PRIVATE SECTOR ASSESSMENT (SUMMARY)\(^1\)

A. Overview

1. Bhutan has made remarkable progress in promoting socioeconomic development by unlocking its hydropower potential. Its fast economic growth has been driven largely by investment associated with hydropower development. However, to sustain high economic growth and make the growth more inclusive, Bhutan needs to broaden its economic base by facilitating private sector development as an engine of growth.

2. While the private sector remains small and underdeveloped, a 2010 World Bank investment climate assessment (ICA) report indicated that the sector outlook was brightening (footnote 1). According to the ICA, the median Bhutanese firm reported increases of 36% in sales and 25% in employment during 2006–2008, while large firms of 100 workers or more reported greater increases in both sales and employment (41% and 104%, respectively). The ICA report also found that about 24% of enterprises surveyed were under 5 years old. One-quarter of these newly established firms were large, employing 100 workers or more. More than one-half of new enterprises were in the manufacturing sector, while older firms were more likely to be in the construction and trade sectors. The ICA found that the tourism, transport, and information and communication technology (ICT) sectors were dominated by new firms.

B. Critical Constraints to Private Sector Development

3. To accelerate private sector development and allow the private sector to play a more pivotal role in the economy, Bhutan needs to create an enabling environment for private investment. Bhutan’s overall rank in the World Bank’s annual ease of doing business assessment deteriorated from 126th of 183 countries in 2009 to 148th of 185 in 2012.\(^2\) While it moved up slightly to 141th of 189 in 2013, its ranking remains the lowest in South Asia.\(^3\) Key impediments to private sector development include (i) limited access to finance; (ii) inadequate infrastructure, particularly in transport; and (iii) limited access to workers with necessary skills and a mismatch between the demand and supply of skills in the labor market.

4. Lack of access to finance. A 2013 diagnostic report on Bhutan’s critical development constraints noted that access to and the cost of finance continue to be key obstacles to private investment, especially for micro, small, and medium-sized enterprises (MSMEs) (footnote 1). Despite the country’s higher levels of financial outreach in terms of the ratio of firms that have loans and bank accounts when compared with other countries in the region, firms in Bhutan tend to perceive access to finance as a major constraint. Of the small and medium-sized firms covered by the ICA, 30% reported that access to finance was a major obstacle. The firms in the trade sector considered this their biggest obstacle. One reason is the relatively high cost of finance. Local banks do not have diversified sources of funding and tend to rely heavily on

---


deposits, which raises their costs of funds. Meanwhile, when international banks consider providing finance to Bhutan, a lack of adequate currency hedging becomes a key concern.

5. Firms with a negative perception of credit accessibility also complain about collateral requirements and complex loan procedures that lack transparency. The complex processing and the collateral requirements are partly a reflection of financier concern about the enforceability of security interests. Although a framework is in place for regulating insolvency, its effectiveness in practice is questionable—Bhutan had the worst ranking for resolving insolvency of all 189 countries in the World Bank’s 2013 Doing Business report. Because a credible insolvency regime gives comfort to creditors by allowing speedy recovery in case of loan defaults, it can also reduce the burden of collateralization on would-be borrowers. Bhutan has, however, made at least some progress on the business credit front. The improvement in its overall ease of doing business ranking in 2013 was partly due to improvements in access to credit. It has improved access to credit information through new regulations governing the licensing and functioning of the credit bureau and by guaranteeing the right of borrowers to access their data.

6. **Inadequate infrastructure.** Bhutan's mountainous terrain makes it difficult to provide adequate infrastructure throughout the country. The lack of infrastructure, especially transport infrastructure, is a constraint on economic opportunities. Landlocked Bhutan’s access to international markets is also complicated by the fact that goods have to go through neighboring countries, which increases transport costs and reduces the competitiveness of its exports. According to the ICA, 52% of exporters surveyed experienced losses due to ground transport difficulties. It is therefore not surprising that Bhutan ranked 172nd for the time and cost of trading across borders in the 2013 Doing Business report. According to the World Bank’s 2012 logistics performance index, Bhutan also ranked a relatively low 107th out of 155 countries for overall logistics performance and 117th for the quality of trade and transport-related infrastructure.4

7. **Inadequately skilled labor force.** The ICA notes that labor costs are higher in Bhutan than in neighboring countries. This underlines the need for the country to raise productivity to remain competitive. For this to happen, an educated and skilled work force is a pre-requisite, something that is currently lacking. An inadequately skilled labor force is cited as a major constraint by businesses in Bhutan. The issue in Bhutan is less about overall education levels than the fact that the education and skills that would-be workers have do not match those demanded by the labor market. Educated young people comprise half of the unemployed in the country because they lack the skills, knowledge, or aptitudes required by employers. Firms in Bhutan often try to meet their labor requirements by recruiting foreign workers, mostly from India and Nepal. However, the ICA found that about one-fifth of the firms surveyed also indicated that difficulty in accessing foreign workers was a major or severe obstacle to their operations. They considered the required use of third-party agents licensed by the government to hire unskilled foreign workers to be costly and cumbersome.

8. It should be emphasized, however, that Bhutan also has outstanding advantages over other countries in South Asia for prospective private sector business. These include its political stability, good governance, low levels of corruption and crime, access to electricity, abundant natural resources, preferential access to India’s large market, and access to skilled and unskilled labor in India.

---

C. Government Sector Strategy

9. Private sector development has long been a key government agenda for promoting economic diversification and enhancing self-reliance. Under the seventh five-year plan for 1992–1997, a large number of state corporations were privatized. The government also implemented technical assistance programs for the private sector, simplified the rules and regulations for imports and exports, and liberalized the licensing system to encourage and promote private sector development. The eighth plan (1998–2003) aimed to enhance human resource development by expanding and improving education and technical training. Private sector development was further emphasized in the ninth five-year plan, 2003–2008, which promoted private sector growth and employment generation as one of its five overall goals. One of the strategic priorities in the tenth plan for 2008–2013 was to vitalize the economy through increased investment in hydropower, tourism, manufacturing, and ICT.

10. The objective of the 11th five-year plan for 2013–2018 is “self-reliance and inclusive green socioeconomic development.” One of its three strategic thrusts is on accelerated green economic development. The plan emphasizes achieving economic diversification through a focus on the development of sectors other than hydropower and on fostering the growth of a dynamic private sector that catalyzes a transition to a green economy. The Rapid Investment in Selected Enterprises Program is going to be the flagship program for accelerating economic growth and reaching the plan’s objective of self-reliance. The program will form the cornerstone of the government’s diversification strategy and aim to develop non-hydropower sectors such as tourism, agro-processing, construction, small and cottage industries (including cultural industries), and manufacturing.

11. To create an enabling environment for businesses, one of the key steps Bhutan took was the launch of its Economic Development Policy in 2010. This seeks to enhance the productivity of the economy and provide a strategic direction for economic development up to 2020. Its vision is a green, self-reliant economy that is sustained by a knowledge-based society enabled by information technology, and its objectives are to achieve economic self-reliance and full employment by 2020. The strategies to achieve these goals include (i) diversifying the economic base, while leaving a minimal ecological footprint, (ii) harnessing and adding value to natural resources in a sustainable manner, (iii) increasing and diversifying exports, (iv) promoting Bhutan as an “organic brand”, (v) promoting industries that build the Brand Bhutan image, and (vi) reducing dependency on fossil fuel in the transport sector.

12. To help implement the Economic Development Policy 2010, the government has formulated new laws and policies since 2010. The most important was a revision in 2010 of the Foreign Direct Investment (FDI) Policy of 2002. Since the revision, 18 FDI projects have been approved, compared with 19 projects in a span of nine years under the original policy. FDI has been concentrated in the hotel, mineral, and metal-based industries; agribusiness and dairy products; and ICT. Other important policies recently approved include the Cottage, Small, and Medium Industry Policy in 2012 and the Alternative Renewable Energy Policy in 2013. A mineral development policy, a telecommunications and broadband policy, and a business licensing policy have been drafted and are to be approved for implementation under the 11th five-year plan. In addition, other new laws and policies that were proposed in the Economic

---

Development Policy 2010, such as a consumer protection act, a competition policy, a trade development act, investment law, and an amendment of the Companies Act 2000, are also to be implemented during the 11th plan period (2013–2018).

13. To complement these efforts, the plan emphasizes the development of key infrastructure. It calls for expediting the establishment of industrial estates and dry ports and the completion of the logistically important southern east–west highway during the plan period.

D. ADB’s Sector Experience and Assistance

14. Under ADB’s country partnership strategy (CPS) for 2006–2010 and the interim CPS for 2012–2013, finance and private sector development was one of four key areas of assistance. To build on comprehensive support provided to Bhutan’s financial sector since 1988, ADB approved the Financial Sector Development Program in 2006 to strengthen the governance of the financial system as a whole and improve financial efficiency. A follow-on initiative to further encourage private sector growth by supporting the expansion and growth of the MSME sector was approved in 2007. This program was aimed at (i) establishing an integrated policy, strategy, and institutional framework for MSME development; (ii) enhancing business laws and regulations to facilitate MSME operations; (iii) increasing access to market-based finance; and (iv) strengthening business support infrastructure.

15. ADB’s Trade Finance Program (TFP) has also been active in Bhutan since 2010. The TFP fills market gaps in trade finance by providing guarantees and loans through more than 200 banks to support trade. It has supported more than $16 billion in trade, involving more than 4,000 small and medium-sized enterprises. In Bhutan, the TFP works with three banks and has supported $5.1 million in trade through three transactions. In addition to filling market gaps, the TFP’s objective is to mobilize private sector capital and/or involvement in ADB’s developing member countries. In Bhutan, more than one-half of all the trade supported through the TFP was cofinanced by the private sector.

16. Under the new CPS for 2014–2018, greater emphasis will be put on private sector development and public–private partnerships. To help address the key constraints to private sector development, ADB will continue helping to foster a business-enabling environment through assistance for (i) financial sector development, (ii) the development of strategic infrastructure (such as dry ports and the southern east–west highway) and urban infrastructure, (iii) the improvement of trade facilitation to enhance cross-border connectivity and trade, and (iv) skills development to help address the issue of the skills mismatch in the labor market. ADB will pursue public–private partnerships in sectors with potential, such as energy, as well as opportunities for providing transaction advisory services.

---

8 ADB. 2006. Report and Recommendation of the President to the Board of Directors: Proposed Loans and Technical Assistance Grant to the Kingdom of Bhutan for the Financial Sector Development Program. Manila.
9 ADB. 2007. Report and Recommendation of the President to the Board of Directors: Proposed Grant to the Kingdom of Bhutan for the Micro, Small, and Medium-Sized Enterprise Sector Development Program. Manila.