appendix 1). These recent rates of growth, while good in themselves, should accelerate over the medium term, with the scheduled completion of the Dungsum cement plant, the Basochu hydropower project (adding 22.2 MW in 2000 and a further 36.2 MW in 2002), the Kurichu project (60 MW) in 2001, and the Tala project (1,020 MW) in 2004.

9. Developments in the industry and services sectors have outstripped those in agriculture, with the result that the share of agriculture in GDP declined from 53 percent in 1981 to 38 percent in 1998 (the latest year for which data are available); that of the industry sector, led by manufacturing, electricity, and construction growth, rose from 17 percent to over 36 percent; and that of the services sector fluctuated in the range of 27-33 percent, being some 29 percent in 1998. Accordingly, the structure of production has seen a notable degree of change over the past 20 years, and the economic base has become more diversified.

10. The agriculture sector, while still dominated by subsistence production, has also become somewhat more diversified since the early 1980s, and remains by far the country's main source of employment. Although some 85 percent of the country's population have commonly been

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<sup>1</sup> For a more extensive discussion, see CER: BHU 99012: *Country Economic Review: Bhutan*, May 1999.

estimated to be living in rural areas, and directly or indirectly dependent on the sector for their livelihoods, preliminary results of two labor force surveys conducted in 1998 and 1999 suggest that, in reality, the proportion could be about 89 percentage points below the traditionally presumed figure because of the rate of rural-urban migration. Rice, maize, and potatoes are the main food crops grown, largely for home consumption. Export crops now gaining significance include medicinal plants, lemongrass, cardamom, and specialty mushrooms. Fruit-growing is also increasing in importance: mostly apples and oranges, but including peaches and strawberries, for both domestic consumption and export, primarily to Bangladesh. Livestock – principally, cattle, yak and pigs – also makes important contributions to smallholder diets and incomes although, in some areas, overgrazing has imposed a strain on the fragile mountain environment.

11. The growth of the industry sector comprising mining, manufacturing, electricity, and construction has slowed in recent years, particularly in the electricity subsector; however, the rate of growth in manufacturing remains buoyant. The sector is dominated by a few large firms, mostly State-owned or recently privatized, and supported by myriad small and cottage enterprises, and some medium-size firms in handicrafts, handmade paper, food processing, wood products, and construction activities. Currently, most manufacturing output and exports are from a narrow range of products – cement, ferro-alloys, calcium carbide, processed foods, and particle board – which tend to be produced with energy – and capital-intensive methods and dependent on skilled and unskilled expatriate labor, largely from India.

12. The Government is firmly committed to the growth of private sector activity. While several institutional, policy, and labor constraints to this growth remain, the Government has been active in privatizing State-owned firms, promoting institutional and legislative reform, and supporting the upgrading of domestic skills. However, industrial policies, particularly with regard to foreign investment, remain somewhat ambiguous. Thus, while sectoral diversification, deepening, and privatization have undoubtedly occurred, the sector is heavily concentrated on a narrow range of products; highly dependent on expatriate labor; restricted by the small, fragmented domestic market and a narrow range of readily accessible export markets; limited by poor, expensive transportation; and constrained by national sensitivities concerning resource exploitation (especially for tourism and logging) and by caution with respect to foreign investment and the employment of foreign labor. The main challenge facing the Government, therefore, is how to realize its commitment to private sector activity in the face of such constraints.

## **2. Macroeconomic Management**

13. In common with its approach to development policy generally, the Government has managed – and continues to manage – the economy prudently. In practice, however, it is fiscal policy rather than monetary policy that has to play the key role in the macroeconomic management of the economy. In terms of monetary policy, the Government has limited scope to exercise much independence, given that (i) the Bhutanese ngultrum is pegged to the Indian rupee at par, which requires a relatively close link between the interest rates of the two countries; (ii) a large but unknown stock of Indian rupees circulates freely and widely in Bhutan even though, technically, the ngultrum is the only legal tender; and (iii) trade between Bhutan and India is virtually free of restrictions, which means that Bhutanese price movements closely reflect those of India. Moreover, India receives over 90 percent of Bhutan's exports and supplies some 70 percent of its imports.

14. In Bhutan's circumstances, therefore, while monetary expansion (M2) has been significantly faster than nominal GDP growth for several years, this has not been reflected in a rise in domestic inflationary pressure<sup>2</sup> but in the increasing monetization of the economy. Moreover, large overall balance of payments surpluses and aid inflows,<sup>3</sup> have led to a buildup in official foreign exchange reserves, currently some 18-19 months of merchandise imports. At the same time, limited domestic investment opportunities have led to a sizable accumulation of excess liquidity in the domestic financial system which, notwithstanding the limits to Bhutan's independence of monetary policy, could possibly be moderated by adopting a rather less rigid and more market-sensitive interest rate structure, and by encouraging greater competition between the two commercial banks. The key questions for the Government in the financial sector for the future are how to address the issue of excess liquidity in the financial system and how to improve financial intermediation so as to encourage private sector operations.

15. The Government's prudence in fiscal policy is evidenced by its attempt to cover its current expenditures with domestic revenue and to finance capital expenditures with grants and soft loans. Current expenditures as a proportion of GDP have been relatively stable over time, despite the significant expansion in the provision of free health and education and the rise in civil service salaries in 1997 and 1998. While current deficits (excluding grants) have been the norm for most of the past 20 years, generous grant assistance – mainly from the Government of India – has bolstered the limited domestic resources and served to finance the domestic deficits. It has also been more than adequate to cover capital expenditures in most years, thereby contributing to rising exchange reserves.

16. However, not all recurrent revenue and expenditure activities are recorded on-budget.<sup>4</sup> These aside, with increased domestic revenues emanating from domestic tax and nontax sources and especially from the corporate taxes and profit transfers of the Chukha plant, the latter now representing over 40 percent of domestic revenues, the Government has been able to increase the country's fiscal self-reliance. Subject to the above caveat, it is now able to meet current expenditures from domestic sources of revenue, although it is still heavily dependent on assistance from India and other sources for its capital expenditures.

17. Notwithstanding the general prudence of the country's fiscal management, fiscal issues and risks remain: (i) the dependence of government revenues on the export of energy to India and thus on the volume of sales and the negotiated export price; (ii) the narrowness of the domestic revenue base (its broadening through the introduction of a personal income tax and increased power tariffs and user charges to cover rising recurrent expenditures for maintaining physical and social infrastructure is being considered); and (iii) the country's large and increasing foreign exchange reserves, which could potentially serve to slow further inflows of aid or to lead to a hardening in their terms.

### **3. Balance of Payments and External Debt**

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<sup>2</sup> Bhutanese annual inflation levels have been 7-9 percent since 1995, and 9-10 percent in the 1985-1995 period, similar to the Indian levels.

<sup>3</sup> In the past five years, for example, grant inflows have been some 5 percent higher than capital expenditures and have formed about half of total government revenues.

<sup>4</sup> Examples are expenditures for the Royal Family and national defense, which are met by Indian grant aid, and various items related to certain turnkey hydropower projects.

18. Throughout the 1980s and the first half of the 1990s, Bhutan had relatively large, fluctuating deficits on its merchandise trade account and its current account with both India and third countries. This situation persists with third countries but with India, Bhutan ran a trade surplus in 1996-1998 following the rise in electricity export prices in 1996. Current account deficits continued both overall and with India. Bhutan imports a wide variety of consumer goods, including certain basic food items, petroleum products, and virtually all capital goods. As noted earlier, it is successfully increasing its exports not only of electricity to India but of a variety of other goods to third countries – notably Bangladesh, Netherlands, Singapore, and Thailand – to earn convertible currency. Deficits on the current account of the balance of payments have persisted; however, official capital inflows, mostly to cover infrastructure investment, have exceeded them.

19. Tourist receipts are also increasing. Contrary to popular perception, tourist arrivals are not subject to numerical restriction. But, as a result of high mandatory expenditure levels for tourists of \$220 per day in the high season and \$160 per day in the off-season, the number of tourist arrivals remains modest but increasing. At the same time, tourist facilities – hotels, motor vehicles, trekking opportunities, and domestic tour companies – are increasing fairly rapidly not only in Thimphu but also in other regional towns.

20. Both the debt-to-GDP ratio and the debt service ratio remain manageable. The debt-to-GDP ratio has been falling in recent years with the repayment of the national airline's commercial loans and the concessional loans from India and Kuwait. This trend will reverse in the coming years as the share of loan financing from the new power projects being constructed will be greater than that from the Chukha project. The convertible currency debt is beginning to rise as a result of increased lending from multilateral development agencies, including ADB. At the same time, the debt service ratio stands at about 11 percent of merchandise exports, mostly to service convertible debt obligations.

## **B. Human and Social Development**

### **1. Human Development**

21. In parallel with an impressive performance in terms of economic growth and diversification, major strides have been made in human development indicators, although from depressingly poor initial levels and to levels that have to be improved further. In the case of health indicators, life expectancy rose from 35 years in 1961 to 46 years in 1977, and to about 66 years in 1998. Similarly, between the mid-1980s and the mid-1990s, the infant mortality rate and the maternal mortality rate were reduced from 142 to 71 per 1,000 live births and from 7.7 to 3.8 per 1,000 live births, respectively, while the under-5 mortality rate fell from 162 to 97 per 1,000 live births. In addition, the crude birth rate was reduced marginally by only four percentage points over the same period, and the crude death rate more significantly by almost half. Major advances in immunization to 90 percent of the children have virtually eliminated neonatal tetanus, polio, and diphtheria. Malaria and leprosy have been brought under control, although malaria remains a problem in the southern part of the country. The program to iodize salt has significantly reduced iodine deficiency. The most common causes of morbidity today are acute respiratory infections,<sup>5</sup> followed by diarrheal diseases (formerly the most common), skin infections, and tuberculosis.

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<sup>5</sup> Probably attributable to the use of wood for heating and cooking in traditional homes with little ventilation.

22. These positive developments were brought about by providing increased access to health facilities (hospitals, basic health units, dispensaries, and outreach clinics); boosting the number of doctors, nurses, and auxiliary health personnel; and improving access to potable water and sanitation. By the mid-1990s, 90 percent of the population had access to free basic health care (up from 65 percent in 1987); 58 percent of the rural population and 70 percent of the urban population had access to safe water supplies (from 31 percent in 1987 and expected to reach 95-100 percent in the next five years); and 80 percent of the rural population had access to means for safe excreta disposal. Moreover, piped sanitation systems either have been completed or are under construction in Thimphu, Phuentsholing, and four other towns. Although housing is generally considered adequate in Bhutan, urban slums and substandard housing have increasingly become a concern due to the rapid growth of the urban population.

23. The main issues facing the country's health authorities are the scarcity of skilled personnel for service delivery and for undertaking promotional and preventive programs, and finance to support a highly dispersed and expanding health care system that seeks to provide improved services to widely scattered communities. Difficulties faced on both fronts, as indeed in many other areas of national development, will be made more acute if the population growth (estimated at 3.1 percent a year in 1994) is not brought under control. The success achieved in reducing the mortality rate between the mid-1980s and mid-1990s was not matched by a similar decline in fertility, with the result that population growth rate by the mid-1990s had actually increased from 2 percent in 1984 to 3.1 percent in 1994. The Eighth Plan accords high priority to population planning, aiming to reduce the growth rate to 2.1 percent by 2002, 1.6 percent by 2007, and 1.3 percent by 2012. Various aid agencies, such as United Nations Fund for Population Activities (UNFPA), World Health Organization (WHO), and United Nations International Children's Emergency Fund (UNICEF), are providing substantial assistance in this area, focusing on reproductive health care and family planning as well as on improving the population database and information system. The Government aims to achieve a replacement rate of two surviving children per woman by 2012 by (i) increasing the contraceptive prevalence rate, currently 24 percent but rising; (ii) expanding education programs, targeting not only girls and women but also boys and men; and (iii) changing traditional attitudes with respect to the benefits of small families, particularly in an economy where population growth is often popularly seen as a solution to perennial domestic labor shortages.

24. As in health, considerable progress has also been made in education over the past 20 or more years. Considering that fewer than 450 children attended secular primary schools in the late 1950s and that the country had no secondary schools at that time, educational achievements in Bhutan have been impressive. The education system in 1999 consisted of 253 primary and community schools, 51 junior high schools, 21 high schools, 7 private schools, and 10 other institutions providing specialized education as well as tertiary and vocational training (including one degree college). Since 1977 alone, the number of teachers has trebled and the number of educational establishments has doubled.

25. The Government provides nine years of free basic education up to junior high school. The primary school enrollment ratio had reached 72 percent (nearly 80,000 children) by 1997 – up from 12 percent in 1980 and from 25 percent as recently as 1990 – which suggests that a 95 percent ratio may be reached in 2002 and universal primary enrollment soon after that. Girls now comprise some 45 percent of primary schoolchildren, or over 60 percent of the gross enrollment ratio, and they tend to have lower dropout rates than primary school boys. Aside from such quantitative improvements, both the quality and the internal efficiency of primary education have improved. A curriculum known as the New Approach to Primary Education, introduced in the

mid-1980s and extended to all primary schools in 1993, seeks to provide a curriculum based on Bhutanese values and circumstances and to develop skills that are useful to those who leave school at the end of their primary education. The survival rate in primary school increased from 35 percent in 1987 to 61 percent in 1998. As a result of these improvements, the adult literacy rate rose from 17 percent in 1977 to 23 percent in 1980, 38 percent in 1990, and 54 percent in 1998. However, the adult rate is only 28 percent for women, and is particularly low – even 10 percent – in some of the more remote rural areas. The situation is being addressed through nonformal education programs.

26. Secondary education has also expanded rapidly, although a shortage of trained, competent teachers at these higher levels remains a major constraint to faster growth. Even so, the Government has built new secondary schools, recruited expatriate teachers (mainly from India) and, importantly, expanded boarding facilities (now covering some 5,000 students) as an inducement to rural students generally and to girls in particular. The gender balance is about 53:47 in favor of boys in junior high schools, 57:43 in high schools, and 52:48 in private schools. At tertiary and vocational levels, males dominate.<sup>6</sup>

27. Notwithstanding the major improvements in basic education facilities, the country faces an acute shortage of skilled and semiskilled workers. The problems thus far have been that the technical and vocational training system has not been demand-driven, the quality of training provided has been poor, the institutions offering training have been weak, and job seekers with even basic educational qualifications have been reluctant to accept training for many vocational occupations or trades. The problems are being addressed as a matter of urgency by the Government, with the assistance of ADB and other aid agencies, but while technical skills remain inadequate, this weakness will continue to be a major barrier to reduced dependence on expatriate labor, to industrial growth, and to the local, productive absorption of an expanding population.

## 2. Poverty

28. As with several other economic indicators in Bhutan, reliable data on incomes are not available. The United Nations (UN) classifies Bhutan among the least developed countries, ranking 145<sup>th</sup> out of 174 countries in its human development index (HDI) for 1997 (published in 1999).

29. However, the quality of life in Bhutan seems higher than might be inferred from this HDI ranking. This ranking is based on the UN estimate of Bhutan's population (over 1.8 million) rather than the official estimate of 650,000, which is based on an extrapolation from the hurriedly conducted 1971 census, and it includes a number of social indicators that are poorer than those that obtain in practice. Indeed, after allowing for these data adjustments, the United Nations Development Programme (UNDP) office in Thimphu concluded that the HDI index for 1996 would have ranked Bhutan 130<sup>th</sup> out of 175<sup>7</sup> countries instead of 155<sup>th</sup> in the official *Human Development Report*. Reflecting official data and using the UN's HDI classification methodology, Bhutan's Planning Commission calculated that the HDI increased from 0.310 in 1984 to 0.510 in 1995 which, if accurate, would be a significant achievement. Either of these revisions would place Bhutan in the "medium human development" country group rather than the "low human development" group, a relatively rare distinction for an otherwise "least developed country."

<sup>6</sup> Data taken from draft consultant's report on Country Profile for Women in Bhutan, July 1999.

<sup>7</sup> See UNDP. 1998. *Bhutan: Development Cooperation. 1996 Report*. p. 16.

30. The estimated \$480 GNP per head is based on the official population estimate and is considered a more accurate reflection of reality. However, while higher than in some other countries, this basic GNP level of \$480 per head in Bhutan is still low: some \$1.30 per head per day. In this sense, therefore, income poverty is widespread.

31. The *Household Income and Expenditure Survey* (1992) revealed that the highest household decile received 36 percent of total income, while the lowest decile received only 13 percent. With a Gini coefficient of 0.563, the survey indicated income inequality as well as low average monetary incomes. Similarly, the *National Nutrition Survey* in 1996 indicated that some 38 percent of children under five were malnourished (weight-for-age) and that 56 percent were stunted (height-for-age). Malnutrition is also a problem for at least 18 percent of women of childbearing age, and iron-deficiency anemia for some 60 percent of pregnant women. While reduced, the incidence of iodine deficiency is still a cause of goiter in about 14 percent of schoolchildren. The immediate causes of malnutrition are a combination of low dietary intake, inadequate child care, and the high incidence of infections, each partly caused by ignorance of proper practices and requirements rather than by lack of food per se.

32. These data are a cause for concern. However, while the *Income Survey* might reflect the situation with respect to monetary incomes and inequalities fairly accurately, one needs to study their precise impact on the life of an ordinary Bhutanese carefully. Improving access to potable water, sanitation, and free education and health facilities in Bhutan, together with a highly developed tradition for cooperation and labor-sharing – particularly in house-building, village road maintenance, grazing land, irrigation water, planting, and harvesting – alleviate the more pernicious manifestations of low incomes and inequalities. Cultural traditions, such as the close-knit family and village and the Government's social policies over many years, serve many of the people's basic needs.

33. Even though Bhutan is classified as a "low income food deficit country," its form of low-productivity subsistence agriculture is still generally sufficient to provide for household food security in most regions of the country. This appears to be related to the small size of the population and relatively equal distribution of landholdings. Coupled with this, the extended family and village systems provide security for the most vulnerable groups, and a system of lending/borrowing food during the off-season helps the poorer families, as do the Bhutan Food Corporation's "fair price" shops and the individual's access to wild forest produce.

34. Thus, while life in much of the country's rugged terrain can be harsh, particularly in the more remote rural areas and in winter, many of the characteristics of poverty found in other parts of South Asia and in Africa – and even among people of similar income levels – are not in evidence. The divide between rich and poor in Bhutan, therefore, does not show itself as being as wide as in several other developing member countries. There is no starvation, although there are seasonal food shortages, malnutrition, and micronutrient deficiencies; there is no urban begging, even though incomes are low and individual access to many consumer goods correspondingly restricted; housing conditions are generally good, although these are being stretched by rural in-migration and are often substandard for those living as squatters on the edges of Thimphu and Phuentsholing and for road maintenance crews; and, while there are vulnerable and disadvantaged groups, these are not exploited in ways so commonly witnessed elsewhere. Nevertheless, rural living in particular is arduous, requiring long, laborious hours of work for small returns, while the limited road network often requires several hours' walk to reach health and education facilities, to buy supplies, or to transport meager farm surpluses to market.

On the other hand, the yields of food crops have increased and new, higher value crops such as fruit and vegetables that have been introduced to enrich diets and, where transportation permits, increase incomes. If the population continues to grow rapidly, however, the social situation and domestic perceptions of poverty could change.

35. Although data limitations preclude a definitive analysis of poverty, the overall picture cautions against making hasty interpretations and policy prescriptions that could be ill-suited to the particular context of Bhutan. Bhutan has what amounts in effect to a welfare state that, to the extent that can be sustained financially, mitigates many of the depressing effects otherwise associated with low incomes. On the other hand, the situation should not deter one from addressing the need to raise average incomes. The strategic challenge for ADB, therefore, is how to raise income levels and, at the same time, to strengthen the Government's success in addressing wider social issues and prevent a possible deterioration in access to social services.

36. Reducing poverty in these circumstances requires continued economic growth, together with the continued spread of health, education, and other facilities to encourage the inclusion of all groups in potential benefits, supported by targeting special assistance at those groups regarded as particularly vulnerable or disadvantaged. ADB would seem to be better equipped to support poverty reduction in Bhutan by promoting economic growth and social inclusiveness through interventions in physical and social infrastructure, private sector development, employment creation and improved economic management rather than targeting the especially vulnerable groups (many of whom live in very remote areas).

### **3. Gender Issues**

37. Bhutanese women comprise 48 percent of the population and play a major role in the development of the country. They do not suffer from gender discrimination, as they have equal status with men and enjoy the same level of freedom under the law. Indeed, property inheritance laws are particularly favorable to women, and most households are headed by women. Women's participation in decision making at community meetings is as high as 70 percent. The percentage is lower at district and block levels, but participation is being actively promoted at those levels and is increasing. Representation in the National Assembly and employment in government service are heavily biased in favor of men, but it is a bias that has shown some sign of decline in recent years. Similarly, as noted earlier, some gender imbalance exists in the primary and secondary school enrollment rates, but it is not marked and had improved in the 1990s. In terms of vocational and tertiary education, there is still marked imbalance.

38. Despite the absence of gender discrimination in Bhutan, and the approximate and improving balance found in many areas of social life, there are a number of issues that impact severely on women. They include high fertility rate, high maternal mortality rate, high infant and child mortality rates, and the gender gap in the adult literacy rate. These have improved enormously since the mid-1980s, but they remain poor absolutely. The impact of these problems is particularly severe among the smaller, more remote communities, where isolation provides an extra dimension to the difficulty of resolving them.

### **C. Environment**

39. The exploitation of the country's rich natural resource base has been at the core of the Government's developmental thrust. Owing to government efforts over time, it is a resource base that fortunately remains largely intact. However, environmental problems and natural

resource degradation processes are increasing because of high population growth, rapid urbanization, and economic development. Major environmental concerns relate to (i) the high rates of population growth resulting in increasing pressure on the natural resource base, especially on land resources (with negative impacts in terms of land degradation and soil erosion as all arable lands are currently utilized and new marginal lands are being brought under cultivation); (ii) additional risks of land degradation and diminished regeneration capacity of pastures and forests, due to higher demand for livestock products and possible increases in overgrazing; (iii) higher deforestation risks, due to population growth and related demands in terms of fuelwood, materials, and nonwood forest products; (iv) increased risks of soil erosion due to rapid and improper road network development; (v) high rural-urban migration flows and increasing pressure on the already poor urban infrastructures and adjacent land resources, especially in terms of inadequate solid waste management and sanitation systems; (vi) possible negative effects on the environment and cultural integrity that could result from rapid and unplanned tourism development; and (vii) additional possible negative impacts due to industrialization, water resources development (including hydropower), and the indiscriminate growth of mining activities.

40. Recognizing the need to achieve sustainable development, the Government established the National Environmental Committee in 1989 (renamed the National Environment Commission [NEC] in 1992) with a broad mandate in environmental planning and management: overall responsibility for the introduction of regulations, standards, and administrative procedures to control pollution, preserve natural resources, and achieve sustainable development. Accordingly, in the past decade, the Government<sup>8</sup> undertook a number of activities, including the preparation of the National Environment Strategy (NES)<sup>9</sup> and the implementation of a program for institutionalizing and strengthening the environmental assessment process in the country.<sup>10</sup> Various line agencies have started to revise rules and regulations in their areas of responsibility to incorporate the different environmental requirements, including environmental impact assessment (EIA) procedures. Another piece of environmental legislation, the Forest and Nature Conservation Act, was approved in 1995.

41. More recently, the Government embarked on a comprehensive exercise to further upgrade its environmental management capacities by establishing additional environmental institutions and administrative mechanisms to prepare for the introduction of the required regulatory and strategy/policy implementation framework. Major efforts are now focusing on (i) the rapid formulation of the National Environmental Action Plan to implement the recommendations of the NES; (ii) effective implementation of the recently adopted Environmental Impact Assessment Act; (iii) adoption of a comprehensive (umbrella) environmental act (the National Environment Protection Act); and (iv) the gradual but firm introduction of policy measures and institutional programs to improve the enforcement of

<sup>8</sup> In particular, NEC and the Forestry Services Division of the Ministry of Agriculture.

<sup>9</sup> "The Middle Path" National Environment Strategy (NES), issued in 1997 and adopted by the Government in December 1998. In short, the NES identified three major avenues to achieve sustainable economic development, namely: (i) expanding hydropower, (ii) increasing agricultural self-sufficiency, and (iii) developing the industrial base. The main challenge for the country is how to realize its ambitious development strategy in an environmentally sustainable way, as the NES clearly maintains that the development of these sectors will not be beneficial to the long-term welfare of the country unless development processes are environmentally sound, socially acceptable, and economically efficient. In this context, a National Environmental Action Plan is expected to be formulated soon.

<sup>10</sup> The Environmental Impact Assessment Act, approved in 1999, includes detailed guidelines and procedures, such as environmental screening guidelines for major sectors and selected environmental quality criteria/standards.

environmental regulations, environmental monitoring, interagency coordination, and the overall mainstreaming of environmental concerns into the economic planning and investment decisionmaking process, also through the adoption of market-based instruments.

42. While economic development in Bhutan will continue to be based mainly on hydropower, wood, agriculture, minerals, and services, major development constraints relate to (i) potential competition for alternative land and water uses; (ii) topographical factors increasing the cost of power, transport, and communications; and (iii) limited access to and supply of raw materials located in remote areas. In consideration of such key environmental constraints, there is a strong need to incorporate and integrate environmental management criteria in the overall development planning, decision-making, and industrial policy formulation process. In this context, the setting of appropriate environmental quality standards together with the corresponding effluent and emission standards, the establishment of adequate institutional/administrative procedures to enforce environmental regulations as well as the efficient implementation of the EIA system, are among the main steps required. Current environmental management capacity-building activities in this area are in the right direction.

#### **D. Governance**

43. For many years, Bhutan has accorded high priority to the development of its administrative institutions and system of governance. In the opinion of most observers, the Government deserves much credit for the achievements made. The civil service is staffed by dedicated and committed officers and led by ministers and other senior staff who exhibit professionalism and understanding of a high order. Refreshingly, and by common consent, there is little if any corruption in the civil service and administrative hierarchy. In the few cases where corrupt practices surfaced in the past, corrective actions were swift and severe. Moreover, discussion on policy and governance issues with government officers, even on issues that might be regarded as politically sensitive, can be conducted openly and directly, without the need for euphemism or the fear of causing offense.

44. Mindful of the possibilities for corruption that could accompany burgeoning private sector activity, a series of seminars was held to raise public awareness of the different forms of corruption, particularly the potential nature of the problem in the country, the control mechanisms, and preventive measures. These efforts also advocate the need to focus on people and to recognize that the Ministry of Finance, Ministry of Trade and Industry, the media, the judiciary, the education system, the business community, and the Royal Audit Authority each have a role to play in curbing unethical, "rent-seeking," and irregular activities. Indeed, the theme for the commemoration of the King's Silver Jubilee in 1999 – efficiency and effectiveness in governance, prevention of corruption in Bhutanese society, and uplifting of the morale of civil servants – testifies to the Government's commitment to good governance.<sup>11</sup>

45. Development efforts in Bhutan have also usually been the result of an "inclusive" process, involving the participation of many elements of society. This is exemplified by the continuing efforts of the King to visit all districts in the country, often on foot or pony, to discuss with villagers and local officials the development needs and initiatives of the different parts of the country, and by the Council of Ministers' recent initiation of a free exchange with the public to ensure that the latter's views are reflected in the process of governance. Moreover, moves in

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<sup>11</sup> See also Royal Government of Bhutan. 1999. *Enhancing Good Governance – Promoting Efficiency, Transparency, and Accountability for Gross National Happiness*. November.

recent years toward the decentralization of government and development planning to district and block levels are further raising the involvement and commitment of local government officials and local people in the planning and decision processes, and have contributed positively to popular participation, transparency, accountability, information flow, and good governance. As such, while Bhutan is still in need of support to strengthen institutional capacity and the legislative framework in various areas, it is technical support that is required, not a change in attitudes or civic values. This is an important distinction: ADB appears better equipped to deal with the former than the latter.

### III. DEVELOPMENT ASSISTANCE EXPERIENCE AND OUTLOOK

#### A. Background

46. Since the start of Bhutan's modernization and planned development in 1961, India has played a vital role, both as the country's main trading partner and as the country's principal provider of development assistance. Assistance has overwhelmingly been provided on grant terms in the form of both recurrent and capital expenditures, with some concessional lending for certain commercial undertakings, such as the Chukha hydropower plant. The first two development plans were wholly implemented with financial and technical assistance from India, and the Third Plan almost wholly implemented with such assistance (Table 1). For the first three five-year plans (1961-1976), the domestic use of Indian assistance was left to the discretion of the Government of Bhutan, but from the Fourth Plan, assistance has consisted of a budget support grant on one hand and grant support for specific projects on the other, including funds to meet local costs and recurrent or maintenance expenditures.<sup>12</sup>

47. Also from the Fourth Plan (1976-1981), other sources increased in importance. For the period 1961-2002, it is estimated that Indian assistance will have contributed some 25.7 percent of total development outlays, other sources 33.0 percent, and domestic resources 41.3 percent. However, while external aid constituted some 50 percent of GDP during the early years to about 1985/86, it now constitutes about 20 percent which, though still high, indicates the trend toward the Government's objective of increasing national self-reliance.

**Table 1: Development Outlays, by Plan Period and Financing Source**

Plan Period	Total Outlay (Nu million)	Source of Finance (Nu million)		
		India	Others	Domestic
First Plan (1961-1966)	107.2	107.2	-	-
Second Plan (1966-1971)	202.2	202.2	-	-
Third Plan (1971-1976)	475.2	426.6	15.8	32.8
Fourth Plan (1976-1981)	1,106.5	853.3	193.7	59.5
Fifth Plan (1981-1986)	4,711.1	2,017.5	1,233.0	1,460.6
Sixth Plan (1986-1991)	10,609.2	2,248.2	2,663.6	5,697.4
Seventh Plan (1991-1997)	19,877.2	3,815.3	6,231.5	9,830.4
Eighth Plan (1997-2002)	35,632.0	9,000.0	13,632.0	13,000.0
<b>Total</b>	<b>72,720.6</b>	<b>18,670.3</b>	<b>23,969.6</b>	<b>30,080.7</b>

Source: Ministry of Finance.

<sup>12</sup> Indian government departments operating directly in Bhutan have provided additional support, such as in road construction and maintenance and in military training as well as indirect assistance reflected in access to concessionally priced goods for the Food Corporation of Bhutan.

48. Following membership in the Colombo Plan in 1962, Bhutan joined the UN in 1971, International Fund for Agricultural Development (IFAD) in 1978, International Monetary Fund (IMF) and World Bank in 1981, and ADB in 1982. UNDP and UNICEF were the earliest agencies of the UN system to provide assistance, followed by World Food Programme, UNFPA, and United Nations Capital Development Fund (UNCDF) during the third and fourth plans. During the Fourth Plan, Danish International Development Agency (Danida) began assistance but, during and since the Fifth Plan, assistance sources have diversified to include Kuwait Fund, IFAD, World Bank, ADB, European Union, and other UN agencies such as International Labour Organisation; 10 bilateral sources (Australia, Austria, Canada, Denmark, Italy, Japan, Netherlands, Norway, Switzerland, and United Kingdom); and seven nongovernment organizations (NGOs). A summary of the activities of the major funding agencies is in Appendix 2.

49. Bhutan's first convertible currency borrowings began in 1980 with a \$6.98 million loan from IFAD for small farm development. This was followed by three loans from the Kuwait Fund for three large industrial projects. As of the end of FY1998, the latest year for which data are available, Bhutan's total public external debt amounted to \$121.5 million, of which \$95 million was in convertible currency – \$93.9 million as concessional debt and \$1.1 million as commercial debt – and \$26.5 million in nonconvertible currency. As noted earlier, the current debt service ratio of about 11 percent is manageable but will increase over the medium term, as the power projects that are being constructed carry a higher proportion of loan financing than the Chukha hydropower plant, and as multilateral lending increases.

## B. ADB Assistance

50. Bank operations in Bhutan began in 1983. By the end of December 1998, ADB had provided 14 loans amounting to \$65.2 million and 61 technical assistance grants (TAs) (43 advisory and 18 project preparatory) amounting to \$22.3 million (Tables 2 and 3).

51. It will be noted that total Bank lending in 1991-1998 was much lower than in 1983-1990, owing to the availability of grant assistance from other external sources. As part of its operational strategy in the country, ADB has tried to assist Bhutan to mobilize grant resources for projects and to provide loans only when grants are insufficient. Accordingly, average annual lending commitments were about \$5.6 million in 1983-1990 with an average loan size of \$5 million, and about \$3.3 million in 1991-1998 with an average loan size of \$5.2 million. However, there was some annual variation in these levels.

**Table 2: Bank Lending to Bhutan by Sector, 1983-1998**

Sector	1983-1990			1991-1998			Total (1983-1998)		
	No.	\$ million	%	No.	\$ million	%	No. (ongoing)	\$ million	%
Agriculture & Natural Resources	2	7.9	20.7	0	0.0	0.0	2 (0)	7.8	13.1
Energy	0	0.0	0.0	1	7.5	25.7	1 (1)	7.5	9.4
Transport	1	4.5	11.1	1	5.2	20.0	2 (0)	9.7	14.4
Social Infrastructure	2	10.4	24.5	1	5.7	23.2	3 (2)	16.1	24.0
Finance & Industry	2	3.7	8.5	2	8.0	31.1	4 (2)	11.7	16.8
Others	2	12.4	35.2	0	0.0	0.0	2 (0)	12.4	22.3
<b>Total</b>	<b>9</b>	<b>38.8</b>	<b>100.0</b>	<b>5</b>	<b>26.4</b>	<b>100.0</b>	<b>14 (5)</b>	<b>65.2</b>	<b>100.0</b>

**Table 3: ADB's Technical Assistance to Bhutan by Sector, 1983-1998**

Sector	1983-1990			1991-1998			Total (1983-1998)		
	No.	\$'000	%	No.	\$'000	%	No. (ongoing)	\$'000	%
Agriculture & Natural Resources	13	6,113.0	61.0	4	1,610.0	13.1	17 (0)	7,723.0	34.7
Energy	0	0.0	0.0	5	2,245.0	18.3	5 (3)	2,245.0	10.1
Transport	3	575.0	5.7	5	2,560.0	20.9	8 (1)	3,135.0	11.2
Social Infrastructure	6	1,491.0	14.9	2	1,000.0	8.2	8 (2)	2,491.0	14.1
Finance & Industry	5	1,190.0	11.9	7	2,792.2	22.8	12 (2)	3,982.2	17.9
Others	4	645.0	6.4	7	2,050.0	16.7	11 (3)	2,695.0	12.1
<b>Total</b>	<b>31</b>	<b>10,014.0</b>	<b>100.0</b>	<b>30</b>	<b>12,257.2</b>	<b>100.0</b>	<b>61 (11)</b>	<b>22,271.2</b>	<b>100.0</b>

### C. ADB's 1991 Operational Strategy

52. ADB's previous (and first) operational strategy for Bhutan was prepared in 1991. Its overall objective was to assist the Government to diversify the economy, through (i) developing the convertible currency earning capacity; (ii) strengthening the capacity of government agencies for development administration and economic management, and the skills of the labor force; (iii) improving physical and social infrastructure; and (iv) protecting the environment. After its adoption, this strategy provided a good basis for ADB's operational program in Bhutan, although the explicit promotion of private sector activity emerged during the course of the strategy's implementation to underpin the broad strategic thrusts identified. Each of the sectors and areas identified were addressed by ADB's operations at one time or another during the strategy period. No major issue between the Government and ADB arose during the implementation of this strategy.

53. Although the level of ADB's operations during the 1991 strategy period was relatively modest, it had a positive developmental impact. Major constraints on the diversification and growth of the economy were seen as stemming from the country's poor physical infrastructure, acute shortage of skilled and semiskilled labor, and weak private sector. While these structural features remain constraints to growth, ADB's interventions have played a role in their amelioration, although it will take time to assess the results with accuracy. Addressing the country's weak skills base had been the primary objective of the loan for technical and vocational education and training, committed just before the publication of the 1991 strategy, and of ADB's earlier assistance to establish the Royal Institute of Management as the country's only institution offering degree courses in the business and commercial fields.

54. After the adoption of the 1991 strategy, ADB's loan for the rehabilitation and maintenance of the East-West Highway served to upgrade the road communications links between Thimphu and the central and eastern parts of the country, to expand marketing opportunities, to expedite the transportation and export of perishable commodities and, by so doing, to support private sector activity. Similarly, and in close coordination with IMF, ADB's two loans to the finance and industry sector – a project loan to a local development finance institution (DFI) and a policy-

based program loan – also served to promote private sector activity and growth by (i) extending the DFI a credit line for the support of small and medium-size industries; (ii) converting the former Unit Trust of Bhutan to the country's second commercial bank, thereby bringing more competition to financial intermediation; and (iii) modernizing the business environment through the liberalization of interest rates and the reform of financial, industrial, and trade policies. ADB, along with Citibank, has also taken an equity stake in Bhutan National Bank.

55. The two other loans approved during the previous strategy period were for rural electrification and urban infrastructure improvement. The objective of the former was to widen access to electricity in selected rural areas as a means of improving the quality of life in those areas, reducing fuelwood consumption, and stimulating smaller scale business initiatives. An important aspect of ADB's assistance to the energy sector has also been the support provided for the corporatization of the Division of Power (DOP), as a precursor for possible cofinancing and private sector financing of future hydropower projects.

56. The objective of the urban infrastructure loan was to address the effects of high rates of rural-urban migration, something that had not been considered a major issue at the time of strategy formulation but which became an important one during implementation. This loan was approved only in 1998, too recent for postevaluation, but rates of in-migration in the main towns of Thimphu and Phuentsholing, estimated at 5-10 percent annually, have placed increasing stress on urban infrastructure and the quality of life for some migrants.

57. The TA program resulting from the 1991 strategy was also consistent with the broad objectives set. Most TAs approved were for advisory and operational purposes and used to support the institutional strengthening of a number of agencies, to prepare action plans, and to address financial and capital market development. The project preparatory TAs were intended, as their name implies, to be more directly in support of specific loan projects, but not all of them resulted in loans by ADB.

#### **D. Lessons from ADB's Project Implementation Experience**

58. Currently, only three Bank loans to Bhutan have been postevaluated: one was rated as unsuccessful, one as partly successful, and another as generally successful. This sample is too limited to allow many definitive conclusions. However, a postevaluation study<sup>13</sup> recommends that the appraisal of future projects consider the need for (i) comprehensive detailed designs, (ii) greater exposure for first-time borrowers and executing agencies to Bank procedures and practices, (iii) the coordination of assistance from different sources, and (iv) assessment of the adequacy of cash creation and fund flows to meet debt-service obligations.

59. Of the three postevaluated loan projects, the unsuccessful project – a multiproject loan (1983) – was the first loan to the country and clearly suffered from having too many subprojects in different sectors. Although four of the six subprojects met their objectives and generated satisfactory economic benefits, the two subprojects that accounted for nearly 75 percent of total project cost were unsuccessful.

60. The second and partially successful loan project – a credit line to the Bhutan Development Finance Corporation (1988) – was successful in providing foreign-exchange financing for industry and broadening the domestic industrial/business base. It thus contributed to the creation of jobs, introduction of new technology, creation and/or saving of foreign exchange, and provision of support to ancillary businesses. However, the institution failed to attract sufficient private sector investment or to develop into an efficient DFI.

61. The third and generally successful project – Highland Livestock Development (1986) – successfully increased local production, especially of milk output, and served to more than double in nominal terms the incomes of the beneficiary farmers.

62. While the implementation of ongoing Bank loan projects has improved, delays, some of them significant, continue to occur largely as a consequence of one or more of a variety of factors: inadequate local budget allocations, shortage of skilled local staff, frequent changes of project staff, weak procurement and contracting capabilities, insufficient delegation of authority, weak monitoring and coordination, and delays in consultant recruitment. Bank review missions for both loans and TAs are endeavoring to identify and then address implementation problems early on so that the desired project objectives and impact can be achieved. In late 1998, a time-bound action plan was agreed upon with the Government to address these issues. Since then, time compliance has been good and certain issues have been resolved, such as the provision of adequate budgetary allocations for ADB-financed projects, and the retention of counterpart staff in their posts, particularly those trained under Bank projects.

63. Five TA projects have been postevaluated. Four of them were provided to the National Budget and Aid Coordination Division during 1988-1993 to enhance its capabilities in budgeting and external resource management. While these TAs improved efficiency in the day-to-day operations of budget accounting and external resource management, they were rated partly successful: they were judged not to have fully developed the necessary institutional capacity to sustain and effectively undertake public expenditure management.

64. The fifth TA – the Western Watershed Conservation and Management Project – was rated as partly successful as it did not adequately cover two of the three items in its scope of

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<sup>13</sup> Asian Development Bank. 1996. *Summarized Postevaluation Results and Findings for Bhutan*. Manila.

work. The lessons learned from this project were that (i) this project participatory TA should have been preceded by an advisory TA to strengthen the relevant institutions; (ii) project design would have benefited from the adoption of a logical framework approach; (iii) more time should have been spent on a socioeconomic survey and on determining beneficiary preferences; (iv) ADB should consider the impact of any ensuing loan on the country's debt-servicing capacity; and (v) there is a need to review the working arrangements with cooperating agencies, such as the Food and Agriculture Organization, as a substitute for engaging consultants.

65. One important general lesson learned in the course of operations in Bhutan, and one that is wholeheartedly supported by the Government, is the need to follow a participatory approach at all stages of the project cycle. Such an approach ensures that projects reflect development needs, promotes ownership, and allows one to incorporate implementation lessons from the past. Moreover, and particularly for project preparatory and advisory TAs, the participatory approach establishes at an early stage mutual understanding among stakeholders regarding the scope and intended outputs of the proposed assistance, and should serve to reduce the time lag between the completion of a feasibility study and the planned investment, for example. It should also reduce the incidence of the general causes of implementation delays noted earlier.

#### **E. Aid Coordination and Cofinancing**

66. Aid management and coordination are the responsibility of the Government. In Bhutan's case, they are the responsibility of the Ministry of Finance, the Ministry of Foreign Affairs, and the Secretariat for the Planning Commission. The discharge of this responsibility is assisted by collaboration among the aid agencies and between them and the Government, with an important role being played by UNDP in Thimphu. The in-country funding community is relatively small and most, if not all members, are well known to one another. This facilitates the exchange of documents, information, and views among them, and between them and the Government, both formally (at roundtable meetings, local aid agency coordination meetings, sector-specific workshops, and interagency meetings) and more informally on the basis of personal contact. ADB also makes regular contact with government and aid agency officials, and contributes actively to sectoral and more general programming workshops.

67. One practical result of past efforts at coordinating assistance programs has been cofinancing. In ADB's case, two Bank loans – Second Multiproject Project (1984) and Urban Centers Sewerage Project (1987) – were cofinanced with Danida, the latter providing \$2.6 million and \$2.15 million equivalent, respectively. Subsequently, Danida financed the entire Urban Centers Sewerage Project. Similarly, in the case of TA projects, ADB cofinanced a master plan for forestry development with Danida and a horticulture TA project with UNDP. As a result of the latter, UNDP and UNCDF financed the ensuing investment project. In addition, possible cofinancing with UNDP/Global Environment Facility (GEF) was discussed to support a mini/micro hydropower component for ADB's Sustainable Rural Electrification Project.<sup>14</sup> However, this did not materialize owing to a delay in processing on the part of GEF. Nevertheless, eventual GEF assistance will form an integral part of the overall efforts in rural electrification.

#### **F. Outlook for Future Resource Inflows**

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<sup>14</sup> Loan 1712-BHU(SF): *Sustainable Rural Electrification*, for \$10 million, approved on 25 November 1999.

68. Bhutan has established a reputation for being able to make effective use of the external assistance it receives and, indeed, for being relatively modest in its requests. Where project implementation delays occur, government officers appear to show as much concern for them as the aid agencies, and to make concerted efforts to address them. There is no cynicism or aid fatigue evident among the funding community; on the contrary, most of their reports applaud the Government's prudent macroeconomic management, the relevance of its development philosophy to the distinctive features of the country, the commitment of the civil service, and the effectiveness with which external assistance has generally been used. This differs quite markedly from aid agency reactions in certain other countries.

69. In these circumstances, there is nothing to suggest a reluctance on the part of the funding community to continue with its assistance programs along the established course. Accordingly, the outlook for external assistance inflows is good. In the case of the World Bank's, consideration is currently being given to the provision of "development program lending" as an alternative to traditional project lending. This would involve the support of the government budget for a multiyear government program, with each tranche of the World Bank's credit being used to meet a time slice of that program. It is proposed that disbursements under such credits reflect the external financing gap rather than the needs of particular projects. While certain targets would be set and monitored, such an assistance initiative appears to be an acknowledgment of the relevance, impact, and effectiveness of the Government's development programs generally, and it might be one that ADB would consider an appropriate response to the effectiveness of the Government's development program.

70. In addition to the likely continuation in external assistance inflows, there is potential for tapping private sources for those projects with a commercial orientation. While this will require institutional and policy reform within Bhutan, there would seem to be good chances offered by hydropower opportunities, such as the proposed Punatsangchu (765 MW) and Mangdichu (360 MW) plants, whose feasibility studies are currently being financed by Japan International Cooperation Agency (JICA) and Norway, respectively. Wider private sector involvement in development, once appropriate policies are in place, would also offer prospects for mobilizing additional private funds.

#### **IV. ADB'S FUTURE ROLE IN BHUTAN**

##### **A. General Considerations**

71. Translating ADB's overarching goal of poverty reduction<sup>15</sup> into a strategy and operational program that reflect the reality of Bhutan's development context requires that five main considerations be noted: (i) the nature and degree of poverty in Bhutan; (ii) the effectiveness of the Government's economic and social development programs in addressing basic human needs; (iii) the country's access to grant funds from India, UN, and other bilateral sources; (iv) the country's debt-servicing and project execution capacities; and (v) the likely initiatives of other aid agencies. In addition, a sixth consideration is that, to make a relatively small program effective, ADB has to be selective and not try to spread available resources too thinly, or to dissipate them by supporting too many objectives.

72. With an estimated GNP of \$480 per head in 1996 – some \$1.30 per head a day – average Bhutanese incomes are low, indicating that income poverty is widespread. However, the

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<sup>15</sup> ADB. 1999. *Fighting Poverty in Asia and the Pacific: The Poverty Reduction Strategy*. Manila.

kind of abject poverty seen in some parts of Asia as a result of such low incomes is not evident, as the Government's social welfare policies over many years have resulted in high levels of human capital and relatively widespread social well-being. Therefore, to reduce poverty in Bhutan, it is necessary to, first, address the income dimension of poverty; and second, support further progress in the nonincome, social dimension.

73. Most of the cost of these welfare policies has been financed by external grants. While there is no particular reason to anticipate a reduction in such flows, there is a need to increase the mobilization of domestic resources for these reasons: (i) because external concessional financing might become more scarce and/or provided on harder terms; (ii) because the operation and maintenance of an expanding network of social facilities and utilities will require an increasing level of resources; and (iii) because the rising aspirations of the population will likely demand an increasing quantity and quality in the services to which they expect to have access. Increasing domestic resource mobilization, therefore, is important to achieving further progress in social conditions.

74. At the same time, the economy has witnessed fairly rapid rates of GDP growth – nearly 8 percent annually in the second half of the 1980s and some 6-7 percent a year since – and significant structural transformation. Much of this has been led by the public sector but, with the privatizing process and moves to promote private initiative emerging during the 1990s, there has been a marked increase in the participation of the private sector in the economy and a modification in the Government's traditional role. For the future, growth and diversification need to be continued so as to generate employment opportunities for a rapidly rising population, to increase average incomes, to underpin domestic resource mobilization efforts, to improve social indicators, and to target vulnerable groups. It is a process that will require a much strengthened setting for private sector activity. It will also require a refocusing of government initiatives to ensure the preservation of its past social, cultural, and environmental achievements and to provide a platform for future progress.

## **B. ADB's Strategic Focus**

75. In this context, ADB's strategy will be to assist the Government in the process of structural transformation and role transition and, at the same time, to support the Government's traditional commitment to its social programs and to socioeconomic equity. It recognizes the importance of following a gradualist approach in the envisaged transition, since destabilizing repercussions could emanate from profound or sudden changes to traditional policies or from an undue concentration of wealth in a few hands. Since the main mechanisms for targeting disadvantaged groups are already largely in place, this strategy will focus on

- ?? strengthening the capacity of government agencies for economic management, governance, and development administration, largely through policy dialogue and technical assistance activities;
- ?? improving physical and social infrastructure through both lending and technical assistance activities;
- ?? promoting private sector development, through the various lending and technical assistance activities associated with physical infrastructure development, skills training, financial sector strengthening, and legislative reform;

- ?? improving the efficiency of public service delivery and cost recovery through policy dialogue and lending and technical assistance activities; and
- ?? environmental protection, largely through ensuring the environmental compatibility of ADB-sponsored projects.

76. ADB's concern for poverty reduction will be addressed through the income and employment generation impact of private-sector-led development, brought about by an improved policy setting and more efficient financial intermediation. This will be complemented more specifically by Bank interventions to

- ?? reduce physical infrastructure constraints, particularly in road transport and rural energy, thereby widening access to more productive, higher income occupations;
- ?? develop the domestic skills base, thereby providing Bhutanese labor with increasing opportunities to take up more rewarding occupations;
- ?? address the increasing stress being placed on housing and urban infrastructure by rural-urban migration, thus improving the urban environment generally and providing added support for the low-income urban groups in particular; and
- ?? support the strengthening of the management and cost recovery of social services so that higher levels of government revenue are generated to expand the delivery of traditional social services and the targeting of vulnerable groups.

77. Thus, it is a strategy designed not only to address some of the major constraints to increased incomes and improved public service delivery, but to weaken the effects of the mutually reinforcing nature of those constraints. Government officials have already shown a commitment to the development of Bhutan, and there is a general congruence of thought behind the Government's development philosophy and that of ADB. What ADB should bring is financial resources and ideas to enable government commitment to be realized, and to support the strategic theme of improving the quality of life for all.

## **C. Emergence of Private Sector Development as a Government Priority**

### **1. Background**

78. The potential role of the private sector in Bhutan has been receiving increasing attention in recent years: first, via the privatization, partial privatization, and corporatization of public sector activities; and second, through the creation of an enabling environment to encourage the establishment of new private activities. The commitment of the Government to both of these initiatives began to receive formal expression as part of the Seventh Plan published in 1991 and receives further endorsement in the current Eighth Plan published in 1997. The Government clearly sees the private sector as the main engine of future income growth and employment generation, and several funding agencies (including ADB) are actively engaged in helping the Government to realize that objective.

79. The longer-run objective of the Government is to withdraw from areas that are commercially viable, and its privatization program of the 1990s is testimony to that. However, the pace at which full privatization takes place is limited by the size of the local equity market, by

concerns to prevent the undue concentration of equity in a few hands, and by the capacity of the private sector to manage major projects.<sup>16</sup> Thus, the Government will continue to finance and implement major projects when they are beyond the capacity of the private sector, or until their financial profitability is sufficient to attract private sector interest. Accordingly, 17 major enterprises have been partially or wholly privatized, and 3 liquidated. Bus services have been privatized, the postal and telecommunications services corporatized, tour companies liberalized, several areas of road and power construction contracted out, and various ministry functions and activities<sup>17</sup> are being considered or prepared for corporatization and privatization. On the other hand, the Government seems unlikely to privatize the Chukha Hydel Power Corporation (because it is too large), Druk Air Corporation (as it would not be attractive to the private sector), or the Bank of Bhutan (as it is a joint venture with the State Bank of India).

## **2. Major Constraints to Private Sector Development**

80. There are a number of constraints to the development of the private sector in Bhutan, and the strength of each is increased by their mutually reinforcing nature as a group. First, there are physical constraints caused by topography, location, and a small, widely dispersed population. In these circumstances, domestic and international transportation are both difficult and expensive as well as frequently interrupted by landslides. The domestic market is fragmented. The small, scattered domestic regional markets are often uneconomic to serve, and the opportunities to sell local production surpluses nationally are restricted. As a result, market integration is impaired, the transmission of market signals and reactions to them are impeded, and potential economic activity and income opportunities are lost.

81. Second, there is an acute shortage of skills of all kinds and, paradoxically – given the rapid population increase and the relatively high local wage levels – even of unskilled labor. Moreover, there is a preference for working in government service rather than in private, paid employment. In the case of unskilled labor, there is a reluctance to work in certain occupations. With restrictions now placed on the growth of the civil service, and the difficult economic circumstances, these attitudes are showing signs of change. However, it will be some time before attitudinal change and the improvement in training facilities permit a better balance to be struck between Bhutanese labor demand and supply. In the meantime, the domestic shortage of skilled and semiskilled labor will continue to pose a constraint, and the higher wages required by Bhutanese workers relative to expatriate Indian workers will continue to affect their recruitment.

82. Third, related to the above, the private sector's small size and comparatively recent emergence in a business environment traditionally dominated by state capitalism place a limit on the exposure of the general public to business development in a market economy. Aside from small-scale cottage industries and trading activities, there have been little history of private commercial development, and little time for business acumen to mature and for private business to become a preferred career for many people. This gives rise to a shortage of entrepreneurial skills to reinforce the shortage of technical and vocational skills, and partly explains the preference of the Bhutanese for government service.

83. Fourth, considerations of national interest, while legitimate, also serve to limit private sector growth in certain areas. Concerns for the environment, the preservation of the country's

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<sup>16</sup> While not precluding them, these factors collectively limit the scope for build-operate-transfer-type schemes.

<sup>17</sup> Particularly some of those currently under the Ministry of Agriculture, Ministry of Trade and Industry, Ministry of Communications, and Ministry of Health and Education.

cultural heritage, the potential invasiveness of foreign ownership, and the expansion of Bhutanese employment serve to limit logging, tourism, direct foreign investment, and the hiring of expatriate labor by domestic companies. With respect to foreign investment, the current limit of 20 percent for foreign equity participation – although it can be relaxed by the Ministry of Trade and Industry on an individual basis – is acknowledged to be a deterrent to foreign investment. Similarly, government investment guidelines<sup>18</sup> require that applications for commercial investment licenses be subject to several reviews prior to approval, including the review of the government agency or department responsible for the sector concerned. This is a process that many consider as a deterrent to investment and one that is in need of simplification and streamlining. More broadly, the legislative and regulatory framework remains weak and often ambiguous although the Government is moving relatively quickly to address it.<sup>19</sup>

84. Fifth, private sector development continues to be hampered by weak financial institutions and inefficient financial intermediation. However, while the Government (with assistance from ADB) has liberalized the financial sector, improved its regulation, strengthened the Royal Monetary Authority's inspection and supervision capacity, increased the potential for competition in the banking system, and freed interest rates from administrative control, the effects have not yet had time to be fully felt. The interest rate structure still reflects the earlier rigidity, while the rates themselves remain high and the spreads wide. Moreover, competition between the two banks has not led to change in this structure, and the accumulation of excess liquidity in the system as a result of the restricted demand for funds – partly a reflection of the interest rate structure and of the overly high collateral requirements – reduces the profitability of the country's financial institutions. At the same time, all financial institutions maintain capital in excess of the required capital adequacy ratio.

### **3. Bank Strategy for Private Sector Development**

85. A Bank strategy for developing the private sector thus emerges from addressing the acknowledged constraints faced by the country's private sector. It is also suggested by the strategic focus of Bank operations over the medium term outlined in paras. 75-77, and will be complemented by some of the sectoral strategies outlined in paras. 92-117 and in the sector development framework of Appendix 3.

86. In brief, the private sector strategy will target the promotion of private sector investment by

- ?? supporting an improved policy setting and more efficient financial intermediation;
- ?? improving road transport and expanding power transmission and distribution; and
- ?? strengthening vocational, technical, and basic skills.

### **D. Relation of the Current Strategy to the Previous Strategy**

<sup>18</sup> Ministry of Trade and Industry. 1997. *General Guidelines for Industrial and Commercial Ventures in Bhutan*.

<sup>19</sup> For example, in 1999 alone, the National Assembly passed, among others, the Bhutan Municipal Act, the Road Safety and Transport Act, the Bhutan Telecommunication Act, the Bhutan Postal Act, the Bankruptcy Act, and the Movable and Immovable Property Act.

87. The broad thrust of the proposed strategy is to address the traditional constraints to Bhutanese development as well as emerging issues and, importantly, to do so in a way that reflects the Government's wider sociocultural concerns. In terms of ADB's own concerns, this involves addressing both the income and nonincome dimensions of poverty, which is consistent with the Government's concern – as expressed in its document *Vision 2020* – to see Bhutan's future as a blending of material and nonmaterial progress, and as a reflection of economic, financial, social, and environmental sustainability.

88. The current strategy does not differ fundamentally from the previous one; in fact, it seeks to maintain continuity with it, especially with those thrusts that have had, or seem likely to have, a positive development impact. It thus represents a fine-tuning of the previous strategy, something that has evolved from the regular consultations among the Government, ADB, and funding community as well as from the changing dimensions and/or pressures of Bhutan's development process. While maintaining continuity, therefore, the current strategy (i) places more explicit emphasis on the need to support private-sector-led growth as a means of creating employment opportunities and of underpinning GDP and income growth; (ii) highlights the importance of widening the Government's revenue base as a means of preserving social achievements, expanding access to social facilities, and improving social indicators; (iii) emphasizes the importance of governance and public sector management; and (iv) proposes more strongly that, given the country's past performance in meeting basic needs, ADB's interventions in social development should be more narrowly focused on addressing the continuing shortage of skills and on improving the efficiency of public service delivery.

89. As in the past, it is envisaged that ADB's operational program in Bhutan will consist of about one or two loan projects per year, with technical assistance projects in support of both these and ADB's broad strategic thrust more generally. To maintain continuity and to allow ADB to revisit a sector every 4-5 years to maintain the reform momentum, it is envisaged that ADB's program will be limited to five sectors: namely, energy, road transport, finance, human resources, and urban development.

90. Perhaps surprisingly, therefore, this sectoral focus omits agriculture and the environment. It also differs from the previous strategy in that it includes the health sector since it represents an important avenue for supporting continued social progress and further reducing nonincome manifestations of poverty.

91. Several other aid agencies are engaged in various aspects of agricultural and horticultural development. Moreover, the Government's own programs are quite well advanced in these areas, and it would prefer to receive external assistance in the form of grants. In the case of the environment, the Government's own programs, policies, and regulatory framework are proceeding well, and grant resources from other sources are available, some of them unused because of limited absorptive capacity. The role of ADB in environment would seem better concentrated on including environmental components in its other loan projects and on ensuring their environmental compatibility, than on stand-alone projects for environmental improvement per se.

## **E. Sector Strategies**

### **1. Road Transport and Rural Electrification**

### **a. The Strategic Rationale for Support**

92. In view of the very large proportion of the population in rural areas and of the increasing issues associated with rural-urban migration, developing private sector activity in the rural areas of Bhutan represents an important opportunity for raising incomes nationally, for dispersing economic activity, and for addressing the income dimension of poverty reduction. Recent developments in agriculture and horticulture, some the result of sponsored programs and some the result of spontaneous initiatives, indicate the potential associated with the production of food staples, especially fruit, vegetables, essential oils, and medicinal plants. Given Bhutan's natural and chemical-free production techniques, the rising exports of these products can be boosted by the increasing worldwide popularity of natural foods. Currently, however, many of the opportunities that these activities potentially provide, particularly for perishable items, are being lost because of communications difficulties, and many of the opportunities that small producers may have are being restricted by isolation and a fragmented domestic market.

93. Given that ADB is unlikely to have any lending operations in agriculture per se, improving the physical infrastructure both within and running through rural Bhutan could provide (i) a potent force for market integration and the release of spontaneous private initiatives; (ii) improved access for tour groups, and a fillip for the labor-intensive services and handicraft industries that cater to them; and (iii) in the case of power transmission and distribution, a means for developing local agroprocessing and generating alternative employment. In turn, this would help to promote balanced regional development, an important consideration of the Government. Emerging rural income and employment opportunities may also contribute to a slowing in the pace of rural out-migration.

94. Moreover, with better access to improved roads and power, there are a number of potential opportunities in mining. There are known deposits of high-quality dolomite, gypsum and limestone as well as of quartzite, graphite, coal, slate, and marble. If exploited, they can provide additional rural employment opportunities and higher incomes than in many traditional subsistence pursuits. They can also provide a basis for downstream processing and export. While there are other constraints to the development of the mining sector, including environmental considerations and the shortage of technical skills, the geographic spread of better roads and power supply can provide over time a positive boost to mineral exploitation and further diversification and growth of the economy as well as promote social development through enhanced accessibility and efficiency of health and education services.

### **b. Wider Energy Sector Considerations**

95. Bhutan is endowed with considerable hydropower resources whose exploitation has supported the growth of energy-intensive industries, expansion of the Government's revenue base, and a rise in exports. Parallel to the expansion of the domestic transmission and distribution system, the key objectives in the energy sector are (i) financial viability and sustainability of power operations through the corporatization of the DOP; (ii) revision of the tariff structure; (iii) private sector participation in the construction of power facilities and, potentially, in their ownership; and (iv) expansion in power generation for export.

96. ADB approved its first loan in the sector (for rural electrification) in 1995, together with technical assistance for the institutional and financial development of DOP. The assistance provided an impetus for reforms in the sector and is envisaged to lead to continued institutional strengthening of DOP and to its commercialization, and to the institution of a tariff structure that

reflects the economic cost of production. The latter, in particular, is a crucial step toward eliminating the current subsidy to industrial consumers and toward ensuring the financial viability of DOP.

97. Accordingly, the current strategy envisages further assistance to expand rural electrification, if satisfactory progress is made with respect to the financial viability of DOP, together with any necessary human resource and institutional development agreed upon with the Government. Future power generation possibilities from Punatsangchu and Mangdichu, or others will require cofinancing of relatively large amounts, including private sector participation. Therefore, continued adherence to the ongoing reform program will be important, and ADB assistance in mobilizing funds and developing the local capacity to negotiate with foreign investors should be considered.

### **c. Wider Road Sector Considerations**

98. The World Bank and UNDP, as well as the Government itself, are actively engaged in developing rural market and feeder roads. The complementary focus of ADB's strategy for the road sector is on main roads and highways. Alternative modes of transport – such as ropeways and domestic air links – have been studied under UNDP auspices, but were found wanting in economic and financial viability. It is envisaged that, given the relatively light traffic levels and the high cost of new road construction when incorporating environmental safeguards, ADB's medium-term strategy will focus on the maintenance of existing (main) roads rather than on the construction of new ones.

99. Thus far, ADB's policy dialogue associated with the physical work on the East-West Highway Project, has concentrated on (i) institutional strengthening of the Division of Roads to improve maintenance management, (ii) development of the local contracting industry, (iii) more efficient allocation of budgetary funds for road maintenance, and (iv) improved cost recovery. Significant progress has been achieved in these areas and, on the assumption that such progress is maintained, further assistance for road improvement will be considered. Similarly, a request for ADB to provide assistance for the development of a master plan for road transport, particularly for main roads and highways with potential for subregional cooperation, could also become an important initiative to consolidate the progress made in strengthening the road maintenance system and the road network as a whole. Social benefits will also be generated because promoting road safety can lead to less road accidents and casualties.

## **2. Financial Sector**

100. Substantial expansion in the financial sector and monetization of the economy have occurred in the 1980s and 1990s, with the sector's contribution to GDP increasing at an average annual rate of 12 percent in real terms over the past 20 years. As part of this growth, several financial institutions have been established. Today, in addition to the Royal Monetary Authority (RMA), which fulfills the role of a central bank, there are four other financial institutions: Bank of Bhutan, Bhutan National Bank, Royal Insurance Corporation of Bhutan, and Bhutan Development Finance Corporation. In addition, the Royal Securities Exchange of Bhutan, which was established in 1993 with Bank assistance, deals with a limited number of traded stocks (about a dozen), government bonds, and RMA bills, supported by four brokerage firms: Bank of Bhutan Securities Limited, Royal Insurance Corporation of Bhutan Securities Limited, Bhutan National Bank Securities Limited, and Druk Securities Limited.

101. Notwithstanding the progress achieved and past Bank assistance, especially but not solely the policy-based Financial Sector Development Program Loan of 1997, the sector continues to exhibit institutional and policy weaknesses. Indeed, a major developmental challenge in the years ahead will be the absorption of the excess liquidity that has built up in the financial system, and the use of these funds to underpin private sector growth. While the nature and timing of specific Bank interventions will be determined by the progress achieved under on-going assistance efforts, the basic strategy for ADB will be to continue to build on its past initiatives for they remain appropriate for the country, and to blend them with the policy initiatives of other aid agencies, particularly those of IMF, World Bank, and UNDP.

102. Thus, ADB will support the Government's efforts to provide an enabling environment for private sector development through (i) the continued rationalization and strengthening of banking and financial institutions; (ii) the continued liberalization of foreign trade, exchange, and investment regulations; (iii) the continued liberalization of interest rates so that they reflect the true underlying cost of resource mobilization, intermediation, and risk; and (iv) the continued preparation of transparent legislation and regulatory procedures.

### **3. Human Resource Development**

103. Human resource development refers here to the development of the health and education sectors, which have each witnessed significant improvement over time. An important consideration in the formulation of a strategy for ADB is the large number of aid agencies that have been, and remain, active in the general area of human resource development. For example, the health sector in Bhutan is receiving assistance from Denmark, India, JICA, WHO, UNICEF, UNFPA, and the World Bank. Considering the access to the grants that most of them provide leaves little room for ADB loan assistance for basic health needs over the strategy period. This also explains the absence of the health sector in ADB's previous strategy.

104. However, an important dimension to the proposed Bank strategy is the need to improve domestic resource mobilization, including improvement in the cost recovery of public service delivery, as a means of promoting financial sustainability and national self-reliance. As a result, it would seem appropriate to consider the provision of policy-based loan assistance and supporting technical assistance to improve efficiency in the management of the health services system, including financing options, system regulation, and private participation. Thus, while the Government has made excellent progress in health care, there is a need to put the long-term financing of health services on a sustainable footing, and to improve the quality of care as well as the efficiency with which it is dispensed. Suitably improved, therefore, the new approach will help meet the recurrent costs of improved services, reduce the fluctuations in the annual allocations of drugs and vaccines, and encourage the introduction of new vaccines and drugs on a sustainable basis. While not targeted directly at improving the current health indicators, this strategy will still provide an important indirect means of addressing them.

105. In the education sector, other sources of aid are also involved: Denmark, Germany, JICA, Netherlands, Switzerland, UN and World Bank. Thus any contemplated Bank assistance must be coordinated with their assistance programs. However, the acute shortage of domestic skills is an abiding obstacle to the creation of productive job opportunities for the Bhutanese, to the development of the domestic private sector, and to accelerated GDP growth. Following on from previous assistance to the Royal Institute of Management, the Royal Bhutan Polytechnic, and the National Technical Training Authority, ADB's strategy in the education sector will be to continue to address the country's need for skills so as to achieve a better balance in the supply of

available skills and the demands of the labor market. This involves the creation of demand-driven structures for technical and vocational education training by (i) strengthening the currently weak but improving institutional capacity, (ii) addressing to the extent possible the negative perceptions of manual work, (iii) improving the quality of technical and vocational training, and (iv) widening access to training facilities and programs.

106. Widening access to training facilities and programs will be particularly important. Current programs often neglect the needs of the rural population, or are not available to them, and they fail to attract many women even in urban areas. However, if ADB is to have a national impact on incomes and the skills situation, ways have to be found to reach more people, particularly women, and to do so in ways that are cost-effective as well as responsive to the needs of the market.

#### **4. Urban Development**

107. Rising rates of rural-urban migration during the 1990s have contributed to rapid urban growth, particularly in Thimphu and Phuentsholing and also in smaller district towns. The problems are most conspicuous in the two large urban centers; they include a shortage of low-income housing; squatting on vacant government land; unplanned conversion of croplands, inadequate water supply; and sanitary and environmental issues associated with solid waste, wastewater, and storm water disposal systems.

108. Although urban planning was introduced in the mid-1980s, it remains rudimentary due to shortages of experienced staff, weak enforcement mechanisms, and inadequate funds. Thimphu and Phuentsholing are administered by their respective city corporations, and the 30 other centers classified as towns, by the district administrations. The two city corporations in particular require strengthening. They have been empowered to impose and retain certain user charges, but they need more clearly defined responsibility and authority and an improved capacity to undertake urban management.

109. The Government recognizes these issues and has adopted policies designed to develop regional growth centers, to devolve authority to local levels, and to provide upgraded urban infrastructure, particularly in Thimphu and Phuentsholing where stress is most evident. Under the current Eighth Plan, the Government plans to achieve a more balanced, sustainable system of settlements, which will incorporate its growth center strategy. More broadly, it will seek to moderate the effects of rural-urban migration, on the one hand, through investment in rural areas so as to create rural employment opportunities areas and stem the flow of out-migrants; and, on the other, through development of secondary towns and supporting the urban infrastructure and management of Thimphu and Phuentsholing. ADB's proposed strategy seeks to support both prongs of the Government's policy: namely, support for accelerated rural private sector activity and employment, and support for urban improvement.

110. ADB's strategic focus thus far has been the provision of support for urban infrastructure improvement in Thimphu and Phuentsholing to improve drainage, roads, footpaths, parking areas, and river protection. It has also provided technical assistance for capacity building in urban management and, importantly, for the preparation of a draft housing policy. A draft of this policy has been prepared, and further assistance to the sector will be premised on a number of issues being adequately addressed in the final, approved document.

111. The issues basically concern the need to develop a housing policy that can be shown to be financially sustainable. They include provision for the development of affordable housing; full cost recovery, with limited subsidies only for low-income groups; identification of medium-term land requirements and the development of a land bank for future housing needs, especially in Thimphu and Phuentsholing; creation of long-term finance mechanisms; and private sector participation in the provision of housing. Once the issues are resolved, ADB may consider the provision of loan assistance for housing development. That will represent an important aspect of ADB's strategy to assist low-income groups and reflect ADB's institutional concern for poverty reduction initiatives.

## **5. Environment**

112. Although direct assistance to the environment sector per se is not envisaged over the medium term, environmental protection is an important concern for ADB as an institution. Accordingly, ADB will continue to monitor environmental progress in Bhutan, particularly in those forces that are causing a rise in environmental stress, and to ensure that its own interventions are environmentally sustainable.

113. For example, the development of water resources (including hydropower) represents an important economic opportunity for the country. However, both the NES and the newly approved EIA Act clearly indicate that this process must be environmentally sustainable and undertaken through an integrated watershed management approach. To this end, in addition to project-level EIA, there is a need to analyze at the earliest stages of the decision-making cycle, whether, where, and what type of development projects should take place. This resource planning exercise can be undertaken through a Strategic Environmental Assessment study at the watershed level and aim at identifying best alternative development scenarios before specific programs and feasibility studies for individual projects are finalized. It will also improve the quality of the debate surrounding water resource development and serve to balance economic, social, and environmental objectives through the active involvement of the private sector, local communities, NGOs, and the wider public. Open dialogue, transparency, and participation of all main stakeholders in this process will definitely help in addressing potential conflicts between existing and future activities, between small- and large-scale projects, and among different sectoral water uses.

114. The rural renewable energy subsector, including minihydro and solar energy, is an important field where Government and aid agencies' efforts may need to focus more systematically. In this context, ADB will consider the possible inclusion of renewable energy components in the scope of future technical assistance and lending programs in the rural electrification subsector.

115. The Government has a number of environmental programs in forestry, biodiversity conservation and sustainable rural development. Nine protected areas that have been established cover nearly 25 percent of the country. The management of these parks and sanctuaries will require significant capacity building and institutional strengthening at both central and local levels, and the country will need considerable support in this area from the funding community. Various sources, including the GEF and numerous bilaterals, have offered grants. In addition, investment income generated from the Bhutan Trust Fund for Environmental Conservation is available. However, the absorptive capacity of the Government in this area is limited and a large part of available funds remains unused. Additional Bank support in this sector, therefore, is not required at this time. A similar situation obtains in social and community forestry,

where the Government has recently started being active and where grant funds from various donors are also available.

116. With respect to the urban environment, future Government programs and aid agency support will also need to give the right emphasis to various priority intervention areas by including appropriate environmental components such as sanitation, solid waste management, drainage, traffic management, footpaths improvement, air and water pollution control, etc. These components are being addressed by ADB's ongoing loan project and may require further assistance in the future.

117. Finally, another area where environmental and social concerns have been raised is the road subsector. Considering the importance of the expansion and improvement of the national road network for the development of the country, prevention of environmentally and socially negative impacts is a major concern. Soil erosion, land degradation, and river valley siltation are often the result of inadequate road construction and inappropriate road siting. The need to incorporate environmental aspects in the design and implementation of road projects, and to devise appropriate mitigation measures, is already recognized by the Government and major aid agencies. However, the level and continuity of the Government's commitment in this area are somewhat inadequate, and current/future road projects will need to pay increasing attention to environmental implications and social problems, such as the living conditions of road workers, associated with specific road construction programs.

## **F. Gender Dimensions**

118. ADB's gender strategy for Bhutan is to ensure that the fruits of economic growth and modernization are spread equally between women and men. In particular, efforts must be made to diversify women's employment, reduce female adult illiteracy, and sustain improvements in women's health, especially maternal mortality. As the Bhutanese economy continues to modernize, and with the new and increasing emphasis on the private sector, one of the major sources for women's empowerment will be access to diverse and well-paying employment opportunities. Strategies to help women of low-income households in poorer areas are directly linked to those already identified for the poor. However, particular emphasis will have to be given to those who are illiterate and do not speak the national language, as they are most likely to be deprived of benefits from further economic growth. The most realistic approach for ADB's gender strategy is to effectively incorporate gender considerations in future interventions, including measures to ensure women's full participation in ADB projects (Appendix 4).

## **G. Governance**

119. It has been noted that, in improving governance in Bhutan, it is technical support that is required to improve development administration, not a change in attitudes and civic values among the administrators. Mainly through its technical assistance activities, ADB has provided considerable support for institutional strengthening in a number of government agencies: for improved policy analysis and macroeconomic management, for procurement procedures and for contracting out certain functions to the private sector, and for statistical development. Given the country's relatively short history of exposure to a modernizing market economy, weaknesses in development administration inevitably remain. Accordingly, ADB will continue to build on past initiatives on a needs basis, but particularly for promoting (i) further strengthening of public sector resource management and aid coordination, by working in close contact with the other aid agencies in these fields; (ii) further enhancement of the sectoral capacity for project implementation; and (iii) further improvement in economic statistics, notably in prices, national income accounts, and selected demographic issues.

120. However, a new area for ADB in Bhutan, and one that should be regarded as an important step in promoting governance nationally, is support for government initiatives in decentralizing decision making and planning to the district level. Currently, the quality and number of staff at district and block levels to undertake these new functions are inadequate, physical facilities poor, and experience limited. The initiative should promote wider "ownership" of development projects, a greater personal identification with their selection and execution, and more popular, transparent participation in the process of government. Through technical assistance support, ADB can strengthen a nascent government initiative, and possibly take the lead by helping to mobilize grant support from other sources. However, given the dispersion inevitably associated with the decentralization of development administration and with the monitoring of assistance that is directed at it, initial concentration on selected districts may be necessary.

## **H. Subregional Cooperation**

121. The globalization of world economies has intensified international competition and simultaneously generated a new wave of regionalism. Geographic proximity, economic complementarity, political affiliation, policy and regulatory coordination, and infrastructure development are factors conducive to the formation of groupings. Subregional economic

cooperation, as one form of coordination, can offer the South Asian countries significant potential benefits. In 1997, Bangladesh, Bhutan, India, and Nepal agreed to establish the South Asian Growth Quadrangle, which will cooperate within the South Asia Association for Regional Cooperation (SAARC) framework. Given their interests, the focus will be on five areas: energy, multimodal transport and communications, trade and investment facilitation and promotion, tourism, and natural resource utilization and the environment. The countries agreed to proceed on a project-by-project, building-block approach, covering bilateral and multilateral cooperation.

122. One major area for subregional cooperation involving Bhutan is the further development of hydropower for export, which is anticipated when the several hydropower plants under construction or being planned come onstream. Another area for potential cooperation concerns the road sector. Bank assistance to the road sector in Bhutan has already improved the road links to and within the eastern, central, and western parts of the country, as well as in the north-south corridor. While this assistance was given to Bhutan's road network, it has strong subregional linkages and benefits: it improves connections to the Indian road system in West Bengal, where a north-south corridor from the border at Phuentsholing to the port of Haldia is being developed. As a small landlocked country, Bhutan needs access to seaports and to potential markets in neighboring countries if its small domestic market is not to continue to limit domestic growth. Improving roads in northern India and facilitating customs facilities etc. for transshipment through India to Bangladesh promise to provide additional benefits.

123. As part of its dialogue with each country of the four-member group, ADB will continue to assist whenever possible in promoting greater subregional cooperation as a means for capitalizing on intrasubregional complementarity and deriving extra subregional benefits.

## **V. INSTRUMENTS OF BANK SUPPORT AND OPERATIONAL IMPLICATIONS**

### **A Lending Operations**

124. Lending will continue to be a major instrument of Bank operations, supported both directly and indirectly by technical assistance activities. Loan operations thus far have been financed from the resources of the Asian Development Fund (ADF). While a change in this situation over the medium term is not anticipated, the uncertainty surrounding the future availability and replenishment of these resources places a premium on the need to use them effectively. For ADB, this means that care has to be taken to ensure the ownership of proposed projects, and to target assistance so that the desired development impact will be brought about in a sustainable manner. For the country, it means that continued access to ADF resources will be linked to progress being maintained in portfolio performance, in the framework for development policy, and, especially, in the specific spheres or sectors contained in ADB's country program for Bhutan.

125. Accordingly, the annual indicative planning figure (IPF) for lending operations in Bhutan will be guided by progress and achievement in the following areas:

- ?? prudence in macroeconomic management, notably in maintaining a manageable debt service ratio and in meeting recurrent budgetary expenditures from domestic revenue sources;
- ?? effectiveness of the regulation and supervision of the financial system, and of the legislative and regulatory framework to underpin private sector investment;

- ?? efforts to improve the quantity and quality of expenditure on social services;
- ?? efforts to improve policies, regulations, and institutions in support of the environment; and
- ?? achieving a rating of at least "satisfactory" during reviews of ongoing loan projects.

126. Acceptable performance in these areas will be consistent with an annual IPF of about \$10 million at the current level of ADF availability. A higher level may be considered if performance is good and the debt service ratio remains manageable, and a lower level – even, in extreme cases, zero – if performance is regarded as unacceptable.

127. In Bhutan's case, major problems in meeting acceptable levels of progress under the above criteria are not anticipated, particularly if ADB takes the effort to adopt a fully participatory approach and to involve the Government – and, possibly, interested aid agencies – at all stages of the project cycle, and thus promote Government ownership of ADB's proposed interventions. As noted earlier, Bhutan has established a good reputation for making effective use of the external assistance it has received from the funding community as a whole, and it has also received plaudits from aid agencies for progress it is making economically, socially, and environmentally. If progress in terms of the above performance indicators is achieved, some consideration may be given to the introduction of a lending modality similar to the World Bank's contemplated "development program lending".

## **B. Technical Assistance Operations**

128. Acceptable achievement under the above performance criteria indicates progress in creating a policy and institutional environment conducive to the generation and sustainability of the desired development impact of government and Bank programs. To assist the Government in making such progress, ADB's technical assistance operations will focus on (i) strengthening institutional capacity, policy formulation capability, and the legislative and regulatory environment; and (ii) directly supporting lending operations, through either advisory and operational or project preparatory activities. Through regional technical assistance, ADB will also seek to play a proactive role in subregional economic cooperation, and to stand ready to facilitate research and policy dialogue in potential areas of mutual interest.

129. The annual IPF for ADB's current technical assistance program in Bhutan is \$2 million which, given the crucial need for institutional development and capacity building to support private sector development and to improve the effectiveness of development administration, may be inadequate and need review. In addition to the traditional technical assistance modalities, some consideration should be given to the use of "cluster TAs." These provide for flexibility in following a phased approach to the support for any given sector or initiative, and comprise a series of interventions – some of which may be individually small – as part of an integrated, defined program over time. On the surface, it would seem a particularly useful modality for supporting the strengthening of the Government's administrative decentralization initiatives.

## **C. Economic and Sector Work**

130. An important aspect of the revised strategy for Bhutan is the emphasis placed on various aspects of institutional strengthening and policy formulation as prerequisites for sustainable macroeconomic and sectoral development over time. Considerable economic and sector work will be required to monitor and evaluate the progress of policy, procedural, and institutional initiatives, and to ensure that they are in line with short- and long-term development objectives and requirements. Moreover, while some statistical improvement is anticipated over the medium term, much of this monitoring and evaluation will have to take place with a still-imperfect database. This will complicate analysis and place a premium on the need for insight and qualitative assessment on the part of the analyst. It will also require an intuitive feel for what is possible in Bhutan, for the sequencing of initiatives, and for the pace at which reforms can be introduced. Both the relevance of policy prescriptions and the quality of their evaluation in these circumstances will be facilitated by maintaining continuity in ADB staff working on Bhutan, and by allowing them sufficient time to become familiar with its development context.

131. To support the strategy more specifically, it is foreseen that continuing economic work in connection with macroeconomic management performance, financial sector progress, and sectoral cost recovery will be required on a continuing basis. Poverty analysis as a priority will be undertaken jointly with the Government to support ADB's overarching objective of poverty reduction and permit regular monitoring and evaluation (Appendix 5). Similarly, private sector development, which involves assessment and analysis across a range of issues, will need to be closely monitored, with a refocusing or strengthening of initiatives introduced on a timely basis if the need arises. Continuing sector work in connection with the strategic interventions in road transport, power, housing and skills training will be necessary if the development impact of the initiatives already begun in these sectors is to be sustained, and much work on health will be required to support ADB's first financial intervention in the sector.

132. While some of this analysis can be done by consultants under the supervision of Bank staff, much of it will need to be done by Bank staff themselves. This requires that adequate staff and financial resources be allocated to support the strategy effectively, not only to complete the technical analysis involved, but to ensure that the various cross-cutting issues of concern to ADB are addressed as an *integral* part of development policy rather than merely as an adjunct to it. This analysis will also be required to ensure that the design of future projects is appropriate to the objectives sought and the country context.

#### **D. Risks**

133. Bhutan has been able to meet the challenge of improving the level of social well-being rather successfully, given its relatively short history of modernization and the many adverse circumstances facing the country. The country has also managed to secure significant economic growth and diversification. It now has to promote a transition that will build on past socioeconomic successes to raise national income levels; to place the financing of its development initiatives on a more sustainable financial footing; to provide for widened access to higher-quality social facilities; and to rely more heavily on the private sector to spearhead growth, diversification, and employment generation. This strategy is directed at the realization of these objectives.

134. While no major dangers that would jeopardize the realization of the strategy's objectives are foreseen, there are potential risks to the achievement of its desired impact. The main one arises from the possible temptation to delay the introduction of domestic resource mobilization and cost recovery measures once increased revenues from the anticipated hydropower plants

begin, or appear imminent. These plants will undoubtedly improve the domestic revenue situation significantly, the promise of which could induce a delay or a change of scope in some of the other contemplated measures to raise the revenue base. A delay would dilute the desired impact of the strategy because, not only would it weaken mobilization efforts per se, it would hold back the efficiency gains that are expected to emerge from increased commercialization. In turn, this would impinge negatively on the anticipated improvements in development administration and in the quality of public services.

135. At the project level, the success of Bank interventions will depend on the performance of its portfolio. On the one hand, it will be partly a function of the Government's absorptive capacity, which will itself be a target for Bank support, and the associated risks of project delays, etc. On the other hand, it will also be partly a function of the appropriateness of project design to the Bhutanese development context, and of the timeliness of introducing any remedial actions that might be required. There are risks associated with both of these. Depending on the nature of the delay, it could affect the creation of an enabling environment for enhanced private sector activity. At the project level, both the Government and ADB have a responsibility in program implementation, which makes it all the more imperative that ADB secure full ownership of the proposed projects by the Government and the executing agency concerned.

**APPENDIXES**

<b>Number</b>	<b>Title</b>	<b>Page</b>	<b>Cited on (page, para.)</b>
1	Country Performance Indicators	36	2, 8
2	Sectoral Framework	38	13, 48
3	Sectoral Development Frameworks	41	22, 85
4	Gender Issues in Bhutan	45	30, 118
5	Poverty in Bhutan	46	33, 131

## SECTORAL FRAMEWORK

Sector	Government Objectives and Strategy	Activities of Major Aid Agencies	ADB Operations	
			Policy and Institutional Focus	Investment Focus
Agriculture	<p>Food self-sufficiency</p> <p>Horticulture Master Plan</p> <p>National Forestry Master Plan (1996-2010)</p> <p>Forest and Natural Conservation Act of 1995</p> <p>National Biodiversity Action Plan</p>	<p>India: sub-tropical integrated area development</p> <p>Austria/World Bank/SDC: forestry</p> <p>IFAD/JICA/Netherlands/Denmark: agriculture development</p> <p>SDC/GTZ: renewable natural resources research</p> <p>EC: livestock, pest management, human resources development, and medicinal plants</p> <p>UNDP: integrated horticulture development, forest resource management, Jigme Dorji National Park</p>	Not envisaged	Not envisaged
Power	<p>Hydropower Development Master Plan (1990-2010)</p> <p>Provision of electricity to 50 percent of rural population by 2012 and 75 percent of urban population by 2020</p>	<p>India: power generation of Tala (1040 MW) and Kurichu (60 MW); and rural electrification</p> <p>Austria: power generation of Basochu (45 MW)</p> <p>ADB: rural electrification and power sector reforms</p> <p>JICA/Norway: Feasibility studies of Punatsangchu (760 MW) and Mangdichu (360 MW), respectively</p>	<p>Corporatization of DOP; DOP's financial sustainability and commercial orientation</p> <p>Policy and legal framework for private sector participation in hydropower development</p>	<p>Transmission and distribution</p> <p>ADB's private sector operations will explore opportunities to mobilize private sector resources for hydropower development.</p>
Transport	Proposed Road Sector Master Plan	<p>India: civil aviation, roads, bridges, bus sheds, and terminals; national highway construction and maintenance</p> <p>ADB: main road and national highway rehabilitation and maintenance; transport network (main roads) master plan</p> <p>UNCDF: construction of eastern feeder roads</p> <p>World Bank: rural access roads</p>	<p>Capacity building of private sector contractors</p> <p>Sustainable budget provision to maintain existing roads</p> <p>Institutional development for technical capacity on road maintenance</p>	<p>Improvement of road network and access to market</p> <p>Promotion of regional transport network and facilitate subregional cooperation in South Asia among Bangladesh, Bhutan, India, and Nepal</p>
Finance	Master Plan for Cottage, Small and Medium-Size Industries	<p>ADB: Financial sector intermediation facility (program and credit line); establishment of a pension fund</p> <p>Citibank/ADB: equity investment in BNB</p>	Market-based interest rates; restructuring of BDFC; enhancement of capacity and institutional development of financial institutions	ADTA to support policy and institutional development; lending only if needed
Human Resources	Human Resources Development Master Plan (1997-2002)	<p>UNDP: human resources development</p> <p>ADB: technical education and vocational training</p>	Institutional development of National Technical Training Authority (NTTA) to plan and formulate necessary training requirements	ADB investment to support the development of the mechanism and facilities to meet training needs

Sector	Government Objectives and Strategy	Activities of Major Aid Agencies	ADB Operations	
			Policy and Institutional Focus	Investment Focus
Health	Health Sector Master Plan  Royal Decree of Population, 1995	India: construction of hospitals  Denmark: human resources development, infrastructure, and disease control  UNFPA: population advocacy and reproductive health  UNICEF: water supply and sanitation  WHO: disease control  UNCDF: construction of basic health units	Health financing, management, and regulation of basic health care	Policy-based lending to pursue the necessary policy and institutional development for the establishment of the Health Trust Fund
Urban Development/ Housing	Draft Housing Policy; proposed Urban Development Plans	ADB: urban infrastructure in Thimphu and Phuentsholing; completed the draft housing policy to establish the framework for sustainable financing and operation of public housing programs  World Bank: ten secondary towns	Adoption of the housing policy and its implementation  Implementation of urban development plans	Possible investment to support the implementation of housing policy and urban development plans
Environment	National Environment Strategy.  Environmental Guidelines for various sectors	Denmark: legislation, EIA, and environmental protection  UNDP: strengthening of environmental management and education  Netherlands: Bhutan Greenhouse project, biodiversity conservation, plant genetics	Not envisaged	Not envisaged
Governance	Decentralization guidelines, 1993  Monitoring and evaluation system for the country by 2002  Enhance domestic resource mobilization  Promote private sector development	UNDP: strengthening capacity for management and decentralization  Denmark: institutional strengthening of RIM, CSC, Department of revenue and customs, BBS, and Kuensel Corporation  SNV: Decentralization support program  ADB: institutional strengthening of CSO  UNFPA: Preparation for population census in 2000	Public sector resources management  Institutional development and capacity building to support private sector development	Not envisaged

SDC = \_\_\_\_\_, IFAD = International Fund for Agricultural Development, JICA = Japan International Cooperation Agency, GTZ = German Agency for Technical Cooperation, EC = European Communities, UNDP = United Nations Development Programme, MW = megawatts, ADB = Asian Development Bank, DOP = Division of Power, UNCDF = United Nations Capital Development Fund, BDFC = Bhutan Development Finance Corporation, ADTA = advisory technical assistance, UNFPA = United Nations Fund for Population Activities, UNICEF = United Nations International Children's Emergency Fund, WHO = World Health Organization, EIA = environmental impact assessment, RIM = Royal Institute of Management, CSC = \_\_\_\_\_, SNV = \_\_\_\_\_, CSO = Central Statistical Organization, BNB = Bhutan National Bank, BBS \_\_\_\_\_.

## SECTORAL DEVELOPMENT FRAMEWORKS

### A. Private Sector Development

**Strategic Objectives:** To develop private sector participation in the economy to enable it to play an increasing role in generating employment opportunities and increasing incomes.

Key Issues & Constraints	Policy & Institutional Focus	Interventions of Asian Development Bank	Performance Criteria
Poor legislative setting	Industrial, trade, and foreign exchange policy	Monitoring ongoing program technical assistance (TAs) and policy dialogue	Transparent industrial policy Liberal trade and exchange
Weak financial sector	Increasing bank competition Liberalizing the interest rate structure Utilizing system's liquid assets	See Section E (financial sector) and Appendix 2	See Section E and Appendix 2
Shortage of skills	Institutional strengthening Improving quality of training Enabling demand-driven training facilities/courses	See Section B (skills training) and Appendix 2	See Section B and Appendix 2
Poor infrastructure	Improving roads & rural power Commercializing Division of Power/ Department of Roads Public/private partnerships Promoting local contracting Promoting private investment	See Sections C/D (road improvement/ rural electrification) and Appendix 2	See Sections C/D and Appendix 2

### B. Skills Training

**Strategic Objectives:** To develop the country's skills base to provide Bhutanese labor with more productive job opportunities, to enhance private sector development, and to stimulate gross domestic product growth.

Key Issues & Constraints	Policy & Institutional Focus	Interventions of Asian Development Bank	Performance Criteria
Weak institutional capacity	Institutional strengthening Increasing cost effectiveness	Technical assistance (TAs) and policy dialogue	Strong institutional and policy setting
Poor quality of training	Improving quality of training	TAs and lending operations	Higher quality training courses and teachers More courses and teachers
Weak link between supply and demand for skills	Improving relevance of courses Reflecting labor market needs	“	Training given more reflective of market demands
Restricted access to training for rural people and women	Catering to particular needs of rural people and women	“	Rising enrollment in courses by rural people and women

## C. Road Improvement

**Strategic Objectives:** To improve road maintenance and improvement so as to (i) integrate the domestic market; (ii) enhance access to local, regional, and international markets; (iii) increase employment opportunities and incomes, especially in rural areas; (iv) stimulate private sector activity, especially in rural areas; (v) develop public/private sector partnerships, especially in the construction and maintenance of the road network; and (vi) commercialize the Department of Roads.

Key Issues & Constraints	Policy & Institutional Focus	Interventions of Asian Development Bank	Performance Criteria
Financial sustainability of Department of Roads (DOR)	Institutional strengthening Commercialization of DOR	Policy dialogue, technical assistance and lending activities for DOR	Measurable trend toward self-financing/ commercialization of DOR
Maintenance management capacity		"	"
High costs of road network Road maintenance revenue	Efficient allocation of budget Improved cost recovery	Master plan for road transport	Master plan completed and progress in implementation
Local contracting capacity	Encourage more private/public partnerships/ contracting out	"	Growing proportion of road maintenance/construction contracted out
Labor shortage	Skills training Local contracting industry	Skills training (Section B)	Fewer expatriate contract workers

## D. Rural Electrification

**Strategic Objectives:** To extend the rural transmission and distribution power system so as to (i) support increasing rural agroprocessing, tourism, and mining activity so that employment opportunities and incomes are enhanced; (ii) support widened access to education and health facilities; (iii) reduce the consumption of fuelwood and the incidence of respiratory infections arising from its use in poorly ventilated homes; (iv) increase the quality of rural life generally; and (v) create the impetus for policy dialogue to increase private sector participation in the construction of power facilities and to commercialize the activities of the Division of Power.

Key Issues & Constraints	Policy & Institutional Focus	Interventions of Asian Development Bank	Performance Criteria
Financial sustainability of DOP Tariff structure/subsidies Export price	Institutional strengthening Corporatization of DOP Pricing policies	Policy dialogue, technical assistance and lending activities for DOP	Demonstrable trend toward commercialization of DOP Tariff structure reflecting economic production costs
Private sector participation Local contracting capacity	Encourage more private/public partnerships/contracting out in construction activities	"	Growing proportion of power construction contracted out
Local capacity for negotiating with potential private investors	Strengthen local capacity	"	Increasing interest in private sector participation/ cofinancing

## E. Financial Sector

**Strategic Objectives:** To strengthen the efficiency of financial intermediation and to broaden access to investment funds so as to support the development of private sector activity.

Key Issues & Constraints	Policy & Institutional Focus	Interventions of Asian Development Bank	Performance Criteria
Buildup of liquid assets in the financial system	Strengthening private sector activity generally	Monitoring ongoing programs	Measurable reduction in liquid assets of system
	Addressing interest structure and collateral requirements	Technical assistance (TAs) and policy dialogue, with policy-based lending only if needed	System reflective of the true cost of resource mobilization, intermediation, and risk
Weak competition between the two commercial banks	Raising profitability of the two banks through generating an increased demand for funds	“	“
Rigid interest rate structure High collateral requirements	Liberalizing operations to reflect their true cost	“	“
Weak securities exchange	Institutional strengthening	TAs, policy dialogue, as needed	Increase in traded stocks

## F. Urban Development

**Strategic Objectives:** To develop the managerial capacity, policy setting, and physical needs of urbanization (especially in Thimphu and Phuentsholing), and to support the articulation of a sustainable housing policy.

Key Issues & Constraints	Policy & Institutional Focus	Interventions of Asian Development Bank	Performance Criteria
Weak urban planning capacity	Institutional strengthening	Technical Assistance (TAs) and policy dialogue	Strong institutions in place
Rising rural-urban migration	Promote rural economic activity to stem out-migration	See Sections C/D (road improvement and rural electrification) and Appendix 2	See Sections C/D and Appendix 2
Overburdened infrastructure Increased urban squatting	Improve physical capacity and zoning regulations/monitoring	Monitoring ongoing TA and lending activity	Physical improvement achieved Adequacy of it
Shortage of land Rising competition for land Lack of housing policy	Zoning regulations and their implementation Develop housing policy	Policy-based lending and TAs	Sustainable housing policy approved Land bank and finance mechanisms established Affordable low-cost housing in place Private sector participation in house construction

## G. Health Sector

**Strategic Objectives:** To place the long-term financing of the health sector on a sustainable footing, as a means of (i) allowing the wider provision of health services, and (ii) promoting an improvement in the quality of health services.

<b>Key Issues &amp; Constraints</b>	<b>Policy &amp; Institutional Focus</b>	<b>Interventions of Asian Development Bank</b>	<b>Performance Criteria</b>
Tradition of providing free health care for all	Possible policy options for cost recovery	Technical assistance, policy dialogue and policy-based lending	Cost recovery measures and sustainable health financing policy approved
Institutional weaknesses in health system management Widely scattered population	Institutional strengthening Managing the Health Trust Fund	“	Revised management system in place, and sustainable Fund in place
Poor quality of health care in some areas of the country	Allocating cost savings to improve quality of care	“	Measures in place

## GENDER ISSUES IN BHUTAN

1. Gender issues in Bhutan are unique in the whole of South Asia. Most observers agree that overt discrimination is relatively rare, that gender disparities are comparatively narrow, and that women's status equals men's in numerous aspects. Despite this relatively positive picture, however, some inequities remain. Changes in the gender balance have occurred as a result of Bhutan's transition from a traditional, rural-based economy to one that is more modern and increasingly urban. Therefore, the goal of the Asian Development Bank's (ADB's) gender strategy for Bhutan is to ensure that the fruits of economic growth and modernization are spread equally between women and men. In particular, efforts must be made to diversify women's employment, to reduce female adult illiteracy, and to sustain improvements in women's health, especially regarding maternal mortality.
2. As the Bhutanese economy continues to modernize, and with the new and increasing emphasis on the private sector, one of the major sources for women's empowerment will be access to diverse and well-paying employment opportunities. Understandably, in such a rural country, the majority of employed women continue to work in agriculture. However, many opportunities, as yet unexplored, may exist for them in the private sector in areas such as trading, agro-industry, and tourism. Already, the anecdotal evidence indicates strong interest by Bhutanese women in nontraditional occupations such as trading and other types of self-employment as well as in engineering and other technical and vocational fields. This interest must be fostered and encouraged.
3. ADB's gender strategy for Bhutan will focus on three main areas:
  - (i) General focus on gender issues in ADB's programs for Bhutan. The most realistic approach for ADB's gender strategy is to pay special attention to gender considerations in each of its loans to Bhutan. Some areas requiring attention are likely to be the provision of economic opportunities for women and improvement of health and education. Generally, project designs need to pay close attention to the constraints that limit women's full participation in ADB projects. This is a particularly important issue when dealing with poor women because their multiple roles frequently do not allow them to become fully involved in projects and programs that benefit them.
  - (ii) Activities focused on poor women. In Bhutan, the most burdened women are those who live in low-income households in the poorest districts of the country. Strategies to help them are obviously linked to those already identified for the poor. However, particular emphasis will have to be given to the special needs of these women. Women who are illiterate and who do not speak the national language are often cut out of economic activities such as trading. They are a particularly vulnerable group.
  - (iii) Promote new knowledge on gender in Bhutan. Very little information or data exist on women in Bhutan, from an either economic or sociological perspective. ADB will identify and explore the possibilities to further support gender research in areas such as gender-disaggregated data, the gap between rural and urban women, and violence against women.

## POVERTY IN BHUTAN

1. Poverty in Bhutan does not take on the characteristics commonly found in other South Asian countries such as Nepal or northern India and Pakistan. While pockets of extreme poverty appear to exist in some remote areas, the liberal and generous social policies of the Government of Bhutan have helped to ensure that the population, as it modernizes, has had wide and equitable access to social services. This concept, known as Gross National Happiness in Bhutan, has been a factor in ensuring that poverty rates do not significantly grow or deepen as the country develops.

2. However, the shift from a traditional, rural-based society to a modern one, especially with the new emphasis on the development of Bhutan's private sector, has created some inequities. To its credit, the Government has recognized this problem in the document *Bhutan 2020: A Vision for Peace, Prosperity and Happiness*, where it states that "Although reliable data are not available, evidence suggests that income disparities appear to be on the increase." Clearly, a more targeted approach may be required to ensure that income distribution remains equitable at the same time that the economy is liberalized and the growth of the private sector is being promoted. The preparation for the introduction of an income tax is the one of the Government's policy initiatives in this regard. The formulation of a growth center strategy that emphasizes the development of areas outside of Thimphu will assist in stemming the rapid tide of urbanization. The Government is also making a strong effort to reduce population growth, in recognition of the importance of the relationship between the number of people who will have to compete for Bhutan's scarce land resources in the future.

3. In view of these policy priorities, the Asian Development Bank (ADB) will support poverty reduction in its strategy for Bhutan in the following manner:

- (i) Support poverty analysis in ADB's Program. ADB will take account of the poverty impact of all its activities in Bhutan and provide support to mitigate negative impacts, where applicable. This is particularly important in the promotion of private sector development, improving social and physical infrastructure, and protecting the environment.
- (ii) Establish a poverty reduction partnership agreement with the Government. There is a dearth of data on poverty in Bhutan. Basic statistics such as poverty lines based on income, consumption, or caloric data are not available. The availability of such databases will considerably strengthen both ADB's and the Government's future interventions. ADB will undertake poverty assessment jointly with the Government to establish a poverty profile as a benchmark in formulating, monitoring, and evaluating future interventions for reducing poverty.
- (iii) Promote new knowledge on poverty in Bhutan. Very little quantitative or qualitative research has been carried out on the multi-dimensional aspects of poverty in Bhutan. The positive impact of the free and relatively widespread availability of essential social services such as health and education is assumed but has not been empirically tested or quantified. Similarly, the relationship between Bhutan's amazing biodiversity and pristine environment and the role of traditional practices by the rural poor has not been sufficiently studied. The possibility for promoting this type of operational research will be actively pursued.