



# Technical Assistance Consultant's Report

---

Project Number: 37166  
March 2007

## Kingdom of Bhutan: Small and Medium Enterprise Development (Financed by the Government of Denmark)

Prepared by GFA Consulting Group GmbH

For Ministry of Trade and Industry  
Government of Bhutan

This consultant's report does not necessarily reflect the views of ADB or the Government concerned, and ADB and the Government cannot be held liable for its contents. (For project preparatory technical assistance: All the views expressed herein may not be incorporated into the proposed project's design.

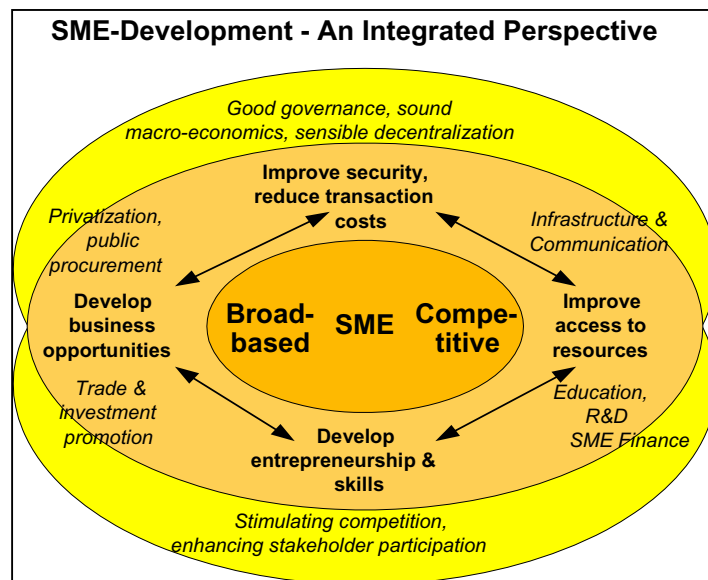
Asian Development Bank



## BHUTAN

TA No. 4412-BHU

### SME Development Final Report



Presented to:

Government of Bhutan  
and  
Asian Development Bank

March 2007

**CURRENCY EQUIVALENTS**

(as of March 2006)

Currency Unit

Nu. 1.00= US\$ 0.02227

US\$ 1.00 = Nu. 44

**ABBREVIATIONS**

|        |   |  |
|--------|---|--|
| ABTO   | - | Association of Bhutanese Tour Operators                        |
| ADB    | - | Asian Development Bank   |
| BAFRA  | - | Bhutan Agriculture and Food Regulatory Authority               |
| BCCI   | - | Bhutan Chamber of Commerce and Industry                        |
| BE     | - | Business Environment   |
| BEPC   | - | Bhutan Export Promotion Centre                                 |
| BDFC   | - | Bhutan Development Finance Corporation                         |
| BDS    | - | Business Development Services                                  |
| BDS-P  | - | Business Development Services Providers                        |
| BNB    | - | Bhutan National Bank   |
| BOB    | - | Bank of Bhutan   |
| BOT    |   | Board of Trustees  |
| BPS    | - | Business Promotion Section                                     |
| BVQA   | - | Bhutan Vocational Qualification Authority                      |
| CEFE   | - | Competency-based Economies through the Formation of Enterprise |
| CIB    | - | Credit Information Bureau                                      |
| CSF    |   | Cost Sharing Facility  |
| Danida | - | Danish International Development Agency                        |
| DoI    | - | Department of Industry   |
| EBE    | - | Enabling Business Environment                                  |
| EC     | - | Environmental Clearance  |
| EPC    | - | Entrepreneurship Promotion Centre                              |
| EDP    | - | Entrepreneurs Development Program                              |
| FDI    | - | Foreign Direct Investment                                      |
| FI     | - | Financial Institutions   |
| FYP    | - | Five Year Plan   |
| GDP    | - | Gross Domestic Product   |
| GNI    | - | Gross National per capita Income                               |
| GNH    | - | Gross National Happiness                                       |
| GTZ    | - | German Cooperation for Technical Assistance                    |

|       |   |   |
|-------|---|---|
| HRD   | - | Human Resource Development                      |
| IFAD  | - | International Fund for Agricultural Development |
| ILO   | - | International Labor Organization                |
| KFAED | - | Kuwait Fund for Arab Economic Development       |
| LED   | - | Local Economic Development                      |
| MSME  | - | Micro, Small and Medium Sized Enterprise        |
| MoA   | - | Ministry of Agriculture                         |
| MoF   | - | Ministry of Finance                             |
| MoLHR | - | Ministry of Labor and Human Resources           |
| MoU   | - | Memorandum of Understanding                     |
| MSE   | - | Medium-sized enterprises                        |
| MTI   | - | Ministry of Trade and Industry                  |
| MU    | - | Management Unit                                 |
| NBFI  | - | Non-Bank Financial Institution                  |
| NEC   | - | National Environment Commission                 |
| NGO   | - | Non-Government Organization                     |
| NPPFB | - | National Pension and Provident Fund Bureau      |
| Nu.   | - | Ngultrum  |
| OSS   | - | One-Stop Shop                                   |
| PPD   | - | Policy Planning Division                        |
| PPTA  | - | Project Preparatory Technical Assistance        |
| PMU   | - | Project Management Unit                         |
| PSDC  | - | Private Sector Development Committee            |
| PTL   | - | Project Team Leader                             |
| RED   | - | Rural Enterprise Development                    |
| REGS  | - | Rural Enterprise Grant Scheme                   |
| REMS  | - | Rural Enterprise Model Strategy                 |
| RgoB  | - | Royal Government of Bhutan                      |
| RIA   | - | Regulatory Impact Assessment                    |
| RIM   | - | Royal Institute of Management                   |
| RICB  | - | Royal Insurance Corporation of Bhutan           |
| RMA   | - | Royal Monetary Authority                        |
| RRCO  | - | Regional Revenues and Customs Offices           |

|      |   |  |
|------|---|--|
| RTIO | - | Regional Trade and Industry Office         |
| SBRC | - | Small Business Resource Centre             |
| SDC  | - | Swiss Development Cooperation              |
| SEDF | - | South Asia Enterprise Development Facility |
| SME  | - | Small and Medium Sized Enterprise          |
| SNV  | - | Netherlands Development Organization       |
| TA   | - | Technical Assistance                       |
| ToT  | - | Training of Trainers                       |
| ToR  | - | Terms of Reference                         |
| UNCF | - | United Nations Capital Fund                |
| UNDP | - | United Nations Development Program         |
| US\$ | - | United States Dollar                       |
| WB   | - | World Bank                                 |
| WG   | - | Working Group                              |
| WTO  | - | World Trade Organization                   |

**NOTE**

In this report, "\$" refers to dollars.

## C O N T E N T S

|  |           |
|--|-----------|
| <b>EXECUTIVE SUMMARY</b>   | <b>I</b>  |
| <b>1 THE PROPOSAL</b>  | <b>1</b>  |
| <b>2 THE MACROECONOMIC CONTEXT</b>   | <b>1</b>  |
| <b>3 THE SECTOR</b>  | <b>3</b>  |
| <b>3.1 Sector Description and Analysis</b>   | <b>3</b>  |
| <b>3.2 Issues and Opportunities</b>  | <b>5</b>  |
| 3.2.1 Government Objectives and Strategy   | 5         |
| 3.2.2 Key Issues   | 6         |
| 3.2.3 External Assistance to the Sector  | 9         |
| 3.2.4 Lessons Learnt   | 11        |
| <b>4 THE PROPOSED PROGRAM</b>  | <b>11</b> |
| <b>4.1 Objectives and Scope</b>  | <b>12</b> |
| <b>4.2 Policy Framework and Actions</b>  | <b>12</b> |
| 4.2.1 Developing an Institutional Framework for MSME Program Formulation and Implementation                          | 13        |
| 4.2.2 Enhance Public Governance and Business Regulations   | 13        |
| 4.2.3 Improving Access to Market Based Finance   | 17        |
| 4.2.4 Enhanced Competitiveness of Bhutanese MSMEs through Improved Access to Qualified Business Development Services | 19        |
| <b>4.3 Capacity Building Technical Assistance</b>  | <b>22</b> |
| <b>4.4 Important Features</b>  | <b>22</b> |
| <b>4.5 Additional Recommendations</b>  | <b>23</b> |
| 4.5.1 Central Registry   | 23        |
| 4.5.2 Standards, Metrology, Testing and Quality  | 23        |
| <b>4.6 Financing Plan</b>  | <b>24</b> |
| <b>4.7 Proposed Implementation Arrangements</b>  | <b>25</b> |
| 4.7.1 Period of Implementation   | 25        |
| 4.7.2 Proposed Program Management Structure  | 25        |
| <b>5 PROGRAM BENEFITS, IMPACTS, AND RISKS</b>  | <b>26</b> |
| <b>5.1 A. Benefits and Impact</b>  | <b>26</b> |
| <b>5.2 Risks and Safeguards</b>  | <b>27</b> |

### Appendixes

1. Program Framework
2. MSME Survey Report
3. Official Classification of Enterprises
4. Business Plan: Cost Sharing Facility
5. Institutional Assessment BDFC
6. Development Coordination Matrix
7. Action Plan
8. Minutes of 2<sup>nd</sup> Tripartite Meeting
9. Summary Poverty Reduction and Social Strategy
10. TOR for Proposed Institutional Capacity Building Technical Assistance
11. Staff Requirement for MSME Program Formulation and Implementation
12. Credit Line Design

## EXECUTIVE SUMMARY

### **The Program Rationale**

Economic activity in Bhutan is dominated by micro/cottage, small and a few medium sized enterprises (MSMEs), which are seen as the engine of urgently needed labor-intensive and broad-based economic growth. The proposed program is to lay foundation for MSME development and the elimination of structural barriers to enterprise development. Extensive consultations with stakeholders from Government and the private sector in form of structured interviews, participatory stakeholder workshops and an MSME survey have led to the identification of the major problems impinging on enterprise development in Bhutan; these are addressed in the Program.

Although the Royal Government of Bhutan (RGoB) in its current 5-year plan (2002-2007) gives high priority to the development of a national industrialization policy and, as part of this policy, the promotion of MSMEs, significant legal, regulatory and institutional reforms are needed to boost the development of the small and vulnerable MSME sector. First, market entrance is complicated by complex and overloaded formalization procedures. Second, business laws and regulations are not based on stakeholder consultations, insufficiently formulated and partly not implementable. Third, the financial sector lacks a competent institution dedicated to MSMEs and endowed with respective sustainable funds for MSME growth. And finally Business Development Services (BDS) are supply driven and existing BDS government programs lack innovation and do not trigger MSME development in rural areas.

Elimination of structural barriers to MSME development is widely considered a priority. The main issues for the program were chosen on the basis of (i) importance for the establishment of new enterprises in particular in rural areas, (ii) significance for increasing competitiveness of existing MSMEs, (iii) Government commitment to reform in line with discussions of two tripartite meetings, (iii) ADB's past and ongoing operations, and (iv) complementarities with other development activities.

### **Objective and Scope**

The objective of the MSME Development Program is to support the Government's efforts to eliminate structural barriers to (i) the creation of new businesses, and (ii) the growth of existing MSMEs. In Bhutan, MSME development is regarded as a vehicle to promote a more even distribution of wealth, both socially and regionally, and to reduce poverty. It shall specifically contribute to a reduction of migration from rural to urban areas and is promoted countrywide. To achieve the aforementioned objective, the program loan focuses on the following:

- (i) developing the institutional framework for MSME program formulation and implementation: (i) strengthen the role of the Private Sector Development Committee (PSDC) giving it a particular role in initiating and monitoring of MSME policy formulation and implementation, and (ii) strengthening the role of MTI - in particular Department of Industry (DoI), Regional Trade and Industry Offices (RTIOs) and Policy Planning Division (PPD) - to generate relevant information from



statistical data, field surveys and implementation of MSME development activities to support PSDC.

- (ii) enhancing public governance and business regulations: (i) improvement of business laws and regulations by introduction and institutionalization of Regulatory Impact Assessment (RIA), (ii) simplification & acceleration of business formation by streamlining the business formalization process, and (iii) increasing accountability and administrative efficiency of RTIOs by the introduction of benchmarked one-stop shops (OSS).
- (iii) improving MSEs' access to formal sources of finance: (i) implementation of an MSE credit line to meet the gap of funds available to MSEs, and (ii) institutional strengthening and capacity building support to Bhutan Development Financial Corporation (BDFC) to enable it to effectively intermediate financing to MSEs.
- (iv) enhancing competitiveness of Bhutanese MSMEs through improved access to qualified BDS: (i) establishment of a cost sharing facility, (ii) access to know-how and information for rural areas through dissemination of business related issues by TV & radio, and (iii) government driven facilitation of innovative BDS in particular cluster and value chain development.

The Program framework is attached in Appendix 1. The Program will be implemented over a period of 36 months.

### **Implementation Arrangements**

PSDC shall coordinate MSME Development Program implementation with other Government ministries and agencies wherever necessary. PSDC, chaired by the minister of MTI, comprises senior officers from all related Government agencies<sup>1</sup>. PSDC will meet at least four times yearly to review among others pending issues regarding the implementation of the MSME Development Program and propose actions for their resolution. Over time, private sector participation in PSDC, which is currently below 40%, will gradually be increased.

### **Risks and Assumptions**

Successful implementation of the Program entails three risks. The first relates to a lack of capacity within the Government to implement the investment package foreseen under the Program and the complex legal and regulatory reforms. So far RGoB has no or very little experience with the formulation and implementation of MSME programs and policies and lacks most of the urgently needed technical expertise. To address this risk, a capacity building component has been designed to support Program implementation, and engage in capacity building measures in particular for RGoB officials.

---

<sup>1</sup> The number of members of the newly revitalized PSDC has been reduced from 26 to 12 members. Members are the Honorable Minister of MTI, Secretaries of the MoF, Ministry of Works and Human Settlement, MoA, MTI, MoLHR, Ministry of Information & Communications, Director General, Department of Industry, MTI, functioning as the member secretary, Executive Head of the Bhutan CCI, and one private sector representative each representing the wood-based industries, the general manufacturing sector and the cement manufacturing sector.

A second risk relates to lack of coordination among various Government agencies. The Program requires close coordination among the relevant authorities. Consultation and coordination will also be required with other donors active in MSME development and the private sector. The Program design addresses this risk by strengthening the newly revitalized PSDC, its secretariat the DoI/MTI and PPD/MTI, both supposed to support PSDC in directing the Bhutanese MSME Development Program.

The third risk relates to the role of BDFC as the major financial institution in sustainable MSE finance in rural and urban areas. BDFC has diverted from its original development banking mandate, which hampers the institution from performing efficiently. The absence of a clear strategy and business plan, deficiencies in corporate governance, inadequate policies and procedures as well as a weak human resource base imperil the effective channeling of funds. The Program addresses these risks by providing TA to BDFC in order to make BDFC a sustainable financial institution with MSEs as target clients.

## 1 THE PROPOSAL

1. The following report provides recommendations on a proposed loan to the Royal Government of Bhutan for the implementation of a Micro, Small and Medium Enterprise (MSME) Sector Development Program (the Program). The program<sup>2</sup> framework is presented in Appendix 1.

## 2 THE MACROECONOMIC CONTEXT

2. **GDP Growth:** Bhutan is a small country with a population of around 650,000<sup>3</sup> inhabitants and a small work force that amounted to 257,000 people in 2005. Even though a stable macroeconomic environment, generous levels of foreign assistance and a thoughtful development policy implemented by the government have contributed to sustainable high annual GDP growth since the opening of the country to the outside world in the 1960s, the country still ranges among the world's smallest and least developed economies. Current real GDP growth rates, averaging around 7.2% p.a. (2000 to 2005), rely mostly on capital-intensive investments (hydropower, cement, building materials, etc.) and commodity exports (electricity) and have not sufficiently contributed to a broad economic development and an equal distribution of welfare.

3. **Sector Shares:** Coming from an economy entirely based on subsistence agriculture, the share of the agriculture sector - still consisting predominantly of subsistence farming and animal husbandry - declined from over 50% of GDP in 1980 to 22% in 2005, while the share of the industrial sector increased significantly from 15% to 36% of GDP during the same period. However, contribution of agriculture to employment is still high with over 42% of Bhutan's total work force, while the contribution of industry and services is only 23%. This gives concerns of hidden unemployment and low productivity in the agricultural sector that are still the main livelihood for Bhutan's population.

4. **Economic development** has been steered by the Government in phases. It started with the development of the energy sub-sector during the late 1980s - producing erratic sector growth rates whenever a power plant started its operation - and was followed by the development of the construction sector during the late 1990s until today. Industrial sector growth rates show that energy and construction are still the engines of growth, while manufacturing has played a less predominant role in particular during the most recent years of industrial development.

5. **Employment:** Due to heavy reliance on raw material imports from India, the promotion of capital-intensive industrial sectors and a high percentage of low-cost Indian workers employed in the booming construction sector, the impact of the quickly expanding industrial sector on employment in particular in rural Bhutan has been limited. Against this background and The World Bank estimates<sup>4</sup> indicating that between 2005 and 2010 approximately 65,000 persons will enter the labor market, the development of more labor-intensive domestic resource-based businesses is needed to effectively cope with anticipated unemployment problems. Labor-intensive businesses can be found in manufacturing, tourism and services (see Table 1).

---

<sup>2</sup> The Program components target the group of MSMEs as a whole, not individually. Some components, such as the proposed BDFC credit line, are targeted at the group of micro and small enterprises (MSEs) only, and others, such as the CSF, are targeted at industrial establishments and exclude trade establishments.

<sup>3</sup> 2005 population census figures are inconsistent with figures of previous years. Previous years figures show a population size of 750,000.

<sup>4</sup> WB, Bhutan Private Sector Survey 2002.

**Table 1: Bhutanese Labor Employed per Nu. 1 Million Output**

| Sector      | Agriculture | Manufacturing | Energy | Construction | Mining | Trade | Tourism | Transport | Services |
|-------------|-------------|---------------|--------|--------------|--------|-------|---------|-----------|----------|
| Coefficient | 17.9        | 5.9           | 0.3    | 1.2          | 0.2    | 2.1   | 6.3     | 0.9       | 8.5      |

Source: Own Calculation based on employment figures from Bhutan Labor Force Survey 2004

**6. Trade Balance:** Aforementioned sector policies have also affected the trade balance that showed a significant increase in the trade deficit between 1998 and 2004 from US\$ 25 million to US\$ 127 million. Imports - in particular raw materials from India – went up, while exports only increased significantly starting from 2003. Surprisingly, this development did not lead to a reduction of foreign currency reserves. On the contrary, foreign currency and especially hard currency reserves increased significantly due to an increased level of foreign assistance. In 2005, foreign currency reserves reached US\$ 512 million and thus a level 1.3 times as high as the annual amount spent on imports.

**7. Exchange Rate:** The value of the Bhutanese Ngultrum is fixed 1:1 to the Indian Rupee and it is possible to pay in either one of the two currencies in Bhutan. Under this regime - the Indian Rupee is not freely convertible - the Ngultrum has almost been stable at a rate of Ngultrum/US\$ 45 during the late 90s until today. This development poses a severe constraint to foreign hard currency earnings since export products such as tourism with a high share of local costs - in particular wages and transportation - have become less competitive over time.

**Table 2: Basic Economic Indicators**

| Item                           | 1998    | 1999    | 2000    | 2001    | 2002    | 2003    | 2004    | 2005    |
|--------------------------------|---------|---------|---------|---------|---------|---------|---------|---------|
| Population*                    | 637,777 | 657,550 | 677,934 | 698,950 | 716,424 | 734,340 | 752,700 | 634.982 |
| GDP per Capita (US\$)          | 586     | 635     | 679     | 708     | 762     | 829     | 969     | 1.313   |
| Real GDP Growth (%)**          | 5.5     | 7.7     | 5.6     | 7.5     | 8.9     | 7.1     | 7.5     | 6.9     |
| Agriculture (%)                | 32.2    | 29.7    | 27.7    | 26.4    | 26.7    | 25.8    | 24.7    | 22.4    |
| Industry (%)                   | 32.4    | 35.1    | 34.3    | 36.9    | 37.3    | 37.0    | 36.4    | 35.9    |
| Service (%)                    | 35.4    | 35.2    | 38.0    | 36.7    | 36.0    | 37.2    | 38.9    | 41.7    |
| Unemployment (%)               | 1.4     | n.a     | n.a     | 1.9     | n.a     | 1.8     | 2.5     | 3.1     |
| Consumer Prices (%)            | 5.8     | 2.2     | 3.6     | 2.7     | 1.8     | 4.6     | 5.5     | 5.3     |
| Exchange Rate (Nu per US\$)    | 43      | 44      | 44      | 46      | 48      | 48      | 45      | 44      |
| Export (US\$ mln)              | 105     | 114     | 106     | 108     | 112     | 149     | 183     | 257     |
| Import (US\$ mln)              | 129     | 180     | 180     | 194     | 188     | 232     | 411     | 384     |
| Balance of Trade (US\$ mln)    | -25     | -65     | -75     | -86     | -76     | -83     | -221    | -127    |
| Rupees Reserves (US\$ mln)     | 71      | 73      | 82      | 79      | 69      | 91      | 77      | 105     |
| Conv. Cur. Reserves (US\$ mln) | 196     | 222     | 217     | 241     | 302     | 287     | 284     | 407     |
| Total Reserves (US\$ mln)      | 266     | 294     | 299     | 319     | 371     | 378     | 361     | 512     |
| Public Revenues (US\$ mln)     | 151     | 180     | 192     | 190     | 146     | 202     | 230     | 306     |
| Tax Revenues (US\$)            | 34      | 46      | 50      | 58      | 61      | 70      | 74      | n.a     |
| Public Expenditures (US\$ mln) | 158     | 173     | 246     | 217     | 206     | 260     | 344     | 361     |
| Budget Surplus(+)/Deficit(-)   | -7      | -18     | -53     | -26     | -60     | -47     | -78     | -56     |
| Outstanding Ext. Debt/GDP (%)  | n.a     | n.a     | 56.3    | 62.9    | 77.8    | 86.6    | 85.8    | 81.7    |
| Labor Force ***                | n.a     | n.a     | n.a     | 232,220 | n.a     | 225,800 | 215,500 | 257.000 |
| Agriculture ***                | n.a     | n.a     | n.a     | 105,796 | n.a     | 167,200 | 132,800 | 108.600 |
| Private Sector ***             | n.a     | n.a     | n.a     | 74,895  | n.a     | 20,100  | 42,200  | 59.600  |
| Public Sector ***              | n.a     | n.a     | n.a     | 28,455  | n.a     | 26,200  | 32,000  | 37.100  |

\* 2005 population figure is based on the latest population census and inconsistent with previous figures.

\*\* GDP at factor cost in 2000 prices.

\*\*\* Consultants' estimates based on figures from statistical yearbooks and labor market surveys. In 2005 almost 50,000 people were not allocated to a specific sector.

**8. Inflation:** Because of the high integration of the small Bhutanese economy into the large Indian market, inflation rate development in the two countries correlate closely. Therefore, declining inflation rates in India combined with high interest rates for loans claimed by Bhutanese financial institutions, keeping inflation of non-tradables in balance with tradables,

have kept inflation low in Bhutan. Most recently, inflation has started to increase accompanied by an increasing demand for housing loans and a rapid increase in demand for imported goods.

9. **Public Finance:** Even though revenue generation has been successful since the late 90s, the Bhutanese budget deficit has considerably increased from a balanced budget to a US\$ 56 million deficit in 2005. An uncritical figure, as in the past capital expenditures always exceeded by far the budget deficit. In 2005, Bhutan's total external public debt reached a high level of 82% of GDP. Since the bulk of the debt is due to investments in highly profitable hydropower projects or long-term low interest government loans, there are no major concerns about this development.

10. **Outlook:** In general, macroeconomic prospects are good, but predominantly based on good future prospect for additional energy exports and higher energy prices. The labor market is sluggish, as the absorption of new entrants requires broad-based growth and a more diversified economy. This, in turn, will only materialize if RGoB is able to promote growth of small labor-intensive businesses. The high integration into the Indian market remains burdensome especially for the Bhutanese export industry as long as the Indian Rupee will not become fully convertible as a result of World Trade Organization (WTO) accession.

### 3 THE SECTOR

#### 3.1 Sector Description and Analysis

11. Besides an analysis of available statistical data, a MSME survey was conducted to identify the major challenges for MSME development in Bhutan. Interviews were held with 39 owners or managers of micro, small and medium enterprises in most of the ten districts shown in Table 4. The results of the MSME market survey that were intensively discussed with Government agencies and private stakeholders are attached in Appendix 2.

12. The private sector of Bhutan is categorized into large, medium, small and micro/cottage industries. Categories are based on initial capital investment (see Appendix 3) which, by definition, consists, of paid-in capital and long-term credit. Each business is registered under one of the above categories and has a business license, which has to be renewed annually. Official statistics refer to the number of licenses rather than to the number of operational businesses and thus do not reveal the true number of active businesses. It was thus required to process raw data available from the MTI. Results are summarized in the tables below.

13. The number of operational businesses refers to the total amount of business identification numbers in each category. Businesses with one identification number holding more than one license were accounted for as one operational business.

**Table 3: Number of Operational Businesses<sup>1</sup> 2006**

| Sector                 | Micro/Cottage | Small        | Medium     | Large      | Total         |
|------------------------|---------------|--------------|------------|------------|---------------|
| Manufacturing & Energy | 437           | 124          | 40         | 41         | 642           |
| Construction           | 1,205         | 215          | 31         | 43         | 1,494         |
| Services               | 5,584         | 871          | 22         | 21         | 6,498         |
| Trade                  | 6,451         | 1,448        | 129        | 151        | 8,189         |
| <b>Total</b>           | <b>13,677</b> | <b>2,658</b> | <b>222</b> | <b>256</b> | <b>16,823</b> |

1) The number of operational businesses refers to the total amount of business identification numbers in each category.  
 Source: Consultants' estimates based on figures from the Business License Register of the MTI 2006.

14. According to our estimates which are based on the license statistics of MTI, in 2006, there were only 16,823 operational business establishments in Bhutan with more than 98% belonging to the MSME enterprise segment, of which less than 1% are medium enterprises. The percentage of micro, small and medium enterprises per sector differs slightly. In services & trade, more than 99% of operational businesses are micro, small or medium. In construction and manufacturing & energy, the percentage comes down to 96%.

15. **Geographical Distribution:** The below table ranks the ten most important Bhutanese districts with respect to their business activities in manufacturing & energy, construction and services<sup>5</sup>.

**Table 4: Operational Businesses per District in % of Total**

| District | Thimphu | Chhuka | Paro | Sar-pang | Jong-khar | Trashi-gang | Wang-due | Mon-gar | Samtse | Bum-thang |
|----------|---------|--------|------|----------|-----------|-------------|----------|---------|--------|-----------|
| MSEs     | 38%     | 13%    | 6%   | 6%       | 5%        | 4%          | 4%       | 4%      | 4%     | 3%        |
| All      | 39%     | 14%    | 6%   | 6%       | 5%        | 4%          | 4%       | 4%      | 4%     | 3%        |

Source: Consultants' calculations based on figures from the Statistical Yearbook of Bhutan 2005.

16. It shows that most businesses are concentrated in the western part of Bhutan, namely in the districts of Thimphu, Paro and the bordering Wangdue Phodrang (48%). A significant number of businesses are concentrated at the foothills of the Himalayas along the Indian border in the districts of Chhuka, Samtse, Sarpang and Samdrup Jongkhar (29%). Finally there is some business development potential in the eastern central districts of Trashigang, Mongar and Bumthang along the central lateral road (12%). Potential in the remaining 10 districts appears low with the exemption of Haa district, where a significant number of wood processing industries are located (see Table 5 below).

**Table 5: Manufacturing Industries According to Sectors and Districts**

| Year           | Agro      | Forest     | Mineral   | Others     | Total      |
|----------------|-----------|------------|-----------|------------|------------|
| Thimphu        | 13        | 59         | 6         | 101        | 179        |
| Chukha         | 30        | 28         | 15        | 68         | 141        |
| Paro           | 3         | 43         | 6         | 8          | 60         |
| S. Jongkhar    | 10        | 14         | 2         | 8          | 34         |
| Samtse         | 7         | 4          | 11        | 10         | 32         |
| Sarpang        | 12        | 17         | 1         | 7          | 37         |
| Wangdue        | 2         | 9          | 2         | 2          | 15         |
| Haa            | 1         | 17         |           |            | 18         |
| Pemagatshel    | 2         | 6          | 8         |            | 16         |
| Punakha        | 1         | 2          |           |            | 3          |
| Tsirang        | 2         | 3          |           |            | 5          |
| Gasa           | 1         |            |           |            | 1          |
| Zhemgang       | 1         | 11         |           |            | 12         |
| Trongsa        | 2         | 5          |           |            | 7          |
| Bumthang       | 6         | 20         |           | 6          | 32         |
| Trashigang     | 2         | 14         |           | 5          | 21         |
| Trashi Yangtse | 1         | 9          |           |            | 10         |
| Mongar         | 2         | 10         | 2         | 2          | 16         |
| Lhuntse        | 1         | 1          | 1         |            | 3          |
| <b>Total</b>   | <b>99</b> | <b>272</b> | <b>54</b> | <b>217</b> | <b>642</b> |

Source: Consultants' estimates based on the Business License Register of the MTI 2006.

<sup>5</sup> Trade was excluded as official statistics do not show the number of trade establishments.

**17. Manufacturing Industries:** Most of the manufacturing enterprises are wood processing industries followed by “Others”, which includes handicrafts and textiles, third ranked are agro industries followed by mineral industries. Most of the manufacturing industries are located around Thimphu, Paro and Phuentsoling.

**18. Growth of the Private Sector:** The overall increase in the number of MSMEs is impressive. The MSME sector has grown substantially with 97.5% between 2000 and 2005 following the significant growth of industrial establishments.

**Table 6: Enterprise Development by Business Establishments\***

| Year          | 2000         | 2001         | 2002         | 2003         | 2004         | 2005         |
|---------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Micro/Cottage | 2,571        | 3,232        | 3,583        | 3,986        | 4,369        | 5,172        |
| Small         | 392          | 542          | 572          | 638          | 682          | 719          |
| Medium        | 67           | 82           | 86           | 67           | 81           | 98           |
| Large         | 81           | 102          | 106          | 106          | 108          | 120          |
| Size unknown  | 143          | 182          | 200          | 221          | 253          | 320          |
| <b>Total</b>  | <b>3,254</b> | <b>4,140</b> | <b>4,547</b> | <b>5,018</b> | <b>5,493</b> | <b>6,428</b> |

\*) Official statistics only provide time series for industrial and service industry establishments and **not** for trade establishments. Source: Consultants' estimates based on MTI statistics 2006 and Statistical Yearbook of Bhutan 2005.

**19. Financing MSME Sector Growth:** In recognition of the contribution and vast potential of the MSME sector in the economy as well as its inherent weaknesses, provision of adequate credit to this sector, in particular working capital and investment loans, is a key ingredient to economic growth. Based on historical data on credit demand of MSEs, the market will face a projected credit demand of at least US\$ 46 million for the Program period. For the period 2005-2010, the credit demand is projected at US\$ 80 million.

**Table 7: Projected Growth of Demand for Credit within the MSE\* Sector**

| Projected Growth of # of Loans per Sector       |       |       |       |                      |
|---|-------|-------|-------|----------------------|
| Year  | 2005  | 2007  | 2010  | Average<br>2008-2010 |
| Trade & Commerce & Transport<br>(Light Vehicle) | 4,850 | 6,303 | 9,338 | 8,238                |
| Manufacturing / Industry                        | 851   | 1,106 | 1,639 | 1,446                |
| Service & Tourism                               | 718   | 933   | 1,382 | 1,220                |

Projected Growth of Demand for Credit (volume) 2005-2010

US\$ 80 million

Projected Growth of Demand for Credit (volume) 2008-2010

US\$ 46 million

\* Figures do not include medium size enterprises as financial institutions offer sufficient access to credit for this segment. Source: Consultants' calculations based on portfolio statistics of all financial institutions in Bhutan.

## 3.2 Issues and Opportunities

### 3.2.1 Government Objectives and Strategy

20. Since the ratio of job creation to capital investment is considerably higher with MSMEs compared to large enterprises, RGoB has given high priority to MSME development. Main objectives are to (i) accelerate the creation of new businesses, and (ii) support the growth of existing MSMEs. In Bhutan, MSME development is regarded as a vehicle to promote a more

even distribution of wealth, both socially and regionally, and to reduce poverty. It shall specifically contribute to a reduction of migration from rural to urban areas and is promoted countrywide.

21. RGoB, in its current 5-year plan (2002-2007), gives high priority to the development of a national industrialization policy and, as part of this policy the promotion of MSMEs, but it does not provide for quantitative targets. Challenges in reaching RGoB's labor market objectives, however, are stunning. The World Bank Private Sector Survey estimates that between 2005 and 2010 approximately 65,000 persons will enter the labor market. The number of persons leaving the labor market will not significantly ease this critical situation, as, according to the 2004 labor market survey, about 75% of the current work force is still below 50 years of age. Labor productivity in the agricultural sector is already low and it must be assumed that agriculture will not create additional employment over the coming years. Although some additional employment will be created in the public sector, as Government capacities need to grow in parallel to the development of the private sector, the public sector is largely saturated and the vast majority of the mostly young entrants will have to be absorbed by the private sector.

22. The private sector currently employs approximately 40,000 Bhutanese and, as a consequence, targets for the development of the MSME sector must be raised to at least doubling its size from 12,188 in 2004 to a target of 24,000 establishments in 2010. The number of industrial and service industry establishments that are in the focus of Government policies must increase from 5,463 in 2004 to at least 11,000 establishments in 2010.

23. In the past, income growth has been vastly driven by energy exports and state demand for construction work. Though these two sectors will continue to play an important role in the future, continued economic diversification is urgently required to achieve the above-mentioned MSME growth targets. Within this context, the development of the tourism sector will be of paramount importance. Tourism has significant backward linkages with agriculture, handicraft, transport and trade. There is excess demand during the short main seasons and high potential to develop off-season tourism. The exploration of these potentials is severely hampered by Government restrictions, which need to be deregulated quickly in order to allow this sector to significantly contribute to achieving captioned MSME growth targets.

### 3.2.2 Key Issues

24. Based on the results of the MSME market survey, intensive consultations with stakeholders and ADB best practice in SME development, key issues for MSME development have been identified.

25. **Limited instruments and capacities to formulate and implement a coordinated MSME development policy.** The development of a common micro, small and medium enterprise development and implementation strategy is characterized by profound fragmentation of strategy formulation and decision making, weak communication and weak coordination both within MTI<sup>6</sup> and between MTI, other Ministries and players from the meso level (e.g. BCCI, business associations). Captioned weaknesses have effectively hindered the formulation and implementation of a common MSME development strategy. However, the most recent revival of the Private Sector Development Committee (PSDC), established to initiate and coordinate supportive private sector development policies and programs, gives hope for a change. This in turn requires that MTI, which hosts the secretariat of PSDC, receives sufficient resources to increase its capacities and develop instruments to effectively support PSDC.

---

<sup>6</sup> E.g. EPC, RTIOs, Department of Tourism, Bhutan Export Promotion Center (BEPC).



**26. Negative impact of business laws and regulations on the growth of the business sector.** In Bhutan, business laws are inadequately considered with unforeseen negative impacts on businesses. First, the absence of an appropriate framework for stakeholder participation prevent firms from intelligently participating in discussions and forming opinions on the objective of a regulation or its impact. Second, laws are drafted and enacted “head over heels” and often lack operative details. The Cooperatives Act, the Bankruptcy Act and the Movable and Immovable Property Act can de facto not be implemented as they lack operative clarity. Third, business regulations and policies lack predictability, since the scope of interventions is often not clearly defined. For businesses, the justification of an administrative action often remains unclear and arbitrary. For example, it is a regulatory maze under which conditions a business license is issued or revoked. The legal framework for Establishment and Operation of Business sets out that a business license may be cancelled unless the responsible Ministry is “fully satisfied”. Certain business activities are not allowed because they are either “banned” or have “strategic importance”. Applicants for a business license will search in vain for a definition of “strategic importance” and will not find a list highlighting the banned business activities. They will not find out on what specific grounds the application has been rejected. RGoB needs to increase familiarity with the basic principles of good regulatory practice and develop the capacity of Government agencies to undertake appropriate levels of regulatory review.

**27. Complex and time-consuming business formalization.** Flexible business entry and exit is essential for an enabling business environment. Government influences this flexibility through its business formalization policy, i.e. the regulatory framework set out for a business to obtain and maintain a legal status throughout its lifecycle. It is confirmed that ineffective, outdated or poorly implemented business formalization regulations block business productivity and competitiveness. All relevant stakeholders, incl. donors have concluded the scale of formalization process in Bhutan to be inefficient, excessive and poorly implemented. A multitude of business and sectoral licenses have to be obtained, which are often duplicative and onerous to obtain. Compliance requirements such as supporting documents and clearances are overlapping and numerous. The World Bank Database on the Cost of Doing Business was updated recently and still ranks Bhutan’s indicators to start a business 66 out of 155, as well as being below regional average. It currently (i) involves 11 procedures, (ii) takes 62 days, and (iii) costs 10.7 % of the gross national capita income.<sup>7</sup>

**28. Lacking efficiency and uniformity of business formalization.** In the year 2005, MTI initiated the following measures which contributed to accelerating the issuance of business licenses at administrative level: (i) establishment of a Business Promotion Section in all six RTIOs, (ii) streamlining the application form for the business license from ten to four pages, and (iii) strengthening the institutional set-up of RTIOs through delegation of partial authority to issue Trade and Industry Licenses and the Environmental Clearance.<sup>8</sup> MTI has further started to streamline the trade license regime and move from an activity-based <sup>9</sup> to a generalized system requiring only one trade license for all related trade activities. Other plans include (i) introduction of a “de-licensing” policy leading to fast-track registration for micro enterprises, (ii) reduction of time needed for the business formalization process closer to good practice of 21 days, (iii) further simplification of the business application form, and (iv) dissemination of business licenses-related information. All measures mentioned above represent an appropriate first step to speed-up the licensing process. However, to gain additional efficiency MTI should also strengthen the functional set-up of RTIOs by becoming a single point of access for business formalization and introduce a monitoring system setting out clear performance indicators against which licenses should be issued.

<sup>7</sup> Doing Business in 2006, Creating Jobs, co-published by the World Bank and the International Finance Corporation, Washington, 2005.

<sup>8</sup> Only in a few cases with higher investment sums and/or severe environmental impact, issuance will be done at the central level in Thimphu.

<sup>9</sup> Activity related trade licenses are currently required in municipalities such as Thimphu.

**29. Low banking intermediation and disintegration of rural areas.** As in many other developing countries, Bhutan's financial sector adds to the cost of doing business and hampers investment and thus the development of the private sector. High intermediation costs reflect the inefficiencies of the financial system, which are further exacerbated by the absence of competition. Despite the sector's high liquidity, financial intermediation is low and plays a small role in converting funds into productive long-term loans, impeding new profitable investment opportunities and the growth of the private sector in general. A strong disparity between the supply of financial services in rural and urban areas is further underpinning the catalytic role of the financial sector necessary for sustainable development and transformation of the economy. The rural areas in Bhutan are still only partly linked to the financial system, excluding a major part of Bhutan's population from access to finance. Bringing financial services to the rural areas is an essential prerequisite for sustaining a high rate of growth and will contribute to the deepening of the financial sector in Bhutan.

**30. Insufficient access to finance for MSEs.** Historically, most of the credit in Bhutan has been channeled to larger corporations, and the upper end of the medium size market. Particularly small enterprises as well as low and middle-income households still lack access to adequate financial services, in particular long-term finance either for capital investment or permanent working capital needs. The lack of suitable collateral, viable qualitative information, financial statements and accounts usually places the MSEs in the high-risk category and they are therefore considered "non-bankable".

**31. Lack of available information on MSEs.** One of the most serious impediments to sustained growth of the private sector in Bhutan is the lack of available information and mechanisms to collect information that makes lenders unable to identify enough profitable projects in a risky environment. Consequently, the provision of financial services is restricted to low-risk clients or based on excessive collateral requirements instead of a credit analysis relying on financial statements and business plans. Experience from other countries shows that a more flexible and dynamic credit information system will improve the accuracy and cost-effectiveness of credit risk decisions made by Financial Institutions (FIs) (e.g. by cutting down on credit appraisal time decreasing demand for collateral). This, in turn, results in improved access to financial services, in particular for small businesses and individual borrowers. Because of its importance and urgency, ADB will provide support to the establishment of the Credit Information Bureau (CIB) under the ADB Financial Sector and NBFi Reform Program.

**32. Institutional deficiencies among FIs.** The low banking intermediation in Bhutan can largely be attributed to institutional deficiencies within the existing FIs, in particular in areas such as corporate governance, strategic business planning, risk management, business diversification, product development, human resources development and IT. Bank of Bhutan (BOB), Bhutan National Bank (BNB) and Royal Insurance Corporation of Bhutan (RICB) have signed MoUs with SEDF for capacity building support to develop and strengthen their general banking and SME lending operations. To enable BDFC to fully exploit its potential and effectively intermediate financing, it is important to strengthen BDFC's role in and capacity for MSE lending. The introduction of specific MSE lending techniques and development of financial services are a prerequisite in particular for BDFC to successfully accomplish its mandate and serve MSEs in urban and rural areas.

**33. Lack of competitiveness of the MSME sector.** Most of the MSMEs in Bhutan are still infant, sell their products locally or, at best, nation wide and are neither exposed to international competition nor prepared for it. With India and Bhutan becoming members of the WTO in the near future, competition is very likely to increase for MSMEs in Bhutan. International experience shows that competitiveness depends on the speed at which an MSME is able to build within itself the different skills, know-how, expertise, and market understanding required. However, especially in rural areas, it is practically impossible for MSMEs to gather and utilize business relevant information on e.g. prices, products, technologies and markets and to employ external services to improve MSME business

performance. Investments, in particular in technological know-how and skills development, are consequently low, impeding heavily on (i) individual business growth, and (ii) the growth of the economy, and therefore leading to an irreversible fallback in international competition.

**34. Lack of capacities of domestic BDS providers.** An effective method to build captioned capacities within the MSMEs is to buy in external business development services. However, the Bhutanese MSME sector is characterized by a generally low usage of external services. Main reason is the fragmented market for BDS, concentrated around the capital and Phuentsholing at the Indian border and direct government implementation of BDS programs, especially for business start-ups and micro enterprises. Government spending on BDS is almost completely internal via EPC, RTIOs and other institutions, effectively limiting the size and development scope of commercial BDS markets. Following the paradigm of market forces, opening these markets to commercial operators will effectively optimize the allocation of Government funds by increasing employment opportunities for the skilled work force in innovative markets, ensuring a more market-oriented BDS with immediate benefits to clients and reduced cost per trainee by allowing for competition.

**35. Weak business linkages.** Though Bhutan's tourism sector is booming, impact on the development of rural enterprises and in particular rural manufacturing industries is low due to weak or missing links in value chains e.g. agriculture, agro industries and tourism. Up to date, RGoB is not systematically supporting the development of clusters or the strengthening of value chains through well-targeted BDS support programs in close cooperation with private sector stakeholders and private BDS providers, which can build the capacity to sustain and disseminate such programs.

**36. Difficult infrastructure and limited outreach of business relevant information.** Bhutan is a mountainous country. Albeit significant improvements in its infrastructure, especially roads and electricity, a vast number of potential rural business start-ups and micro enterprises effectively have no access to business development services and relevant information on e.g. sales markets, market opportunities, prices and technologies. Up to now, business development services, be it face to face training, consulting services, or demand-oriented information services and distance learning programs via radio or television, do not reach remote areas of Bhutan, leaving significant potential for rural economic sector development untapped. While RGoB initiated economic extension services at least in 6 sub centers around the country, few potential rural start-ups in remote areas know of their existence and if so think twice before taking a 2- to 3-day journey to reach them. Programs serving start-ups, micro and small enterprises with business relevant information via regular radio and/or TV shows are currently not implemented, but should urgently be considered by MTI in order to support the creation of rural employment and thus mitigating the negative effects of rural urban migration.

37. The key issues identified above relate to fundamental and structural barriers that impede on MSME development in Bhutan today. First, the "we know better than them" attitude of the Bhutanese administration leads to tendencies to over-regulate and to the implementation of supply-oriented ineffective private sector support programs. Second, decentralization evokes the danger of an inconsistent implementation of administrative procedures and avails corruption as long as no proper management systems are in place. Thirdly, in terms of corporate governance, institutional framework and products, a vastly underdeveloped financial system does not support the development of a diversified and vibrant private sector.

### **3.2.3 External Assistance to the Sector**

38. There are several major ongoing donor activities, which directly or indirectly relate to the creation of an improved policy framework for MSME development by helping RGoB to overcome severe capacity constraints in policy formulation and implementation (see Appendix 6 for more detail). First, EU assists RGoB with its preparation for WTO accession through the implementation of a "Trade Capacity Building Program". The program amounts

to EUR 1.2 million technical assistance and supports measures at policy level, institutional level and company level and will ultimately increase the competitiveness of the Bhutanese private sector, which is dominated by MSMEs. Second, UNDP provides capacity building at grassroots level to strengthen bottom-up planning abilities and grassroots information networks. Block grants will be provided for local level development and small-scale socioeconomic activities, which build the basis for increased local & regional economic competitiveness and may foster enterprise growth in particular in disadvantaged rural areas. Third, under the SNV Rural Enterprise Development (RED) Project most of the total of EUR 1.5 million is spent for capacity building of the six RTIOs of MTI. Core activity is the establishment of RTIO/Business Promotion Sections (BPS) handling the following services: (i) information services, (ii) intermediary services, (iii) training services, (iv) organization of events, (v) business planning support, and (vi) licensing services, which include the provision of sector-specific license information and assistance to applicants to complete the business license form. Fourth, the Indian Government injects approximately US\$ 1.2 million into the RGoB budget for the implementation of industrial investment studies which aim at the identification of district based opportunities for private sector development. Fifth, there is a focus of donor activities on the development of the tourism sector, the most important sector for MSME development in Bhutan. A TA for the preparation of a sustainable tourism development strategy and for strengthening the capacity of the Department of Tourism/MTI is provided by Austria. SNV also provides capacity building by establishing a research cell in the Department.

39. The World Bank will start a new “Private Sector Development Project” in 2007. This project will amount to US\$ 8 million and mainly target at infrastructure support for selected industrial estates and a Distant Learning Centre/ICT Park. However, it will also include institutional and policy support to government agencies, capacity building to strengthen the advocacy role of private sector associations and the promotion of financing mechanisms for private sector development, all this related to the private sector in general and not to the particular needs of MSMEs. This area will be left to ADB.

40. There are two ongoing donor activities related to the establishment of an enhanced regulatory framework for business formalization. The major one is a World Bank US\$ 14.7 million multi-sectoral policy grant, which is, among others, tied to the reduction of the length of business formalization from 62 days to 47 days. A minor SEDF activity involves the creation of a reliable and easily accessible database of registered businesses.

41. Further two donor activities relate to the improvement of the legal environment. The major one is the Danida “Good Governance and Public Administrative Reform Program”, which aims among other things at strengthening the rule of law. The weak rule of law is currently heavily impeding on the development of the enterprise sector. A minor SEDF activity resulted in another review of the legal and regulatory environment relevant to the private sector with no groundbreaking results.

42. SEDF is in different ways supporting the access to finance for SMEs. SEDF organized training in Credit Appraisal for SMEs (2003) and in Reconstruction of Financial Statements and Credit Scoring for SMEs (2004). The latter training was followed up with delivery of material on the implementation of the credit-scoring model. Moreover, SEDF will support BOB, RICBL and BNB with technical assistance to develop and strengthen their general banking and SME lending operations. SNV (Netherlands Development Organization) supports BDFC in strengthening rural and micro-credit delivery in Bhutan since 1999.

43. Several donor programs currently fully or partly support BDS for the MSME sector. The SNV/UNDP Rural Enterprise Development (RED) Program implements a small sub program of US\$ 87,500 for training facilitation directed at rural BDS Providers. The SNV/IFAD program currently spends approximately EUR 300,000 for strengthening private sector development in the eastern districts through training of extension agents and activities directly related to regional product marketing and the establishment of new innovative

enterprises. SNV supports BDS development in the tourism sector through strengthening the Association of Bhutanese Tour Operators and the development of community-based tourism.

44. Danida has launched a Business Partnership Program, which will bring Bhutanese entrepreneurs in contact with possible joint venture partners from Denmark. First results have been very encouraging. SEDF supports exports of Bhutanese companies through a special program. This program will also especially promote collaboration between Bhutanese and foreign companies beyond the regional market.

### **3.2.4 Lessons Learnt**

45. A number of important lessons can be learned from donors' past operations in Bhutan:

- (i) For program loans, the commitment of RGoB is crucial for successful outcomes. There remains considerable scope for increasing RGoB's participation in the design of projects in order to increase ownership.
- (ii) In Bhutan, a number of projects encountered delays in the implementation of project components due to a lack of preparatory time and resources.
- (iii) Specific attention also needs to be paid to implementation aspects of program loans. ADB tends to underestimate RGoB's needs for capacity building. Capacity building measures through TA and regular dialogue remain critical for program loan implementation.
- (iv) Given the small MSME sector in Bhutan and the huge amount of donor money spent to develop this sector, programs need to develop close linkages and synergy with other related projects to avoid costly overlapping and have a more sustainable effect.

46. The PPTA implemented a consultative approach throughout program formulation. Besides regular consultations with key government agencies, two stakeholder workshops, a study tour and two tripartite meetings were organized to guarantee commitment of Government and key stakeholders. The PPTA also arranged for an additional PPTA, which will upgrade BDFC for delivering key outputs under the upcoming Program. A voluminous TA is planned for capacity building and support during program implementation. Furthermore, the Program is designed to maximize linkage between projects from ADB and other development agencies.

## **4 THE PROPOSED PROGRAM**

47. A comprehensive diagnostic analysis was conducted to identify the major constraints in the sector and the results of the analysis were intensively discussed with Government agencies and private stakeholders individually and at a stakeholder workshop held on October 6<sup>th</sup>, 2005 in Thimphu. Stakeholders emphasize the importance to focus on core fields and priority actions for gradually implementing an MSME development strategy built on the following four pillars:

- (i) developing an effective institutional framework for MSME program formulation and implementation, allowing also for stronger involvement of the private sector,
- (ii) improving the legal and regulatory framework at national and local levels to enhance the business climate and accelerate growth of the business sector,
- (iii) enhancing access to finance to foster investments in modernization and business growth, and
- (iv) enhancing access to and the quality of non-financial services to strengthen the competitiveness of MSMEs and to allow for an accelerated growth of business start-ups in particular in rural Bhutan.

48. The four pillars of the MSME development strategy and the program interventions were also presented and discussed at a tripartite meeting carried out on March 24<sup>th</sup>, 2006. Feedback and comments from participants have been incorporated into this final report.

## 4.1 Objectives and Scope

49. The overall objective of the program is to foster an enabling policy and regulatory environment, eliminating structural barriers constraining access to key resources - finance and non-financial BDS, supporting BDS providers market entrance – for small enterprises (MSMEs), and providing capacity building for BDFC. The Program's emphasis on the elimination of structural barriers to enterprise development can only be achieved with close coordination among key Government agencies and a sustainable development bank dedicated to small enterprise finance. To facilitate the coordination process, a Private Sector Development Committee was founded by RGoB, which consists of representatives of involved sector ministries and representatives of the private sector. The PSDC is chaired by the Minister of MTI. The Program will enhance the capacity of MTI, which acts as a permanent secretariat to PSDC. The Program will enable MTI to lay the foundation for the formulation and implementation of effective MSME policies. The program will also include measures to increase MSMEs' access to finance – mostly by improving BDFC's institutional capacities and introducing an MSME targeted credit line within BDFC.

50. Elimination of structural barriers, which impede MSME development, is particularly relevant for Bhutan where rural urban migration and increasingly lacking job opportunities for young people may lead to increased poverty and result in social and economic unrest. All components of the program in its combination are essential for a successful development of the MSME sector and cannot be implemented as stand-alone measures. Through the analysis of ADB TA 4412-Bhu: SME Development, and based on the dialogue with the Government and other stakeholders, the issues selected for support under the Program were determined by (i) their contribution to improving the employment situation, (ii) perceived commitment of RGoB to required reforms and actions, (iii) ADB past and ongoing operations in Bhutan; and (iv) the Program's complementarities with those of other development agencies.

## 4.2 Policy Framework and Actions

51. The overall policy framework and specific policy actions include the following: The policy framework and actions will aim to strengthen RGoB with regard to MSME policy formulation and implementation and in particular strengthening MTI, which acts as a permanent secretariat to the PSDC. This includes (a) the establishment of an MSME unit in MTI with the task of BDS product development, (b) recruitment and contracting of additional MTI staff dedicated to MSME development for the duration of the Program, and (c) capacity building measures for the newly established unit as well as MTI Policy and Planning Division (PPD) and the Business Promotion Sections of the six RTIOs. A set of Program measures will enhance governance and accountability of RGoB. Components include (a) making better business laws and regulations by revealing the costs and benefits of respective laws and regulations, (b) simplification and acceleration of business formalization removing unnecessary requirements for both business registration and licensing, and (c) increasing accountability and administrative efficiency of RTIOs by installing effectively monitored and benchmarked one-stop shops.

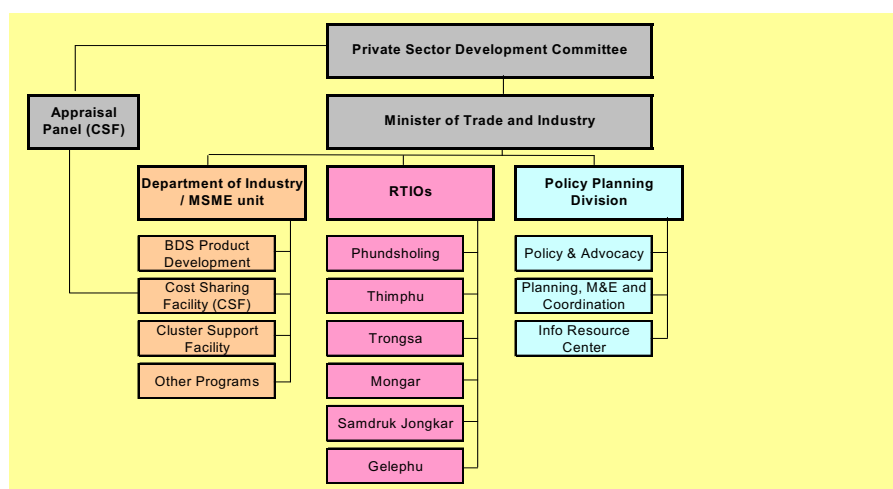
52. Other actions will improve MSMEs' access to financial and non-financial services by (a) making BDFC a sustainable partner for MSMEs in access to finance, (b) establishment of a Cost Sharing Facility (CSF) within the new MTI/MSME unit, (c) the facilitation of cluster and supply chain initiatives by the new MTI/MSME unit, and (d) broad dissemination of business information also to hardly accessible parts of the country, the latter (b), (c) and (d) in close cooperation with the BPS/RTIO.

53. All measures are intended to eliminate structural barriers to MSME development. Reforms to be supported by the proposed Program are presented in the Policy Matrix in Appendix 7 and the Program Framework in Appendix 1.

#### 4.2.1 Developing an Institutional Framework for MSME Program Formulation and Implementation

54. The Program foresees MTI - harboring the secretariat to the PSDC - to take over the lead role in MSME program formulation and implementation. It includes the alignment of tasks and functions needed for an effective approach in MSME development to (i) the DoI, (ii) the PPD and (iii) the Business Promotion Sections (BPS) of the six RTIOs under the MTI. The responsibility for effective coordination between the parties involved within MTI is assigned to the Minister of MTI (see table below).

**Table 8: Institutional Set-Up for MMSE Policy Formulation and Implementation**



55. Under the program, the role of PPD of MTI will be enlarged to (i) the elaboration and regular review of 3-year multi-sectoral and inter-ministerial SME development action programs based on inputs of round tables and stakeholder conferences, and (ii) to the regular publication of a White Paper on small enterprise development based on data collected from studies and regular data collection to be done by BPS/RTIOs.

56. The MTI will establish a separate MSME unit to carry out (i) BDS product development and (ii) the implementation of BDS programs in rural areas in cooperation with BPS/RTIO and private BDS providers. As flag ship operation, the MSME unit will also host a Cost Sharing Facility, which is governed by a PSDC.

57. The BPSs/RTIO will have additional tasks to accommodate the implementation of the Program. They will have (i) a help desk and marketing function in order to support the successful operation of the CSF and (ii) support the testing of new BDS approaches in cooperation with the MSE unit established under MTI.

58. As manpower endowment in MTI is very scarce (currently 54 staff in DoI, 58 staff in RTIOs, 11 staff in PPD) the implementation of the program will need to be accommodated by a significantly increase in personnel (+ 31 staff in DoI, + 26 staff in RTIOs, + 5 staff in PPD). Details are given in Appendix 11.

#### 4.2.2 Enhance Public Governance and Business Regulations

59. The Program includes reforms to enhance public governance and business regulations. First, business laws and regulations are reformed by applying Regulatory Impact Assessments (RIA) and initiating a decision by the National Assembly on the

institutionalization of RIA. The reform will imply increased stakeholder participation in law making and the determination of regulatory processes and achieve increased transparency of the costs and benefits of business laws and regulations. Second, specific measures are undertaken to simplify and accelerate the business formalization process. The measures entail reducing the costs and procedures/ requirements and will bring Bhutan's performance in business formalization closer to the Asian average. Third, administrative efficiency and transparency of business formalization will be enhanced by the introduction of OSS at regional level further reducing costs and accountability of the administration involved.

#### 4.2.2.1 Improving of Business Laws and Regulations

60. In order to ensure that regulators make "better" regulations, the Program foresees the introduction of RIA, which involves a systematic appraisal of the costs and benefits associated with new/ existing regulations and provides a framework for a participative process, involving all relevant stakeholders in law making.

61. Within the Program, the regulatory review of specific business laws and the institutionalization of RIA will follow an integrated approach (see Table 9). During a **Preparation Phase**, the RIA methodology will be adapted to the Bhutanese context and introduced to public and private stakeholders, followed by the establishment of a RIA Working Group (WG). One of the tasks of the WG will be to prepare a shortlist with regulations to be reviewed. In the **Pilot Phase**, the WG will review four regulations (preferably Bhutan Enterprise Act; Labour and Employment Act, Industries and Investment Act and Food Act) and prepare assessment reports accordingly. During the **Evaluation Phase**, the willingness and feasibility of institutionalizing RIA will be further assessed. This will include a thorough assessment of the impact of a new RIA Law, which would provide for the legal framework institutionalizing RIA. The purpose of this law would be to make RIA mandatory before adopting a new regulation, as well as to evaluate existing regulations. Subject to a positive outcome, the new RIA policy would be promoted at cabinet level. In the **Institutionalization Phase**, RIA policy would be formulated and implemented.

**Table 9: Work Plan RIA**

| Phase            | Preparation Phase  | Pilot Phase  | Evaluation Phase  | Institutionalization Phase   |
|------------------|--|--|---|--|
| Duration (years) | 0 – 0.5  | 0.5 – 1.5  | 1.5 - 2   | 2 – 3  |
| Objective        | RIA methodology introduced   | 4 Laws reviewed  | Willingness and feasibility of RIA institutionalization assessed  | RIA Unit established and operative   |
| Outputs          | <ul style="list-style-type: none"> <li>• Training modules developed</li> <li>• RIA Working Group established</li> <li>• Laws and related constraints identified</li> </ul> | <ul style="list-style-type: none"> <li>• Training for WG conducted</li> <li>• 4 Laws reviewed</li> <li>• 4 RIA reports prepared</li> </ul> | <ul style="list-style-type: none"> <li>• Cost/ Benefit of RIA institutionalization assessed</li> <li>• MoU for institutionalization</li> <li>• Concept for institutionalization outlined</li> </ul> | <ul style="list-style-type: none"> <li>• RIA policy formulated</li> <li>• Institutions established</li> <li>• Operative details set out</li> <li>• RIA continuously conducted</li> </ul> |

62. During the first 18 months, the Program aims predominantly at strengthening the technical skills of WG members in terms of basic techniques for reviewing regulations (e.g. data collection and impact assessment). Reviewing regulations includes: (i) identification of main problem related to a regulation, (ii) outlining of options for solving the identified problem (e.g. elimination of regulation, reduction, streamlining, simplification or maintaining the status quo), (iii) assessment of the benefit and the cost of each option, (iv) decision on the option with the highest benefit and the lowest costs, (v) analysis of stakeholder feedback in any of the above mentioned steps, and (vi) preparation of an RIA report.



63. Then, after 18 months the Program foresees the preparation of a decision on the institutionalization of RIA. The decision shall be taken during month 24. Institutionalization typically requires: (i) endorsement of RIA policy and establishment of a RIA WG adopting a regulatory reform policy at highest political level, (ii) establishment of a Central Regulatory/Oversight Body for RIA, and (iii) establishment of RIA Units under the regulating function of the ministry in charge of the regulation. The initiative to adopt a regulatory reform policy should be endorsed at the highest political level, for example by the prime minister<sup>10</sup>, and executed by a RIA Task Force, whose task is to set out a nation-wide RIA policy and draft an RIA Law. At minimum, such an RIA Law should (i) specify procedures for creating and changing a regulation, and how to apply RIA within the regulatory process, (ii) specify mechanisms for consultation with stakeholders as well as mechanisms for ensuring transparency within the stakeholder consultation process, (iii) specify types and level (order) of regulations subject for reviewing, and (iv) specify enforcement mechanisms (including rewards and sanctions).

#### **4.2.2.2 Simplification and Acceleration of Business Formalization**

64. The main objective of the simplification and acceleration of business formalization is to reduce the cost of doing business and promote the establishment of new enterprises, in particular in labor-intensive manufacturing and service industries.

65. RGoB has undertaken significant efforts to reduce time and costs involved in the business formalization process and is committed to reducing the overall time to start a business from 62 to 47 days as one of the conditions for a World Bank policy grant of US\$ 14.7 million under the World Bank Country Assistance Strategy. The Program foresees a further reduction from 47 to 30 days bringing Bhutan closer to good international practice of only 21 days.

66. To reduce the cost of doing business and promote self-employment in trading, the Government has initiated a reform of the trade-licensing regime including the abolishment of the annual license fee. As of April 1<sup>st</sup>, 2006 the present single-activity license will be replaced by a multi-activity license. Micro establishments with a turnover of less than Nu. 1 million will no longer pay an annual license fee and simply register at the Regional Trade and Industry Offices. It is expected that the reform, which was also proposed under ADB TA 4412-BHU: SME Development will be completed at the start of the Program.

67. The regulatory framework for business formalization foresees exemptions for micro and small enterprises only in the case of rural cottage industries with an investment of less than Nu. 1 million<sup>11</sup>. As a consequence, urban micro/cottage industries and rural micro/enterprises wishing to formalize their business have to abide by the same regulations as small, medium, and large enterprises. The program foresees to exempt **all** micro enterprises and introduce a fast-track formalization facility simplifying the formal requirement for all micro business start-ups with an investment sum of less than Nu. 1,000,000 (more than 95% of all businesses). Instead of applying for a business license, micro and small enterprises should simply register with RTIO. The basic requirements for this initial notification should be limited to: (i) the purpose of the business, (ii) basic information about the business, and (iii) the identification document of the entrepreneur. Notification of tax authorities will be the responsibility of RTIO. At the time of notification, the Registry Office will inform businesses whether they require a sectoral or operational license (e.g. environmental clearance), depending on specific sectors, processes, products or perceived environmental impact. The respective businesses will have to comply with additional requirements before receiving a registration certificate. For many

<sup>10</sup> The Prime Minister, Lyonpo Sangay Ngedup, already initiated the assessment of Government's performance under the 1999 Good Governance Plan. A 26-member task force as well as a 14-member technical support committee has been established to review and recommended changes to policies.

<sup>11</sup> Rules and Regulations for Establishment and Operation of Industrial and Commercial Ventures in Bhutan, 1996, Rule 1, 2<sup>nd</sup> sentence in conjunction with the Official Classification of Enterprises (2001).

businesses, further compliance will not be required, so notification would directly lead to the 'fast track' issuance of a registration certificate.

#### 4.2.2.3 Increasing Accountability and Administrative Efficiency of Regional Trade and Industry Offices

68. As reliable and up-to-date information on how to obtain licenses and clearances to start a business is not available and the information on the MTI web site is incomplete, does not reflect the current status, and is partly inaccessible to applicants (e.g. the application format for the business license), the Program includes the preparation of information materials, which explain in detail the process of each license, as well as time and cost involved. A brochure would operate like a "glass box" through which Government processes can be brought into the light and be open for public scrutiny. In this way, arbitrariness in the performance of essential services in the license process can be eliminated. In addition, the brochure can evolve into a manual of standards of time and quality of service that the public can expect to receive. To improve the availability and accessibility of information, the following steps are proposed: (i) establish a working group consisting of Government officials from all administrative levels, (ii) select licenses/clearances (include sub-licenses and sectoral licenses) to be included in the brochure; illustrate the detailed procedures required for obtaining each of the selected licenses/clearances (including time and cost), (iii) set out more details in explanatory notes and guidelines, (iv) stipulate public interest and sanctions, and (v) reproduce and disseminate brochure, and enhance outreach through mass media (radio, newspaper) and update in MTI web site.

69. The introduction of a single access point or OSS, which handles business formalization and other bureaucratic processes under one roof under the proposed Program will increase efficiency and ease market entrance for start-up businesses. It is foreseen that the positioning of such a service unit within the administrative framework is related to the actual stage of decentralization and delegation of authority. In Bhutan, three government levels are involved in the business formalization process: at the central level MTI and the Revenue and Customs Office, at the regional level RTIOs and the Regional Revenue and Customs Offices, and at the local (Dzongkha/municipal) level, those authorities which issue local clearances. Considering the current stage of decentralization, the Program includes the establishment of OSS units in the RTIOs at the regional level by implementing the following steps: (i) establishment of a working group consisting of government officials from all administrative levels, (ii) familiarization with functions and alternative models of OSS, including a 2-day workshop with involved institutions/ stakeholders for exchange of experience and discussion of advantages and disadvantages of each model, (iii) implementation of a study tour to the OSS in Bangkok which is regarded as one of the most advanced OSS in South East Asia, (iv) decision for one model and elaboration of an action plan, and (v) implementation of the action plan.

70. The Program also includes the introduction of OSS benchmarks, which are necessary to standardize services, increase efficiency in service provision, and to improve the overall quality of services. The benchmark system would comprise indicators covering **service efficiency** and **service quality**. The benchmark system would be developed by the responsible parties. Examples are given below.

**Table 10: Proposed Benchmark Indicators for RTIOs**

| 1   | Service Efficiency  | 2.    | Service Quality  |
|-----|---|-------|--|
| 1.1 | Percentage share of staff <sup>12</sup> related to business licensing services  | 2.1   | Quality of procedures for complaint handling                         |
| 1.2 | Percentage share of income related to business licensing services <sup>13</sup> | 2.1.1 | Availability of staff for complaint handling                         |
| 1.3 | Average cost per approved service <sup>14</sup>                                 | 2.1.2 | Percentage share of complaints per total number of business services |
| 1.4 | Approval ratio <sup>15</sup>  | 2.2   | Regular evaluation reports on user satisfaction                      |
| 1.5 | Realized average processing time <sup>16</sup> against target                   |       |  |

71. To further support the introduction of OSS benchmarks, the following steps will be implemented: (i) provide appropriate framework for data collection, (ii) develop, discuss, decide and test benchmark indicators, (iii) conduct detailed assessment of RTIOs, disseminate and discuss results, (iv) develop targets and monitoring system based on results; (v) develop action plan and support implementation, (vi) monitor and assess RTIO activities regularly, and (vii) evaluate monitoring system and adjust accordingly.

**Table 11: Work Plan OSS**

| Phase            | Preparation Phase  | Pilot Phase  | Evaluation Phase   | Replication Phase  |
|------------------|--|--|--|--|
| Duration (years) | 0 – 0,5  | 0,5 – 1,5  | 1,5 - 2  | 2 - 3  |
| Objective        | Accessibility and availability of information regarding government services improved   | Single access point for business formalization introduced  | OSS and monitoring system tested and improved  | Six OSS functioning according to targets   |
| Outputs          | <ul style="list-style-type: none"> <li>Working Group established</li> <li>Brochure developed</li> <li>Benchmarks for RTIO performance developed</li> </ul> | <ul style="list-style-type: none"> <li>OSS model decided</li> <li>Action Plan for OSS model implemented</li> <li>Monitoring system developed and introduced</li> </ul> | <ul style="list-style-type: none"> <li>OSS model evaluated</li> <li>Monitoring system evaluated</li> </ul> | <ul style="list-style-type: none"> <li>All OSS units established</li> <li>Business start-ups handled continuously</li> </ul> |

### 4.2.3 Improving Access to Market Based Finance

72. The Program includes complementing measures to enhance MSEs' access to market-based finance. Outputs include (i) the implementation of a credit line to address the lack of financing for MSEs and meet the demand for investment finance from local businesses; and (ii) institutional strengthening and capacity building support to BDFC to ensure sound banking practices, better performance and greater operational efficiency.

#### 4.2.3.1 Credit Line for MSE Lending

73. As in many other developing countries, access to finance is one fundamental constraint for MSEs in Bhutan. The MSME survey conducted under this PPTA verifies that only 25% of the micro enterprises and 77% of the small enterprises interviewed had received a loan from

<sup>12</sup> Total staff for business related services/ Total staff.

<sup>13</sup> Total income from business related services / Total income RTIO.

<sup>14</sup> Cost of business licensing staff x Operational costs/ approvals.

<sup>15</sup> No. approvals year XX / No Applications year XX.

<sup>16</sup> Target processing time / Actual processing time.

a FI. The lack of suitable collateral, viable qualitative information, financial statements and accounts usually places the MSEs in the high-risk category and financial institutions are, thus, reluctant to lend to this target group.

74. In 2004, the number of MSEs in Bhutan stood at 11,669 (10,820 micro and 849 small enterprises). Based on historical data on credit demand of MSEs the market will face a projected credit demand of at least US\$ 46 million for the period 2008-2010. To help overcome the financial constraints of this sector and induce Bhutanese financial institutions to provide credit facilities to the MSE sector, particularly the small entrepreneurs, the proposed Program comprises a credit line for providing medium- and long-term finance to MSEs.

75. As the financial intermediary, BDFC is seen as the most appropriate agency given its unrivalled outreach in rural areas and current focus on micro and rural lending. The details per FI (Appendix 5) show that BDFC has 44% of total clients and 12% of total principal outstanding. As of end 2005, BDFC had 14,764 active clients in rural areas or 17.2% of the total rural households<sup>17</sup>. Even though BDFC accounts for over 90% of rural lending in Bhutan, this market is currently not sufficiently covered by supply of finance.

76. As a non-bank financial institution, BDFC is not allowed to mobilize savings from the public, with the exception of savings mobilization within the framework of its rural finance operations. The main sources of funds are therefore external concessional loans and grants from international agencies, such as ADB, KfW and IFAD. BDFC's loan portfolio growth projections for the next 5 years, however already exceed the organization's current funding resources. The main problem with BDFC is therefore a lack of long-term funds.

77. To support BDFC to realize the full growth potential and to respond to the increasing demand for financial intermediation from the private sector, a credit line to BDFC of US\$ 5 million is proposed. The credit line is supposed to finance the demand of additional 4,000 MSEs entering the market between 2008 and 2010, which means that BDFC will face a projected credit demand of up to US\$ 8.8 million. The credit line is recommended for long-term finance and permanent working capital for MSEs with a maximum tenor of 15 years. The terms and conditions of the credit line are detailed in Appendix 12.

#### **4.2.3.2 Institutional Strengthening and Capacity Building Support to BDFC**

78. BDFC was established in 1988 with assistance from ADB and equity participation from RGoB and other FIs to act as the development finance institution for providing credit to both small and medium scale industrial and agricultural activities in Bhutan. Later the focus was shifted to micro and rural finance. Due to its unclear mandate, BDFC has been involved in multipurpose lending activities, which has adversely affected its operational performance and viability.

79. In 2003, BDFC revised its strategy with assistance from ADB and developed its 9<sup>th</sup> Five Year Business Plan (2003-2007). The business plan was never fully implemented nor revised during the last three years and is therefore outdated. As all financial institutions in Bhutan, BDFC has limited capacity in providing financing assistance to MSEs. Loan officers who are responsible in loan processing lack relevant skills needed for better management of MSEs and the evaluation of MSE risks. BDFC's lending operations are still collateral-based and the portfolio quality has been affected by (i) weak loan appraisal and monitoring, (ii) weak credit risk management, and (iii) inadequate internal control and audit.

80. To enable BDFC to fully exploit its potential and effectively intermediate financing, it is important to strengthen BDFC's role in and capacity for MSE lending. It is strongly recommended that BDFC reconvert into an effective development bank. By operating within

---

<sup>17</sup> Rural areas cover about 85% of the country's approximate 670,000 population with an estimated 86,000 rural households.

a very narrow band of development bank lending, BDFC could more appropriately fill a gap in the provision of financial services, which it could perform efficiently.

81. A TA is proposed to continue the capacity building measures initiated under the PPTA, but expand the scope and focus of the activities on strengthening BDFC's MSE lending capacities (see Appendix 10). The TA is considered essential to strengthen BDFC's institutional capabilities in project appraisal and loan monitoring to ensure an efficient utilization of funds.

#### **4.2.4 Enhanced Competitiveness of Bhutanese MSMEs through Improved Access to Qualified Business Development Services**

82. The Program includes multiple measures to enhance MSMEs access to business development services. First is the establishment of a CSF in order to increase competitiveness of Bhutanese MSMEs through demand-driven access to BDS. The market survey carried out during ADB TA 4412-BHU shows that Bhutanese MSMEs lack competitiveness because of delayed investments of MSME in particular in technological know-how and skills development due to the small profit margins of Bhutanese MSMEs operating under high cost conditions. Second is the implementation of an interactive radio/TV program for rural development as business start-ups and MSMEs in rural areas face significant impediments due to lack of information on business ideas, markets, technologies, financing facilities and business support services. Third is the development of new government-driven and fully subsidized pilot BDS programs such as cluster and value chain development initiatives based on the results of district investment studies carried out during the 9<sup>th</sup> plan, fiscal year 2006/07.

##### **4.2.4.1 Establishment of a Cost Sharing Facility (CSF)**

83. As most of the industries are still infant in Bhutan, investment in particular in technological know-how and skills development is still low. Small entrepreneurs are aware of the need to invest in human resources and know-how. However, given the current conditions they lack capital and often tend to postpone necessary investments. This in turn heavily impedes on (i) the growth of businesses, (ii) the growth of the economy, and (iii) may finally lead to an irreversible fallback in international competition.

84. The program plans to implement a CSF to facilitate demand-oriented external support services. The function of CSF is to reduce the cost of external service provision by co-financing projects of successful applicants with a flat rate of 50% of the total project amount. In doing so, it increases the utilization of BDS by MSMEs and thus perpetuates the development of MSME and the market for commercial BDS. The program will run for a period of 3 years after which it will be terminated, if not prolonged, based on the positive outcome of an impact assessment at enterprise level. CSF will operate on a first come – first serve basis. Typically, the CSF will finance a consultant to create new designs, but not a permanent designer. It will finance an expert to improve the quality and efficiency, but not finance the purchase of capital investments as a result of the expert study<sup>18</sup>. The CSF will allow for individual and group applications by enterprises and providers (e.g. BCCI, NGOs).

85. CSF will operate countrywide. Based on discussions with relevant stakeholders such as representatives of BCCI, sector associations and government departments, it is estimated that about 25 large projects with a grant volume of US\$ 12,500, and about 225 with a grant volume of US\$ 2,500 will be realized during the 3-year implementation phase. CSF will limit applications by applying a minimum grant volume of US\$ 1,000 (project cost US\$ 2,000) and a maximum grant volume of US\$ 25,000 (project cost US\$ 50,000) to keep administrative

---

<sup>18</sup> Credit operations should be strictly limited to the financial market to adhere to best banking practices, avoid disrupting a level playing field and handing out hidden subsidies.

costs at a tolerable level and ensure that the main beneficiaries are served. The amount of CSF grants and CSF operational cost was conservatively calculated at US\$ 0.875 million and US\$ 0.261 million consecutively, based on (i) projected number of MSMEs during the implementation period of CSF, (ii) average yearly spending of MSMEs on BDS, (iii) estimated average CSF project cost, (iv) analysis of operational costs for comparable operations, and (v) international benchmarks.

86. CSF will be the flag ship operation of the newly established MSME unit in MTI and shall be organized as follows:

- i. PSDC shall govern the facility. It will appoint a CSF unit manager and endorse the CSF business plan (see Appendix 4) as well as possible annual changes of the plan and, approve business providers eligible under the scheme;
- ii. A management unit (MU) shall be responsible for marketing, project analysis, financial management and monitoring & evaluation. The management unit shall be implanted into the MSME unit and marketing as well as monitoring & evaluation will be strongly supported by BPS/RTIO staff. The unit shall employ four professional staff, taking over one or more of the following functions: (i) unit management, (ii) marketing, (iii) project appraisal, (iv) financial appraisal, (v) accounting, and (vi) monitoring & evaluation. Staff shall be selected and contracted by MTI and have a strong private sector background to ensure a close affiliation with the private sector and a high understanding of their needs and requirements, regarded essential for appropriate project appraisals. As there is no previous experience in Bhutan with project related grant facilities, it is recommended to give strong support to the management of the facility by an international expert during its first year of operations.
- iii. RGoB will appoint a five-member Appraisal Panel as a sub-committee. Its function is to review the CSF grant proposals recommended by the MU. A quorum of three members will be required to approve applications, by majority vote if necessary. The CSF unit manager of the MU shall be a full voting member of the Appraisal Panel.

87. The CSF shall not become a division of meso level institutions, namely BCCI or sector associations, due to (i) a conflict of interest regarding the potential dual role of these institutions as BDS provider and CSF manager, and (ii) a bias of these institutions towards lobbying functions for their own clients.

#### **4.2.4.2 Enhancing Rural MSMEs' Access to Know-how and Information**

88. International experience shows that both radio and TV can play an important role in (i) business education, (ii) business information, (iii) business linkages, and (iv) advocacy by providing interactive programs including investigative reports, interactive talk shows and live calls. Radio programs are relevant to all those "would be" entrepreneurs and MSMEs, whose primary source of information is radio and TV and who do not have access to business services and business-related education.

89. To supply rural start-ups and MSMEs with crucial information, the Program will start and implement focused radio/TV programs in the three main local languages Dzongkhat, Sharchop and Nepali on (i) business education, (ii) business information, (iii) business linkages, and (iv) advocacy. Project implementation shall follow the steps laid out below:

- i. **Market and Capacity Assessment:** The MSME unit of MTI will conduct a market assessment to determine (i) whether the program shall be radio or/and TV, (ii) preferred listening times and languages, (iii) topics and issues of concern to the target group, (iv) the program format, (v) technical requirements for production and broadcasting, (vi) human resource development requirements, and (vii) potential customers for advertising;

- ii. **Pilot Program:** The MSME unit will develop a pilot program, test run it with the potential target group, market it to potential sponsors and conclude advertising contracts with sponsors;
- iii. **Program Debut:** The MSME unit promotes and broadcasts the pilot program with real advertisement and obtains immediate feed back from listeners;
- iv. **Program Opening:** The MSME unit will hold an official opening ceremony for the program, inviting prominent members of the target group, entrepreneurs, and government officials;
- v. **Program Broadcast:** The program is broadcasted regularly in one language on frequencies established during the market assessment. The target group is encouraged to participate through interviews, live discussions, by calling into programs and by sending e-mail, fax or letter. The program may also employ price games as feed back incentives. The MSME unit will continue its marketing efforts;
- vi. **Program Extension:** After approx. 6 months of regular transmission in one language, the program will start broadcasting in two additional languages;
- vii. **Program Monitoring:** The MSME unit will monitor outreach and record and implement changes as established with the target group.

| Typical Program Format of IRPED   |                    |
|-----------------------------------|--------------------|
| Content                           | Duration (minutes) |
| Program Theme & Opening Billboard | 1                  |
| Program Introduction              | 2                  |
| Business News                     | 3 to 5             |
| Main Feature                      | 10 to 15           |
| Listener Feed Back                | 5                  |
| Business Opportunities            | 3                  |
| Sponsors Message                  | 2                  |
| Closing Remarks                   | 2                  |
| Program Theme & Closing Billboard | 1                  |

#### 4.2.4.3 Innovative Government Driven BDS Programs

90. Under the Program, RGoB will start to systematically support the development of clusters and value chains, be it the critical linkage between agriculture, agro industries and tourism or in manufacturing. The role of MTI/MSME unit shall include the facilitation of clusters or value chains, e.g. by (i) designing and planning cluster/value chain support projects, (ii) acquiring resources required for such projects from various sources, (iii) contracting BDS providers for implementation and (iii) coordinating project implementations.

91. Within this context, the MTI/MSME unit will prepare value chain analyses from procurement of raw materials to final marketing through all the stages of production for at least two value chains namely the agro industry/tourism and the wood processing/construction chains. Consequently, weak or missing links in the value chains are identified. Solutions are devised for creating the missing links or strengthening the weak ones. The cooperation of stakeholders in the value chain is strengthened and subsequently a value chain development program is launched with the ownership of the stakeholders.

92. In addition, the MTI/MSME unit will also facilitate the implementation of cluster development programs in at least 10 Gewoks. These programs will follow-up on the results of industrial investment studies, which are carried out Dzongkhag wise by MTI under the 2006/07 budget and draw lessons learnt from experiences made in other Asian countries with the "one village one product" approach.

93. Value chain and cluster initiatives shall be carried out by the MMSE unit in close cooperation with the provincial BPS/RTIOs and shall be based on joint action plans. BPS/RTIO staff shall be in the driver seat for facilitating local economic development initiatives related to cluster or value chain development. Local stakeholders in particular local representatives of business associations, BCCI, banks, local BDS providers and other

private stakeholders shall be involved in the implementation of such initiatives to the greatest possible extent.

### **4.3 Capacity Building Technical Assistance**

94. A major objective of the proposed technical assistance (TA) is to assist the Royal Government of Bhutan in developing a business environment conducive to small enterprises (MSMEs) development, in conjunction with the Micro, Small and Medium Enterprise Development Program (the Program). The major outputs and deliverables are (i) technical support to the Government and relevant private sector institutions in its efforts to undertake the reforms; (ii) capacity-building support to the Government through workshops, roundtable discussions, and formal/informal discussions; and (iii) support for consensus building and information dissemination, which will be conducted through a series of workshops and other related events to foster consensus building and information dissemination

95. The TA will focus on capacity building measures to guarantee the achievement of four major outputs (i) a policy coordination framework on MSME development; (ii) improved business regulatory environment; (iii) enhanced MSEs' access to market-based finance and (iv) enhanced MSMEs' access to non-financial business development services (BDS). These components aim to help the Bhutanese Government to increase private sector activities in the labour intensive MSME segment of the economy leading to the creation of jobs for Bhutanese for the increasing number of new entrants into the labour market. Detailed terms of reference for the capacity building technical assistance are attached in Appendix 10.

### **4.4 Important Features**

96. In an economy where business laws are inadequately formulated and often lack operative details, the business environment remains highly uncertain and lacks transparency and investments tend to be discouraged. On the other hand, an efficient market economy with a highly transparent and predictable set of market-based rules that are enforceable through an efficient legal system will encourage investment and economic transactions to take place. Enterprises will have incentives to outsource to MSMEs through subcontracting or other arrangements and the MSME sector will grow.

97. The Program will have an impact on MSMEs by creating a more predictable and efficient business environment. This will result from (i) coordination and a more strategic direction for MSME development, (ii) improved business laws and reduced regulatory requirements, (iii) improved access to formal sources of finance and (iv) enhanced access to BDS. The elaboration of an annual MSME white book will significantly improve the availability of information on the development of the MSME sector relevant for policy formulation. A better informed PSDC is expected to cater for more effectively targeted and focused policies and programs which will better challenge the problems of increasing unemployment and migration from poor rural to urban areas. Regulatory impact assessments will ensure that unnecessary laws and regulations that discourage MSME establishment and growth are reconsidered and a simple and transparent regulatory regime will reduce the costs of self-employment, establishing businesses and complying with statutory rules and regulations. The effective channeling of funds to MSEs will stimulate growth of the MSME sector in Bhutan, and the extension of the MSE credit line to rural areas will help to ease regional and economic inequalities. Enhanced institutional capabilities of BDFC will reduce transaction costs making financial services affordable in particular for the rural poor. A cost sharing facility will introduce demand-driven BDS in Bhutan and stimulate enterprise growth in more advanced areas while Government initiatives in cluster development and supply chain development will stimulate enterprise growth in less developed regions. Finally TV/Radio programs on basic entrepreneurial skills, technological and market opportunities in Bhutan's three native languages will support the accelerated growth of enterprises also in hardly accessible, economically disadvantaged areas of the country.



98. The importance of MSME development for Bhutan as a vehicle to promote a more even distribution of wealth, both socially and regionally, and to reduce poverty is well recognized in the design of the Program. The summary poverty reduction and social strategy is annexed as Appendix 9.

## 4.5 Additional Recommendations

99. There are two issues which were addressed in the mid term report of the PPTA: (i) the establishment of a central registry and (ii) the establishment of an appropriate infrastructure for product standards, testing standards and product certification. Both issues have not been followed up in detail by the consultants since the participants of the second tripartite meeting assigned lower priority to these issues<sup>19</sup>. However the consultant still believes that both issues are important to be addressed in the medium term and some preparatory activities may be included under the Program if this can be agreed with RGoB during upcoming consultations. The rationales for the two issues and recommendations for further action are given in the following.

### 4.5.1 Central Registry

100. **Rationale:** To date no registrar for securities has been established in Bhutan, where mortgages or other security interests in moveable and immovable property can be registered. Lacking a proper registrar, the borrower must first obtain a clearance from all financial institutions before a new loan can be processed<sup>20</sup>. In Bhutan, the information structure is weak with regard to tax records and the collateralization of transactions. Even though there are two land registrars at the central and local level<sup>21</sup>, they only maintain records on ownership but not on collateralization of land and buildings. Other registrars for securities have not been established. The failure to establish a registrar for secured transaction is against the provisions set out in the Loan Act 1981, partly repealed by the Movable and Immovable Property Act 1999. The Act calls for a registrar for secured transactions (c.f. Part VI, sec. 35-39), where mortgages and other security interests in moveable and immovable property can be registered. Six years after enactment, this law is still not enforced. The RGoB is obliged by Law to establish a registrar for secured transactions. The reliable registration of securities is a prerequisite for all lending and the financial institutions strongly support a Central Registry for secured transaction to be established.

101. **Action:** It is recommended that RGoB establishes a working group for the implementation of a central registry at RMA. The working group will launch a feasibility study for this purpose and coordinate efforts with those implementing the establishment of the credit information bureau.

### 4.5.2 Standards, Metrology, Testing and Quality

102. **Rationale:** Regulations with the objective to improve standards and quality can be one key to improve the competitiveness of global businesses, leading to innovation, added value and improvement. In Bhutan regulations exist with regard to safety and environmental protection, e.g. building regulation, occupational health and safety standards, environmental laws and regulations. BAFRA<sup>22</sup> sets out import licences, process standards for the

<sup>19</sup> See Appendix 8 Minutes of 2nd Tripartite Meeting

<sup>20</sup> To remedy this situation the government usually sets up a central registrar and provides the legal and judicial system needed. This includes: (i) registrar of residents; (ii) registrar of companies; (iii) registrar on licences; (iv) tax records; and (v) land registrar.

<sup>21</sup> The Ministry of Agriculture under the Department of Survey maintains the land registrar. Another registrar is maintained at the district level (district court).

<sup>22</sup> Regulatory authority to act on behalf of Forestry Act, Seed Act, Livestock Act, Pesticide Act; and with regards to Import/ Export Biodiversity Act, and Social Forestry Rules.

agricultural and food sector, and the Standards & Quality Control Authority (SQCA) within the Ministry of Works & Human Settlement sets out standards for the construction sector. Product and process standards are not introduced in the industry sector. Albeit the importance to adhere to international quality standards for increased exports, competitiveness and success, the only standard identified was the 1995 Bhutan package commodities rules and regulation, supervised by MTI.

103. **Action:** RGOB addressed this issue in the framework of its intention to join WTO by commissioning a paper on National Policy on Standards, Metrology, Testing and Quality<sup>23</sup>. This paper emphasizes the eminent need for launching an SMTQ policy for a successful accession of Bhutan to WTO and comes up with the recommendations to set up a National Standards Committee and a Multi-Sectoral WTO TBT (Technical Barriers to Trade) Committee with a liaison office in SQCA. Important tasks of the committee are (i) to supervise preparation, adoption and application of national standards and (ii) to operate TBT National Enquiry Point to collect, collate and disseminate information on regulation, standards and conformity assessment procedures effecting national trade to agencies concerned. This recommendation is strongly supported by the PPTA as it would effectively solve the prevailing institutional shortcomings.

104. At an initial stage, the Committee will have to look at the possibilities to introduce a one standard, one conformity assessment and one test report system in Bhutan. Recognition of national standards by the committee as well as harmonization of national standards (or creation of equivalent standards) with regional and international standards, wherever possible are the next steps to facilitate interregional and international flow of goods and services and would finally be the gateway to the establishment of infrastructures for (i) standard development, (ii) operation of an accreditation system for conformity assessment, (iii) accreditation of laboratories and (iv) mutual recognition of certificates and test reports.

## 4.6 Financing Plan

105. The total loan amount for the Program is proposed on the basis of the strategic importance of developing the MSME sector and the costs of investment and structural reforms to be supported under the recommended Program. Costs arising from investment to be implemented under the Program are estimated to be around US\$ [10.3] million and costs arising from reforms are estimated at more than US\$ 4,7 million equivalent during the 36 months planned for Program.

106. The project costs arising from investment relate to the following:

- (i) funding of workshops and study tours under the cluster and supply chain development program amounting to US\$ 0.3 million;
- (ii) costs related to the introduction of an OSS benchmarking system such as additional computer equipment and software, computer training, workshops and training sessions amounting to US\$ 0.5 million;
- (iii) costs related to further streamlining of the business formalization process such as additional computer equipment and software, computer training, workshops and training sessions amounting to US\$ 0.5 million;
- (iv) cost related to the introduction of RIA such as assignment of lawyers, implementation of stakeholder workshops and conferences amounting to US\$ 0.5 million;
- (v) capacity building measures for radio and TV staff, journalists and government officials in the context of interactive rural business information broadcasting

---

<sup>23</sup> National policy on Standards, Metrology, Testing and Quality (SMTQ), Draft, Unido-SMTQ Project for SAARC LDCs.

amounting to US\$ 0.5 million;

- (vi) BDFC credit line for MSEs amounting to US\$ 5.0 million; and
- (vii) capacity building needed for the implementation of the Program loan amounting to US\$ 3.0 million.

107. The program cost arising from reforms relate to the following:

- (i) knowledge & information dissemination for government officials of various ministries to better understand cross cutting MSME development issues amounting to US\$ 0.3 million;
- (ii) contracting of additional staff to be employed in the MMSE unit, PPD and the BPS in the RTIOs amounting to US\$ 1.2 million including the staff needed for the CSF;
- (iii) funding of small infrastructure, equipment, subcontracts to local business providers and local business development initiatives under the cluster and supply chain development program of the MMSE unit amounting to US\$ 1.8 million;
- (iv) materials and equipment to support the implementation of additional activities in the MSME unit, PPD and the BPS in the RTIOs amounting to US\$ 0.6 million;
- (v) subsidies for the delivery of BDS to MMSEs under the CSF amounting to US\$ 0.9 million;
- (vi) TV and radio broadcasting time for at least two 30 minutes broadcastings a week amounting to US\$ 0.9 million;
- (vii) costs related to the reduction of fees due to the streamlining of business formalization amounting to US\$ 1.5 million; and
- (viii) other non quantifiable costs occurring as the result of reforms in particular outside of MTI for example in the course of review and possible revision of the Employment and Labour Act or the Food Act.

108. Streamlined licensing, and business registration procedures are expected to reduce fees by US\$ 0.5 million per year. However, the costs associated with the reforms are expected to be compensated by an increase in Government revenues in the long term. For example, as the Program stimulates the growth of the MSME sector and the competitiveness of MSMEs, more enterprises will register and increase profit, and thus revenues from fees and taxes will also increase.

## **4.7 Proposed Implementation Arrangements**

### **4.7.1 Period of Implementation**

109. The period for implementation of the proposed program shall be 36 months.

### **4.7.2 Proposed Program Management Structure**

110. The newly revived PSDC will ensure the participation of all relevant Government Agencies, donors and the private sector in future MSME policy formulation and implementation. PSDC will meet at least quarterly and review pending issues and propose concrete actions for their resolution to ensure timely program implementation.

111. [MOF] will be the Executing Agency and [MTI] will be responsible as Implementing Agency for the production of required reports; launching of legal and implementation of regulatory reforms; and further development and implementation of the MSME development framework, including (i) enhancement of administrative transparency and accountability

among others through the establishment of benchmarked one-stop shops at regional level, (ii) commissioning of studies relevant for MSME policy formulation and elaboration of an MSME White Book, (iii) facilitation of MSME support schemes with CSF as flagship intervention, and (iv) implementation of a credit line for MSEs at BDFC.

112. MTI will create an MSME unit. The Minister of Trade and Industry will assign a coordination function to this unit in order to coordinate MSME development activities within MTI in particular between DoI, PPD and the RTIOs.

## **5 PROGRAM BENEFITS, IMPACTS, AND RISKS**

### **5.1 A. Benefits and Impact**

113. The ultimate beneficiary of this program are business start-ups, micro, small and medium enterprises. The program's impact on MSMEs will be a more predictable and efficient business environment, characterized by (i) an effective and efficient institutional set-up for demand-oriented policy formulation and program delivery, (ii) a legal and regulatory environment supportive to MSME development and adhering to the principal of "Rule of Law", (iii) BDFC as key financial institutions commercially effective and efficient in catering for the MSE credit need, and (iv) an improved access of business start-ups and growing MSMEs to demand-driven business development services, geographically and financially accessible by Bhutan's MSMEs.

114. An improved institutional set up for policy formulation and program delivery will include greater coordination between the various ministries involved and co-ordination between RGoB, the meso level (e.g. the CCI, Sector Associations), and the private sector. It will be able to cater for the development of demand-oriented MSME policies and programs through institutionalized stakeholder participation, systematic MSME feed back via sector analysis, and the gradual transition of RGoB from MSME program implementer to facilitator.

115. An improved legal and regulatory environment will include increased participation of stakeholders in the formulation of laws and regulations and provide the ground for the effective and efficient implementation of these laws and regulations. This will decrease legal uncertainties felt by many entrepreneurs, reduce the cost of doing business in Bhutan, simplify the establishment and operation of private small businesses and thus stimulate MSME sector growth.

116. The implementation of a credit line is expected to play an important role in ensuring the effective channeling of funds to MSEs and thereby stimulating growth within the MSE sector in Bhutan. The extension of the MSE credit line also to rural areas will help to ease regional and economic inequalities. Sub-loans from the credit line will have a positive impact on the local economic situation and employment level as micro and small enterprises are enabled to grow and develop further. In addition, the credit line will contribute to meeting the gap of funds at BDFC for fulfilling its mandate and to financing the demand created by 4,000 MSEs entering the market between 2008 and 2010. The capacity building support to BDFC promotes institutional development and will contribute to the strengthening of the overall financial sector.

117. The existence of demand driven business development services, providing information on e.g. market developments, technology, and improved business management, accessible to MSMEs in urban centers, as well as rural areas is crucial for accelerated MSME development. Three programs will support MSMEs' access to relevant information and external consulting inputs: (i) the CSF will provide the flexible means to provide financial incentives for a wide range of MSME development initiatives, which, without such assistance, would not go ahead, (ii) radio programs on basic entrepreneurial skills, technological and market opportunities in Bhutan's three native languages will support the accelerated growth

of rural enterprises, and (iii) Government driven cluster and value chain programs will support the integration of Bhutanese MSMEs into the world market.

118. Impact of captioned sub programs will be evaluated in yearly intervals, comparing new data with baseline information established at the beginning of the program. Data will be evaluated at enterprise level (e.g. enterprise performance data, tax, employment, finance, impression on legal environment), at BDFC (performance indicators to be established at the of the Program), and at BDS providers level (e.g. enterprise performance data, clients, return clients, # of products). Impact monitoring will be an integrated function of the reformed institutional set up, discussed above and will continue after program completion.

## **5.2 Risks and Safeguards**

119. Successful implementation of the Program entails three risks. The first relates to a lack of capacity within the Government to implement the investment package foreseen under the Program loan and the complex legal and regulatory reforms. So far, RGoB has no or very little experience with the formulation and implementation of MSME programs and policies and lacks most of the urgently needed technical expertise. To address this risk, a capacity building component has been designed to support Program implementation, and engage in capacity building measures in particular for RGoB officials and BDFC.

120. A second risk relates to lack of coordination among various Government agencies. The Program requires close coordination among the relevant authorities. Consultation and coordination will also be required with other donors active in MSME development and the private sector. The Program design addresses this risk by strengthening the newly revitalized PSDC, its secretariat the DoI/MTI and PPD/MTI, both supposed to support PSDC in directing the Bhutanese MSME Development Program.

121. The third risk relates to the role of BDFC as the major financial institution in sustainable MSE finance also in rural areas. In the past, BDFC has diverted from its original development banking mandate, which hampered the institution to perform efficiently. The absence of a clear strategy and business plan, deficiencies in corporate governance, inadequate policies and procedures as well as a weak human resource base imperil the effective utilization of funds. The Program addresses these risks by institutional capacity building to BDFC under the Program in order to make BDFC a sustainable financial institution with MSEs as target clients.

122. Overall, the environmental implications of the Program loan were reviewed and no significant adverse impact was identified. The loan is classified as category C under ADB's environmental classification system.

## Appendixes

## **Appendix 1**

### Program Framework

## PROGRAM FRAMEWORK: SME DEVELOPMENT PROGRAM

| Design Summary   | Targets/ Measurable Indicators   | Monitoring Mechanisms  | Risks and Assumptions   |
|--|--|--|---|
| <b>Goal</b><br>Development of Bhutan's micro, small and medium enterprise (MSME) sector resulting in broad based economic growth, employment, and poverty reduction through accelerated creation of new businesses, and growth of existing MSMEs | Increased share of the manufacturing and services sector in gross domestic product (GDP) (2003=7.79%, 2004=16.1%)<br>Increased share of employment in the manufacturing and services sector (average 2003/04=25%)<br>Increased number of registered and operational MSMEs in particular in the manufacturing and services sector | Economic reports including MSME white book and official statistics of the Government, private sector organizations, and international aid agencies<br>Asian Development Bank (ADB) review missions                           | General economic climate remains positive<br>Sustained positive development of the Bhutanese economy  |
| <b>Purpose</b><br>(1) Set up an institutional framework to support effective MSME sector development   | Effective implementation and coordination of official Government MSME policies, which are based on better statistical information on the sector as well as on overall market principles  | Economic reports and official statistics of the Government, private sector organizations, and international aid organizations<br>Interviews with private sector stakeholders<br>Consultant reports<br>Review missions of ADB | Political commitment to undertake reforms at both central and local governments levels<br>Steady capacity-building and sufficient financial resources of the Government institutions to undertake reforms |
| (2) Improve the legal and regulatory framework for MSMEs to remove barriers for entrance into the private sector   | Revised business laws based on stakeholder consultations, cost-benefit considerations and improved Government services<br>Streamlined, transparent and uniform Government regulations on business registration and licensing   | Official copies of laws, decrees, regulations, etc. from the involved Ministries<br>Cost of doing business reports (World Bank)  | The Government's close and effective partnership with the private sector  |
| (3) Enhance access to market-based finance for MSEs to enable MSE sector growth & MSE competitiveness  | Improved access to (medium- and long-term) finance for MSEs (number of loans)<br>BDFC acts as a sustainable financial development institution according to its mandate   | BDFC reports<br>BDFC Business Plan<br>Reports and official statistics from RMA<br>ADB review missions  | Political commitment to access to finance for MSEs<br>Government supports the creation of a Credit Information Bureau<br>BDFC commitment to MSE finance   |
| (4) Enhance access to and quality of non-financial services to foster MSME sector growth & MSME competitiveness  | Increase availment of business development services foster export businesses of MSMEs or result in import-substitution business<br>Creation of new innovative business ideas leading to startups and small enterprise growth in rural areas  | Monitoring Reports of MTI<br>Statistics of Cost Sharing Facility<br>Reports of BPS officers  | Lack of domestic BDS providers' capability in offering quality BDS  |



| Design Summary  | Targets/ Measurable Indicators  | Monitoring Mechanisms   | Risks and Assumptions  |
|---|---|---|--|
| <b>Outputs</b><br><b>(1) Institutional and Policy environment</b><br>(i) Setup of an MMSE unit within DoI/MTI with the following tasks:<br>- Development and pilot testing of innovative BDS approaches to value chain BDS, cluster & participatory local economic development<br>- BDS facilitation services in the framework of the implementation of key note programs (i.e. Cost Sharing Facility, Cluster Development etc.)<br>both in cooperation with BPS/RTIOs and local BDS providers<br>(ii) Strengthened PPD giving strategic policy advice based on improved statistical information derived from sector studies and regular collection of data by BPS/RTIO | RGoB approval of MSME unit including its functions<br><br>Budget figures reflect (i) increased manpower requirements, (ii) increased financial requirements for testing of innovative BDS and, (iii) financial requirements for the implementation of key note programs in particular the CSF.<br><br>Annual "White Book" on MSME development (2 after 3 years) provides useful information and analyses for policy formulation<br><br>Annual review of the MSME Development Program based on stakeholder consultations and enhanced information on the MSME sector | Government Decree<br><br>Budget plans of MTI<br><br>Evaluation of interviews with donors/stakeholders on "White Book" content<br>Official copy of the MSME Action Program issued by the Government  | Sufficient technical skills locally available<br>Sufficient resources/TA for capacity building of MSME unit, PPD and BDS staff<br>Absorption capacity of target groups |
| <b>(2) Enabling Regulatory and Administrative Environment</b><br>i. Improved business laws and enhanced capacity of business regulators<br><br>ii. Simplified and accelerated business formalization<br>iii. Improved efficiency of RTIOs with business formalization   | RIA Working Group established; Stakeholder participation introduced;<br>Objective of laws and regulations are made transparent to the business community<br>Regular impact assessments of regulations are introduced<br>Unnecessary formalization procedures are eliminated and time needed for business formalization for all micro-enterprises reduced  | Minutes of Meeting of Stakeholder Workshops<br>Interviews with private sector stakeholders<br>World Bank reviews on "Cost of doing business"<br>RIA reports<br>OSS Monitoring Reports<br>Brochures including time benchmarks for business formalization | Political commitment to undertake reforms at both central and local government levels<br>Sufficient resources for capacity building of regulators                      |

| Design Summary  | Targets/ Measurable Indicators   | Monitoring Mechanisms  | Risks and Assumptions  |
|---|--|--|--|
| <b>(3) Access to market based finance</b><br>i. Increasing access to market-based finance for MSEs through a credit line and introduction of cash-flow based MSE lending techniques   | Finance to MSEs has increased (compared to 2004)<br>Accelerated loan appraisal process<br>Reduced collateral requirements for MSE loans  | Periodic reports of BDFC and RMA<br>ADB review missions  | Lack of skills of BDFC staff to implement institutional strengthening measures<br>Willingness of BDFC to implement reforms   |
| <b>(4) Access to business development services</b><br>i.) Increased competitiveness of MSMEs by accelerated use of business development services through implementation of key note programs(i.e. Cost Sharing Facility, Cluster Development etc.)<br>ii. Increased capacities of BPS/RTIOs and local BDS providers<br>iii. Increased outreach of business relevant information | BDS products and quality of service providers are better known by the clients<br>MSMEs' increased sales, increased export sales, growth in profitability and increased employment<br>Accelerated growth of businesses in rural areas<br><br>Increased number of BPS/RTIO clients<br>Increased number of clients and revenues of at least 10 registered and accredited BDS providers (i.e. BCCI)<br>Rural population listening to radio program<br>Businesses use program for advertising | Number of funded projects by CSF<br>MSME market and domestic BDS provider analysis/surveys<br>Financial statements of selected MSMEs<br><br>Financial statements of domestic BDS providers<br>Reports of BPS officers<br><br>Survey on outreach<br><br>Report on feed back by listeners during radio shows<br>Sales of advertisements in the radio program | Sufficient skills with domestic BDS providers available<br>Sufficient number of skilled people willing to work in rural areas for the Program<br>Simple access to radio facilities by target group, transmission quality and coverage satisfactory |
| <b>Activities</b><br><b>(1) Redesign institutional setup at policy level</b>  |  |  |  |
| i. Newly established MSME unit under DoI/MTI to facilitate implementation of key note BDS programs<br>ii. PPD to advise the Private Sector Development Committee (PSDC) on MSME policy formulation and implementation<br>iii. BPS/RTIOs to assist PPD in data collection and MSME unit to implement BDS schemes   | BDS programs are implemented according to pre-set targets<br>High utilization of earmarked program funds<br><br>Multi-sectoral and inter-ministerial MSME development action plans supported by PSDC<br><br>PSDC minutes of meeting include MSME specific issues<br>Government implements MSME related recommendations of PSDC   | Plan of operations for key note BDS programs<br>PDSC/MTI minutes of meeting<br>PSDC policy papers<br>MTI budget utilization reports  | Political will to change the institutional setup<br>Lack of capacity of local staff to carry out tasks as envisaged in the BDS key note programs   |

| Design Summary   | Targets/ Measurable Indicators   | Monitoring Mechanisms  | Risks and Assumptions  |
|--|--|--|--|
| <b>(2) Create an enabling regulatory environment</b>   |  |  |  |
| <p>i. Improve Business Laws and Regulations</p> <p>(a) Introduce RIA Methodology;</p> <p>(b) Review 4 laws/ regulations</p> <p>(c) Assess willingness and feasibility of RIA institutionalization</p> <p>(d) Establish and operate RIA unit</p> <p>ii. Simplify and accelerate business formalization</p> <p>(a) Reduce time and number of necessary procedures</p> <p>(b) Exempt all micro enterprises and introduce fast track formalization</p> <p>iii. Increase accountability and administrative efficiency of RTIOs by improving the information policy and introducing one-stop-shops</p> | <p>Training modules developed, RIA working group established, Laws and related constraints identified</p> <p>Cost-Benefit of RIA assessed and concept outlined</p> <p>RIA policy formulated, operative details set and approved by the National Assembly and RIA continuously conducted</p> <p>Business formalization according to new legal framework</p> <p>Streamlined trade license system (single sub-sector license converted into multi sub-sector license)</p> <p>Fast track formalization for micro-enterprises</p> <p>Accessibility and availability of information regarding government services improved</p> <p>Single access point for business formalization introduced</p> <p>OSS and monitoring system tested and approved</p> <p>Six OSS functioning according to targets</p> | <p>Corporate governance documentation on RIA Working Group; Reports on impact assessments</p> <p>Official copy of RIA decree</p> <p>Reports on impact assessment</p> <p>World Bank "cost of doing business survey"</p> <p>Stakeholder reports</p> <p>Stakeholder reports</p> <p>Government statistics</p> <p>Legal documents on business formalization</p> <p>Standard Operating Procedures (SOPs) for OSS</p> <p>Monitoring reports and monitoring benchmarks for OSS as outlined in the SOPs</p> | <p>Delays may occur in the implementation of reform</p>                  |
| <b>(3) Enhance access to market-based finance</b>  |  |  |  |
| <p>i. Develop demand-oriented products for MSEs</p> <p>ii. Capacity building</p> <p>iii. Institutional strengthening of BDFC</p>   | <p>Active use of credit line</p> <p>Loan appraisal process shortened</p> <p>Loan quality improved</p> <p>BDFC operates according to its mandate</p>  | <p>BDFC reports</p> <p>RMA reports</p> <p>BDFC reports</p> <p>Quarterly and annual reports of BDFC</p>   | <p>Insufficient capacity of BDFC staff to implement required changes</p> |

| Design Summary   | Targets/ Measurable Indicators   | Monitoring Mechanisms  | Risks and Assumptions   |
|--|--|--|---|
| <b>(4) Improve Business Development Services for MSMEs</b><br>i. Operate a Cost Sharing Facility and test and establish other key note programs in order to (a) enhance the competitiveness of MSMEs and (b) strengthen domestic BDS providers<br>ii. Enhance general business information in rural areas by way of a TV/radio program | Development of standard BDS based on BDS supply and demand study (1 after 1 year) information<br>Cost Sharing Facility is funding projects according to business plan<br>Cluster development initiatives established in at least 10 dzongkas<br>At least 2 supply chain initiatives successfully implemented<br>At least 2 broadcastings a week. | Study outcomes<br>CSF statistics<br>Field reports of MSME unit and BPS/RTIO<br>TV/Radio statistics   | Lack of skills with domestic BDS providers to offer high-quality BDS<br>CFC Management capable of implementing the program  |
| <b>Inputs for the Program</b><br><b>1. Program Loan</b><br><br><b>2. Project Loan</b>  | Loan effectiveness (\$4.7 million from ADB's Special Funds' resources)<br><br>Government contribution for the program<br><br>Capacity and institution building to support program implementation (\$10.3 million) in 2007 – 2010.  | Program documents and Loan Agreement (development policy letter)<br><br>MTI budgets<br>ADB review missions<br><br>Review missions by ADB<br><br>Fielding of consultants<br><br>Reports by the consultants<br><br>Workshops and seminars attended by the Government, consultants, and other stakeholders. | <u>Assumption</u><br>Timely loan effectiveness<br><br><u>Risk</u><br>Timely financial allocation by the Government to MTI to increase human resources available for MSME Program implementation<br><br><u>Assumption</u><br>Consultants are selected in an early and effective manner<br>Procurement of equipment in an early and effective manner.<br><br><u>Risk</u><br>Active ownership and monitoring from the Government and ADB |

## **Appendix 2**

### MSME Survey Report

## **BHUTAN**

**Preparing the Small and Medium  
Enterprise Development Program  
TA 4412-BHU**

**Market Survey on Micro, Small and Medium Enterprises  
Evaluation**

*Presented to:*  
Asian Development Bank  
6 ADB Avenue,  
Mandaluyong City  
0401 Metro Manila  
The Philippines  
April 2006

GFA Group GmbH  
Telephone +49-40-603 06-104  
Facsimile +49-40-603 06 109  
E-Mail: [info@gfa-group.de](mailto:info@gfa-group.de)

Prepared by: Christoph Kaut

## TABLE OF CONTENTS

|          |  |          |
|----------|--|----------|
| <b>1</b> | <b>Rationale .....</b>   | <b>1</b> |
| <b>2</b> | <b>MSME Survey Results.....</b>                                      | <b>2</b> |
| 2.1      | Characteristics of MSME Entrepreneurs Interviewed .....              | 2        |
| 2.2      | Business Climate, Infrastructure & Main MSME Business Problems ..... | 3        |
| 2.3      | Licensing & Inspections .....  | 5        |
| 2.4      | Access to Finance .....  | 6        |
| 2.5      | BDS Utilization & Market Size .....                                  | 7        |

## List of Abbreviations

|       |   |
|-------|---|
| ADB   | Asian Development Bank                          |
| BAFRA | Bhutan Agricultural & Food Regulatory Authority |
| BCCI  | Bhutan Chamber of Commerce & Industry           |
| BDS   | Business Development Services                   |
| MSME  | Micro, Small and Medium Enterprises             |
| MTI   | Ministry of Trade and Industry                  |
| Nu    | Ngultrum  |
| PPTA  | Project Preparatory Technical Assistance        |
| PR    | Public Relation                                 |
| RGoB  | Royal Government of Bhutan                      |
| UNDP  | United Nations Development Program              |
| USD   | United States Dollar                            |

## 1 Rationale

1. A number of studies by e.g. the World Bank and UNDP have analyzed the private sector in Bhutan and added greatly to the available knowledge of growth opportunities and impediments in this country. However, surveys excluded Central and Eastern Bhutan and the target group of micro, small and medium enterprises (MSMEs) was at best randomly interviewed; a systematic evaluation of their requirements and bottlenecks was not available at the start of this PPTA.

2. Given captioned constraints on direct information from MSME, indispensable for a proper gap analysis, the PPTA set out to directly interview MSMEs in all areas of Bhutan with significant economic activity. The sample of 38 interviews is small and should be extended within the framework of a comprehensive MSME study. However, it systematically explores the opinion of micro, small and medium entrepreneurs on their business environment, including (i) infrastructure, (ii) effects of RGoB laws and regulations, (iii) access to finance, and (iv) the utilization of business development services by RGoB and commercial providers.

3. The sample of 38 enterprises includes 4 medium, 22 small and 12 micro enterprises and is fairly accurately balanced in representing the sector with small enterprises being the engine of growth. The sample is confined to enterprises from the manufacturing and services sector and excludes the trade sector, as it mainly consists of micro and ad hoc trade operations. The PPTA used the latest MSME classification from the Ministry of Trade and Industry (MTI), which defines industrial and service industries based on invested capital as follows:

- i. medium enterprise are those with an invested capital of Nu. 10 million to Nu. 100 million,
- ii. small enterprise are those with an invested capital of Nu. 1 million to Nu. 10 million, and
- iii. micro enterprises are those with an invested capital of less than Nu. 1 million.

In Bhutan, micro enterprises in the manufacturing industry are referred to as “Cottage Industries”.

4. The geographic distribution of interviews follows the economic relevance of regions as identified in this PPTA inception report. The following table gives an overview of size and geographic distribution of enterprise interviewed:

**Table 1: Size & Geographic Distribution of MSMEs Interviewed**

| Category     | Thimphu / Paro | Phuentsholing | Punakha / Wangdi | Bumthang / Trongsa | Gelephu / Sarpang | Samdrup-J. / Trashigang |
|--------------|----------------|---------------|------------------|--------------------|-------------------|-------------------------|
| Medium       | 1              | 3             | 0                | 0                  | 0                 | 0                       |
| Small        | 9              | 5             | 0                | 3                  | 0                 | 5                       |
| Micro        | 0              | 1             | 2                | 3                  | 3                 | 3                       |
| <b>Total</b> | <b>10</b>      | <b>9</b>      | <b>2</b>         | <b>6</b>           | <b>3</b>          | <b>8</b>                |

5. The average age of interviewed entrepreneurs varied slightly between micro, small and medium enterprises and is displayed in table 2.

**Table 2: Average Age of Entrepreneurs Interviewed by Size of Enterprise and Total:**

| Category    | Micro Enterprises | Small Enterprises | Medium Enterprises | All Enterprises |
|-------------|-------------------|-------------------|--------------------|-----------------|
| Age (Years) | 44                | 42                | 46                 | 44              |



6. The average turn over and employee grouping<sup>1</sup> of the sample of 38 interviewed micro, small and medium enterprises looks as follows:

**Table 3: Average Annual Turn Over (Mio. Nu) & Employees by Size of Enterprise:**

| Category        | Micro Enterprises | Small Enterprises | Medium Enterprises |
|-----------------|-------------------|-------------------|--------------------|
| Turn Over       | 1.02              | 7.89              | 82.25              |
| 1-4 Employees   | 7                 | 7                 | 0                  |
| 5-19 Employees  | 4                 | 11                | 0                  |
| 20-99 Employees | 1                 | 4                 | 4                  |

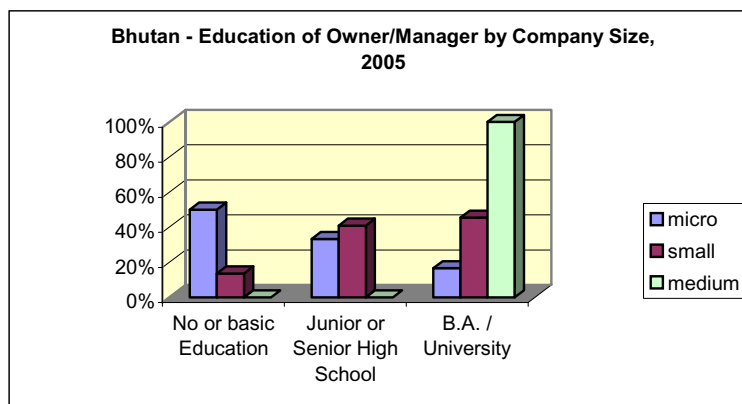
7. Interviews were conducted by the PPTA Team Leader, BDS Expert and local Industrial Expert between 19 August and 16 September 2005 in Thimphu/Paro, Phuentsholing, Punakha/Wangdi and Bumthang/Trongsa and between 10 October and 20 October 2005 in the remote eastern areas of Gelephu/Sarpang and Samdrup-Jongkar/Trashigang by the Industrial Expert. Interviews were conducted with either the proprietor or the manager of the enterprise and lasted on average between 90 and 120 minutes. The PPTA utilized a pre-formulated questionnaire to allow for easy comparison of answers between the enterprises. However, the questionnaire was formulated in a fashion to allow for the inclusion of individual answers, concerns and recommendations by entrepreneurs interviewed.

## 2 MSME Survey Results

8. The results of this compact MSME survey will be presented along the structure of this PPTA. The survey evaluation will open with observations regarding the general business climate as perceived by MSME, MSME perception on the infrastructure of Bhutan and main problems in conducting business. The evaluation will continue with the evaluation of the Bhutanese legal and administrative environment with focus on licensing issues and RGoB inspections. This section will be followed up by an evaluation of access to the finance by MSMEs, and will concluded with the evaluation of sources of business development provision, BDS utilization, payment structures and the market size of commercial BDS for MSMEs.

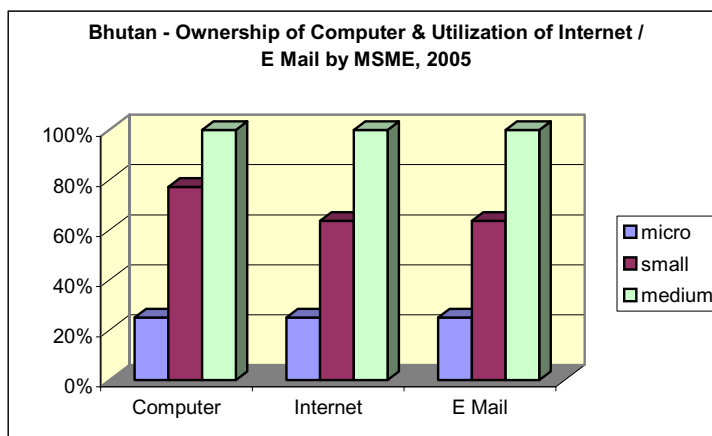
### 2.1 Characteristics of MSME Entrepreneurs Interviewed

9. Age and education of entrepreneurs are important parameters with regard to the dynamics of future development, e.g. the adaptation of new technologies, market trends, marketing & design. The picture shows a relatively high average age of micro entrepreneurs of 44 years, allowing the conclusion that only a minority of micro enterprises are start up operations with the potential to develop into small enterprises. Moreover, a look at the educational level of micro entrepreneurs shows that only 50% have a basic



<sup>1</sup> for details on employee grouping, see annexed questionnaire

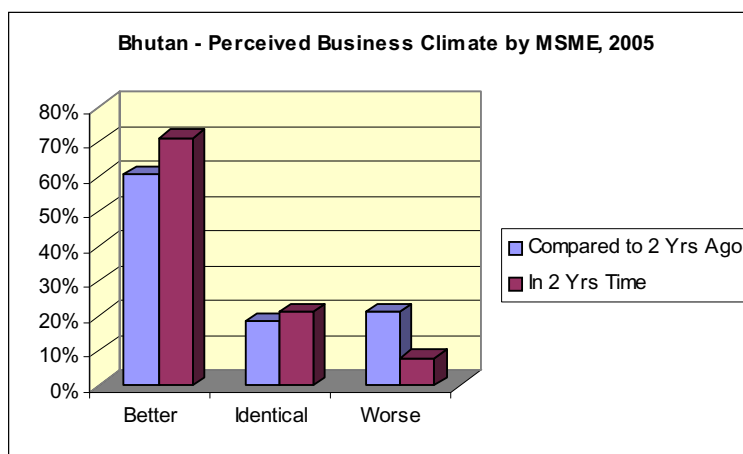
education with another 33% having completed either junior or senior high school. A mere 17% of interviewed entrepreneurs have completed a bachelors degree or hold a university degree. In parallel to this low formal education, only 25% of all micro entrepreneurs utilize computers and are familiar with using the Internet. While the average age of small entrepreneurs is about the same as that of micro entrepreneurs, their education is significantly better with 41% having completed junior/senior high school and 45% holding a bachelors or university degree.



Accordingly, their use of computers and utilization of the Internet with 77% and 64% respectively is significantly higher. All those small entrepreneurs utilizing the Internet are also using e-mail as a contact point and means of communication. Medium entrepreneurs are on average the oldest with 46 years of age. All interviewed entrepreneurs hold a bachelors or university degree and all use computers and access the Internet regularly.

## 2.2 Business Climate, Infrastructure & Main MSME Business Problems

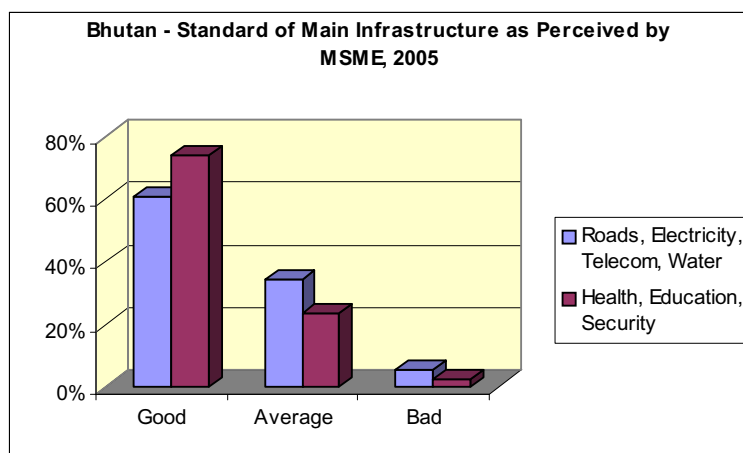
**10. Business Climate:** Looking back 2 years, the vast majority of Bhutanese MSME state that their economic situation has improved. The trend is the same for micro, small and medium sized enterprises. Close to 60% of all enterprise interviewed state that they are better off now than two years ago, compared to 20% of interviewees stating that their business performed better previously. The outlook for MSME is even more optimistic, with more than 70% stating that they expect their business to grow during the coming 2 years, more than 20%



stating that it will at least remain the same and only 8% stating that they expect their business to decline. Businesses are optimistic, because they see an expanding domestic market, more business opportunities in neighbouring India and, in agro processing, the high-end markets of Japan, USA and the European Community.

**11. Hard Infrastructure:** The picture regarding infrastructure is more heterogeneous than that regarding the business climate. For example, enterprises with high requirements for reliable electricity supplies, e.g. bakeries and sawmills, are far more critical regarding frequent and unannounced power cuts than companies less dependent on electricity. The same applies to the road network, generally perceived as very good, with the main argument, that it was much worse 10 to 20 years ago and now reaches into fairly remote areas of this mountainous Kingdom. Wishes for improvements on the road network come largely from

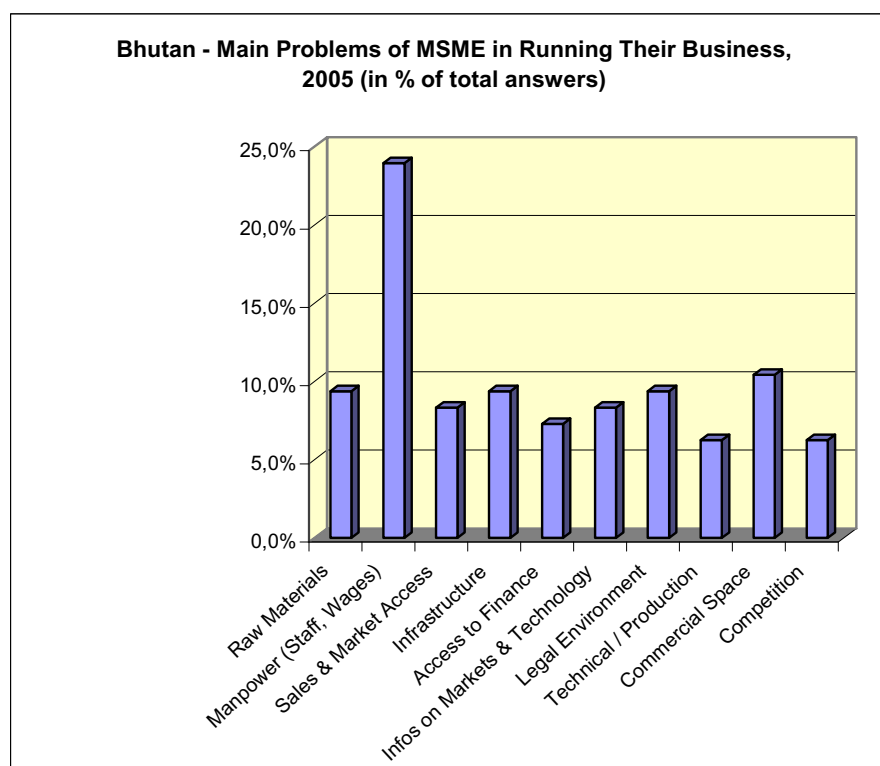
bulk producers and from producers in remote areas, who complain about high transport cost and transit times. Telecommunication, Postal and Courier services as well as the supply with potable water has dramatically improved over the past 10 years according to interviewed entrepreneurs and are not considered to be a problem in daily business operations and future expansions.



**12. Soft Infrastructure:** The main soft infrastructural characteristics health, education and the overall security situation in the Kingdom are generally perceived to be excellent. Especially health facilities and prevention programs and the security situation are regarded as very good. The perception of the educational system, however, is less favorable. Entrepreneurs criticize government schools as less innovative and creative than private schools and complain about the large size of classes of over 30 pupils compared to about 15 in private schools.

**13. Main Impediments in Conducting Business:** MSME face a range of problems in running and expanding their business. Main problem identified is labor with regard to

(i) qualification, (ii) availability of qualified labor, (iii) wage level, and (iv) immigration regulations, preventing entrepreneurs to fill gaps with Indian labor, regarded as being less expensive, better qualified and more productive than indigenous laborers. The next largest problem for an MSME entrepreneur is to find a suitable commercial space. Some MSME reported frequent

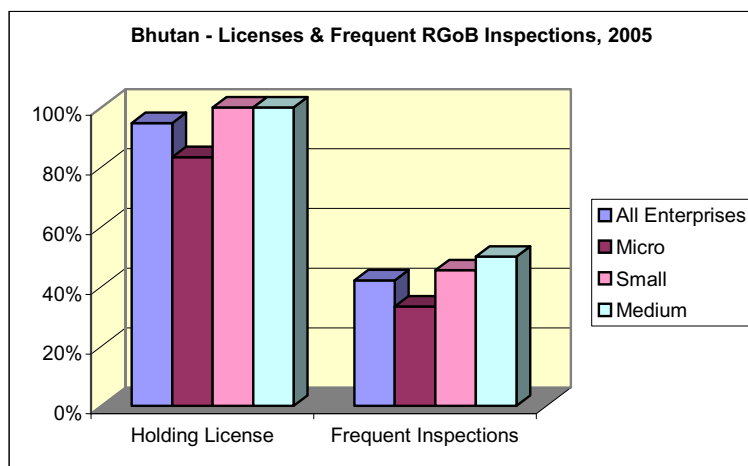


relocations due to changes in spatial plans, difficulties in procuring sufficient space and long waiting periods before removals to larger and more suitable locations. At about the same level are problems concerning (i) raw materials, (ii) access to finance. (iii) sales & market access, (iv) infrastructure, (v) information on products, markets and technology, and (vi) the

legal environment. Problems concerning raw materials are largely related to Bhutanese MSMEs purchasing input products in India, having to travel to the Indian markets themselves, and fluctuating raw material prices, especially for steel, over the last few years. Problems concerning access to finance are largely connected to the stringent collateral requirements. In those cases, where collateral was available, the main problem was the volume of credits granted by banks, which was generally smaller than what entrepreneurs did apply for. Problems with market access and sales are largely attributed to the limited size of the Bhutanese domestic market, forcing larger MSME at the border to search for sales markets in India. Infrastructural problems are largely attributed to the instable supply of electricity and mainly affect bakeries, sawmills and wood processing enterprises. Information on products, markets and technology is regarded crucial by MSME. In order to keep or raise their competitiveness and expand their business, entrepreneurs mainly look for international information, best practices and benchmarks. Currently information on these topics is not adequately provided for by RGoB and meso level institutions (e.g. BCCI, sector associations) and frequently too expensive to gather by individual MSMEs. With regard to the legal environment, entrepreneurs especially criticized high taxes, complex import procedures and frequent inspections by a plethora of RGoB departments. Competition and technical problems related to production are rated lesser problems in running an MSME in Bhutan.

## 2.3 Licensing & Inspections

**14. Licensing Procedures:** In Asia, Bhutan is a rare example for enterprise compliance with business license procedures<sup>2</sup>. Except for three newly established micro enterprises, every enterprise of the survey sample holds one or more licences according to the prevailing regulations. Main problems in obtaining a new business licence were (i) the police clearance and (ii) the locational clearance. Complex procedures and long processing times were a particular issue for those businesses that had to obtain an environmental clearance. Most micro enterprise have to complete the same formalization



procedures as small, medium and large enterprises. Micro enterprises considered missing exemptions in the formalization process a particular problem. Business licence renewal procedures, in turn, are fairly simple and fast, taking as little as a few hours. The tax clearance as prerequisite for the yearly renewal of a business licence is issued without further delay by the Regional Revenue and Customs Office after Income Tax has been assessed and paid.<sup>3</sup>

**15. Inspections:** On average, more than 40% of all MSME interviewed recorded and complained about frequent inspections, disrupting their business operations for up to 3 days. Inspections by RGoB law enforcement officers vary with regard to the geographic location of enterprises and sectors. Along the border to India, raids by immigration officers are as

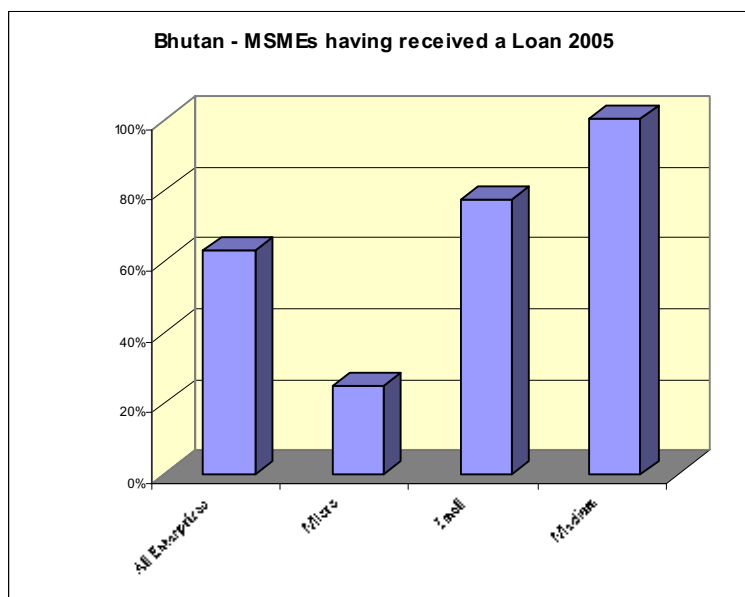
<sup>2</sup> In Indonesia for example compliance of MSME with licensing regulations lies in the range of 5-10%,

<sup>3</sup> Income Tax is frequently estimated as the majority of enterprises do not keep books of accounts, albeit it is required for all licensed enterprises in Bhutan

frequent as twice monthly, while there are hardly any raids in the interior districts of Bhutan. Environmental inspections, including control functions on occupational health, are more frequent in the industrialized areas of Bhutan along the Indian border and around the Thimpu/Paro area, while frequent tax inspections are recorded from all over Bhutan. Health and hygienic inspections are largely confined to agro processing industries. For instance, one bakery in the Bumthang Valley complained about twice-weekly health and hygienic inspections by the local branch of BAFRA. The major governance problem behind random and frequent checks is that Ministries and regional branch offices inspect without a sufficient legal base. Lacking a detailed authorizing legal framework which sets out the scope, requirements and other formalities for government action, inspections infringe the principle "Rule of Law", meaning that the enforcement of legal frameworks should be predictable, fair and impartially particularly if it comes to legal rights like the protection of property and economic freedom.

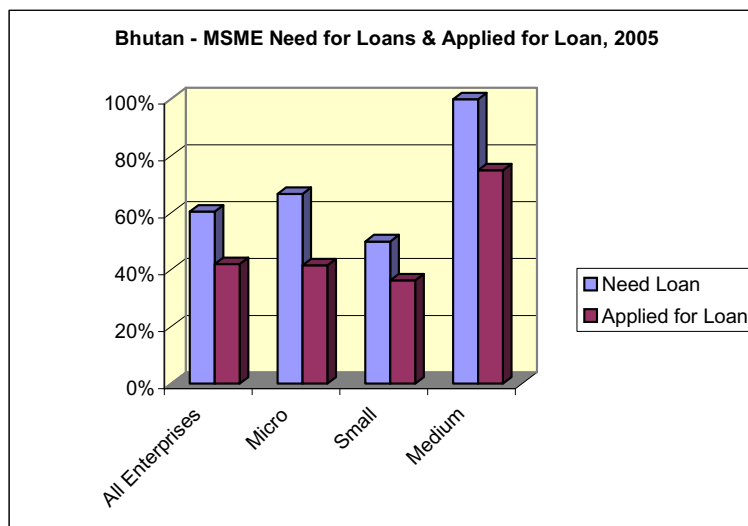
## 2.4 Access to Finance

**16. Loan Received from Financial Institutions:** The MSME survey verifies that access to finance is one fundamental constraint for MSMEs as only 60% of all enterprises interviewed had received a loan from a financial institution. However, the picture varies greatly between MSMEs. Medium enterprises seem to be well received among the financial institutions as all of them had received a loan. The survey shows, however, that the amount received was not sufficient as all medium sized enterprises required additional loans (see graph below). The entrepreneurs were also asked from which financial institutions they received the loan and interestingly enough the financial institutions were almost equally represented.



Actually two of the entrepreneurs had received loans from two separate financial institutions. One reason to the equal representation of the financial institutions might be that close to 50% of enterprises interviewed were located in Thimphu or Phuentsholing, where all financial institutions are represented and competition is high.

**17. MSME Requirements for Loan:** The majority of MSMEs interviewed were in need of a loan. Even though all medium enterprises have already received a loan, they required additional external finance, leading to the assumption that loan amounts received were not sufficient. The same applies to the micro and small enterprises. That the MSMEs needed a loan does not necessarily mean that they also applied for a loan as the graph to the right shows. The major reason for not applying (or for having applied, but being declined) was insufficient collateral. The survey indicates further that the need for external sources of finance among small enterprises is smaller than among micro or medium enterprises. This finding is not in line with international benchmarks. It may be a peculiarity of Bhutan and should be further evaluated within the framework of a larger, comprehensive MSME study.

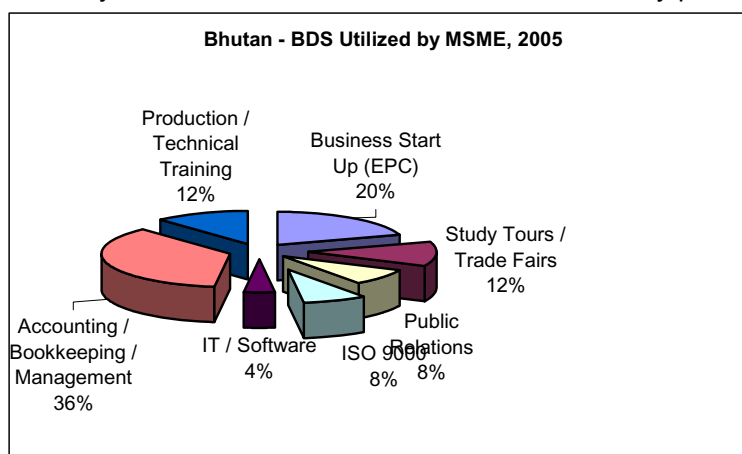


**18. Further Sources of Finance:** To meet the demand for finance the MSMEs had to use further sources of finance. 20% of all enterprises interviewed had received a loan from friends or relatives. In some cases these sources were used in addition to a bank loan, but mostly as the only source of external finance.

**19. Lack of Collateral:** About 20 % of all MSMEs stating that they require a loan did not apply. The reasons for not doing so was without exception lack of sufficient collateral, which was confirmed to be the biggest constraint in access to finance. The survey explored the collateral situation of entrepreneurs. All but three loan recipients had given mortgage of land and buildings as collateral, either solely or in combination with machines or third party guarantee. The reason for banks to decline loan applications was in most cases the low value of mortgage offered as collateral.

## 2.5 BDS Utilization & Market Size

**20. BDS Utilization:** The MSME survey shows that the market for BDS is covered by private providers, providers from the meso level (e.g. BCCI) and RGoB. Providers cover a fairly comprehensive range of BDS, including basic training courses in business establishment and start up, accounting & book keeping, production & technical training, study tours and trade fair participation, quality certification (ISO 9001), PR and IT training & software development and installation. Especially larger small and medium enterprises wish for more opportunities to visit international trade fair and



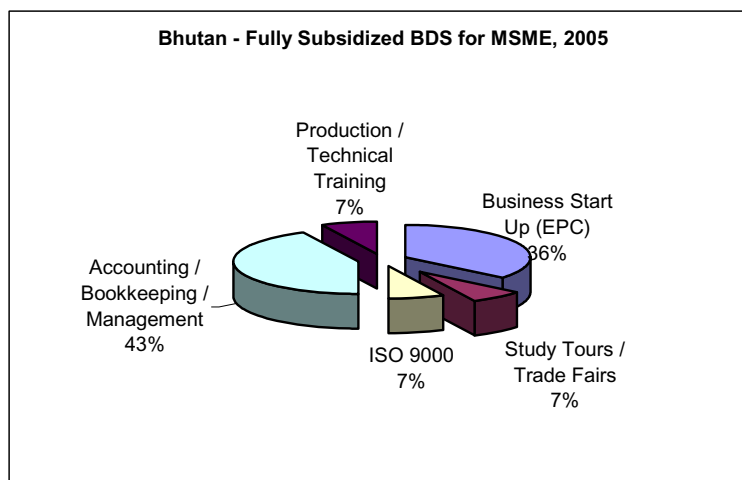


manufacturing industries to get a better picture of the production standards, market requirements, productivity level and sales prices on international markets with the idea of being better prepared to compete with increasingly high quality imports and to eventually cut a share in export markets.

**21. Fully Subsidized Services:** In Bhutan two overlapping markets exist for the provision of BDS; the demand driven market for BDS, covered by private providers, and the supply driven

market for BDS, covered almost entirely by providers from government, largely catering for Start Ups and the lower end of MSMEs. This market is characterized by full operational subsidies by government and donors, and the scarcity of private providers due to the lack of viable opportunities. Fully subsidized BDS are most prominent in (i) training courses for business start ups, and (ii) basic accounting, book keeping

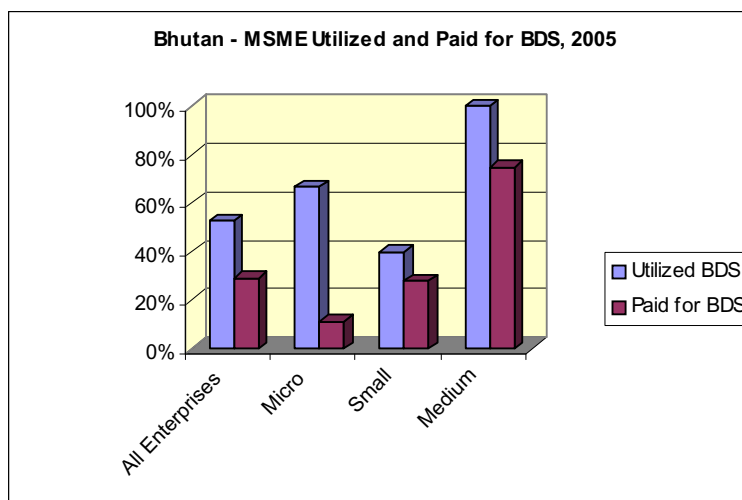
and management courses, making up almost 80% of all subsidized BDS. These are the core BDS financed and implemented by government. The remaining 20% are equally shared by (i) study tours/trade fair participation, (ii) production & technical training, and (iii) quality certification, largely financed by external donors.



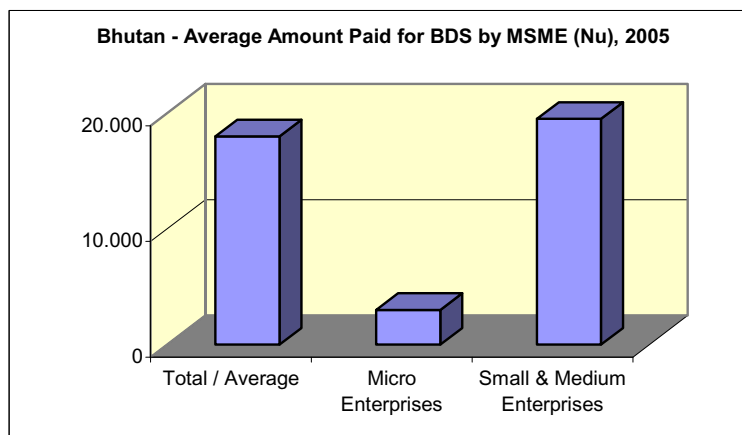
**22. Fully Paid BDS:** Albeit the dominance of government in the provision of MSME support services, a market for commercial BDS exists and so do commercial operators. As shown in

the graph on the right, commercial providers cater for small businesses and especially medium scale enterprises or operate in niche markets not touched by government (e.g. IT training & software, PR). The survey shows the surprisingly high number 53% of all interviewed MSME, having utilized external support services and 29% having either always or sometimes paid for BDS. The combined

figures for small and medium enterprises show an even higher level of paid BDS of close to 35% and helps to explain the existence of commercial BDS providers, albeit almost exclusively confined to the economic centers of Thimphu/Paro and Phuentsholing.



**23. BDS Payments & BDS Market Size during Loan Implementation:** Compared to inter regional benchmarks, the payment for business development services is in range with micro enterprises with an average of Nu. 3,000. Small and medium enterprises, however, spent a significant average amount of Nu. 19,500 on commercial BDS. Calculations of the market size for commercial business development services are based on captioned average prices. The projection of the total average number of MSMEs during the implementation period was calculated based on latest statistics from MTI and using an exponential trend formula. Table 3 summarizes the estimation.

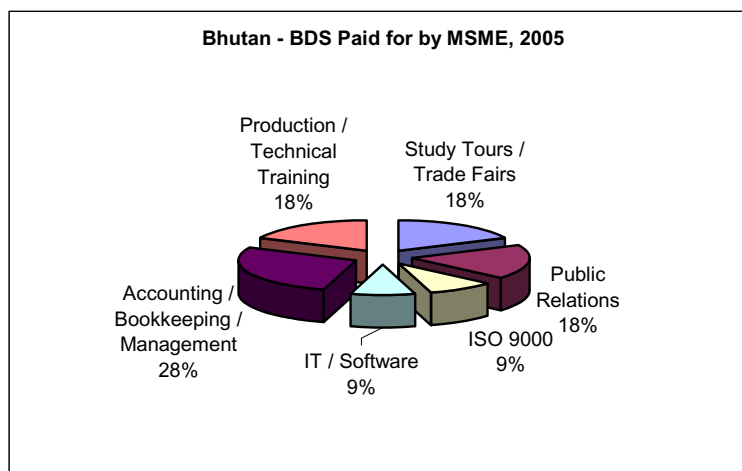


**Table 3: Estimated Average Yearly Volume of the Market for Commercial BDS, 2007 to 2009:**

| Category                   | # of Units | A'ge Unit Expenditure p.a. | Total p.a.       |
|----------------------------|------------|----------------------------|------------------|
| Small & Medium Enterprises | 1,393      | 19,500                     | 27,153,600       |
| Micro Enterprises          | 7,989      | 3,000                      | 23,967,000       |
| Average / Total p.a. (Nu)  | 9,382      | 5,450                      | 51,130,500       |
| <b>Total (USD) p.a.</b>    |            |                            | <b>1,162,057</b> |

Exchange rate: USD 1 = Nu 44

**24. Overlap of Commercial and Subsidized Services:** Comparison of the graphs on fully subsidized BDS and paid BDS reveals an overlap between subsidized and commercial BDS, especially in the field of (i) accounting, book keeping and management, and, to a lesser extent, in the fields of (ii) production, technical training, (iii) study tours & trade fairs, and (iv) quality certification (ISO 9000). These survey findings indicate that commercial capacities exist here and may be utilized by government in case RGoB ceases its own BDS operations and decides to outsource the



implementation of subsidized BDS to private providers. IT and software services and services in PR are only available on a commercial basis. Finally interviews revealed that currently BDS is only available either fully subsidized or on a full pay basis. Any partially subsidized or co financed BDS could not be identified.



## **Appendix 3**

### Official Classification of Enterprises

**APPENDIX 3: OFFICIAL CLASSIFICATION  
OF ENTERPRISES (2001)****I. TRADE**

| <b>Category</b> | <b>Investment Range</b>  |
|-----------------|--------------------------|
| Large           | More than Nu. 10 million |
| Medium          | Nu. 5-10 million         |
| Small           | Nu. 1-5 million          |
| Micro           | Less than Nu. 1 million  |

**II. MANUFACTURING INDUSTRY**

| <b>Category</b> | <b>Investment Range</b>   |
|-----------------|---------------------------|
| Large           | More than Nu. 100 million |
| Medium          | Nu. 10-100 million        |
| Small           | Nu. 1-10 million          |
| Cottage         | Less than Nu. 1 million   |

**III. SERVICE INDUSTRY**

| <b>Category</b> | <b>Investment Range</b>   |
|-----------------|---------------------------|
| Large           | More than Nu. 100 million |
| Medium          | Nu. 10-100 million        |
| Small           | Nu. 1-10 million          |
| Cottage         | Less than Nu. 1 million   |

## **Appendix 4**

### Business Plan: Cost Sharing Facility

**BHUTAN**

**Preparing the Micro, Small and Medium  
Enterprise Development Program  
TA 4412-BHU**

**Cost Sharing Facility – Business Plan**

*Presented to:*  
Asian Development Bank  
6 ADB Avenue,  
Mandaluyong City  
0401 Metro Manila  
The Philippines  
April 2006

GFA Group GmbH  
Telephone +49-40-603 06-300  
Facsimile +49-40-603 06 399  
E-Mail: [info@gfa-group.de](mailto:info@gfa-group.de)

Prepared by: Christoph Kaut

## TABLE OF CONTENTS

|                    |   |           |
|--------------------|---|-----------|
| <b>A</b>           | <b>EXECUTIVE SUMMARY .....</b>                              | <b>1</b>  |
| <b>B</b>           | <b>BUSINESS PLAN .....</b>                                  | <b>3</b>  |
| <b>1</b>           | <b>Rationale, Objectives and Outcomes .....</b>             | <b>3</b>  |
| 1.1                | Rationale.....  | 3         |
| 1.2                | Objective, Expected Results and Duration of the CSF .....   | 4         |
| <b>2</b>           | <b>Structure and Implementation.....</b>                    | <b>4</b>  |
| 2.1                | Eligible Applicants and Services.....                       | 4         |
| 2.2                | BDS Providers .....   | 5         |
| 2.3                | Subsidy & Disbursement Strategy .....                       | 6         |
| 2.4                | Promotion .....   | 6         |
| 2.5                | Performance Evaluation .....                                | 6         |
| 2.6                | Duration & Exit Strategy .....                              | 8         |
| <b>3.</b>          | <b>Organizational Set-up .....</b>                          | <b>8</b>  |
| 3.1                | Role of Key Institutions .....                              | 8         |
| 3.2                | The CSF Management Unit.....                                | 10        |
| <b>4.</b>          | <b>Financial Projections .....</b>                          | <b>12</b> |
| <b>5</b>           | <b>Project Phasing – Work Plan.....</b>                     | <b>15</b> |
| <b>C</b>           | <b>APPENDICES .....</b>                                     | <b>16</b> |
| <b>Appendix 1:</b> | <b>CSF – Job Descriptions of Key Personnel.....</b>         | <b>17</b> |
| <b>Appendix 2:</b> | <b>Financial Summary.....</b>                               | <b>20</b> |
| <b>Appendix 3:</b> | <b>Terms of Reference for PSDC Involvement in CSF .....</b> | <b>22</b> |

## List of Abbreviations

|      |  |
|------|--|
| ADB  | Asian Development Bank                                 |
| AP   | Appraisal Panel  |
| BCCI | Bhutan Chamber of Commerce & Industry                  |
| BDS  | Business Development Services                          |
| BEPC | Bhutan Export Promotion Center                         |
| BoT  | Board of Trustees                                      |
| BP   | Business Plan  |
| BPS  | Business Promotion Sections (Departments within RTIOs) |
| COO  | Chief Operating Officer                                |
| CSF  | Cost Sharing Facility                                  |
| FY   | Fiscal Year  |
| HRD  | Human Resource Development                             |
| M&E  | Monitoring and Evaluation                              |
| MIS  | Management Information System                          |
| MSE  | Micro and Small Enterprises                            |
| MSME | Micro, Small and Medium Enterprises                    |
| MoA  | Ministry of Agriculture                                |
| MoF  | Ministry of Finance                                    |
| MTI  | Ministry of Trade and Industry                         |
| MU   | Management Unit (of CSF)                               |
| OVI  | Objectively Verifiable Indicators                      |
| PPTA | Project Preparatory Technical Assistance               |
| PR   | Public Relation  |
| PSDC | Private Sector Development Committee                   |
| RGoB | Royal Government of Bhutan                             |
| RIM  | Royal Institute of Management                          |
| RTIO | Regional Trade and Industry Office                     |
| SOP  | Standard Operating Procedures                          |
| TA   | Technical Assistance                                   |

## A EXECUTIVE SUMMARY

1. **Economic Benefits of a Cost Sharing Facility for MSMEs:** As most of the industries are still infant in Bhutan, investment in particular in technological know how and skills development is still low. Small entrepreneurs are aware of the need to invest in human resources and know-how. However, given the current conditions they lack capital and often tend to postpone necessary investments in HRD and information. This, in turn, heavily impedes (i) the growth of businesses, (ii) the growth of the economy, and (iii) may finally lead to an irreversible fallback in international competition. Keeping in mind that between 2005 and 2010 about 65,000 young people will search for employment, it is the manifested public interest to accelerate private sector development, company growth and support businesses in overcoming their prevailing constraints. Captioned framework ultimately does not only justify but also require government co-financing of MSME development schemes. For government, the value added of the Cost Sharing Facility (CSF) is indirect in form of accelerated enterprise growth, additional employment opportunities, and subsequently higher tax payments to RGoB. Project monitoring will quantify captioned factors and evaluate the benefits of the facility.

2. **Functions of CSF:** The core function of CSF is to reduce the cost of external service provision, increase the utilization of BDS by MSMEs and thus perpetuate the development of MSME and the market for commercial BDS. The program will run for a period of 3 years after which it will be terminated, if not prolonged, based on the positive outcome of an impact assessment at enterprise level. It operates on a first come – first serve basis. CSF will co-finance projects of successful applicants with a flat rate of 50% of the total project amount. This share proportion is an internationally established benchmark and gives high assurance, that entrepreneurs only apply for CSF funds, if the project genuinely provides for value added to their enterprise. The characteristic of CSF is inclusive rather than financing a limited scope of projects. Typically, the CSF will finance a consultant to create new designs in the furniture industry, but not a permanent designer. It will finance an expert to improve on the quality and efficiency of a dairy, but not the purchase of capital investments as a result of the expert study<sup>1</sup>. The CSF will allow for individual and group applications by enterprises and providers (e.g. BCCI, NGOs), but will exclude public and parastatal enterprises. Encouraging the development of a market for commercial BDS, the CSF will support BDS start-ups and allow for their qualified applications for seed capital co-financing.

3. **CSF Coverage and Size:** CSF will operate countrywide. Against the backdrop of international experience and benchmarking, it is estimated that a total of 250 projects will be granted. CSF will limit applications by applying a minimum grant volume of USD 1,000 (project cost USD 2,000) and a maximum grant volume of USD 25,000 (project cost USD 50,000) to keep administrative costs at a tolerable level and ensure that the main beneficiaries are served. The amount of CSF grants and CSF operational cost is conservatively calculated at USD 0.875 million and USD 0.261 million respectively. The calculation is based on (i) the projected number of MSME during the implementation period of CSF, (ii) average yearly spending of MSMEs on BDS, (iii) estimated average CSF project costs, (iv) analysis of operational costs for comparable operations, and (v) international benchmarks.

4. **Organizational Set Up of CSF:** The facility shall be organized as follows:

---

<sup>1</sup> Credit operations should be strictly limited to the financial market to adhere to best banking practices, avoid disrupting a level playing field and handing out hidden subsidies.

- i. **Board of Trustees (BOT):** PSDC functions as Board of Trustees and shall govern the facility. PSDC which is supposed to meet at least at quarterly intervals, shall endorse yearly work plans, budgets and accounts of the management unit;
- ii. **CSF Management Unit (MU):** The MU shall be responsible for marketing, project analysis, financial management and monitoring & evaluation. The management unit shall be accountable to PSDC. The unit shall employ three professional staff, taking over one or more of the following functions: (i) unit management, (ii) marketing, (iii) project appraisal, (iv) financial appraisal, (v) accounting, and (vi) monitoring & evaluation. Staff shall be selected by PSDC and have a strong private sector background to ensure close affiliation with the private sector and a high understanding of their needs and requirements, regarded essential for appropriate project appraisals. As there is no previous experience in Bhutan with project related grant facilities, it is recommended to have the facility managed by an international expatriate during its first months of operations. The management unit shall ideally be integrated as a temporary sub-unit with the MSME unit of MTI to create synergies and reduce overheads by partly utilizing the same facilities, in particular the BPS/RTIOs of MTI.
- iii. **Appraisal Panel (AP):** A five-member Appraisal Panel will be appointed as a sub-committee to PSDC. Its function is to review the CSF grant proposals recommended by the MU. A quorum of three members will be required to approve applications, by majority vote if necessary. The manager of the MU shall be a full voting member of the Appraisal Panel.

The CSF shall not become a division of meso level institutions, namely BCCI or sector associations, due to (i) a conflict of interest regarding the potential dual role of these institutions as BDS provider and CSF manager, and (ii) a bias of these institutions towards lobbying functions for their own clients.



## **B BUSINESS PLAN**

### **1 Rationale, Objectives and Outcomes**

#### **1.1 Rationale**

**5. Economic Benefits of a Cost Sharing Facility for MSMEs:** As most of the industries are still infant in Bhutan, investment in particular in technological know how and skills development is still low. Small entrepreneurs are aware of the need to invest in human resources and know-how. However, given current conditions, they lack capital and often tend to postpone necessary investments in HRD and information. This, in turn, heavily impedes (i) the growth of businesses, (ii) the growth of the economy, and (iii) may finally lead to an irreversible fallback in international competition. Keeping in mind that between 2005 and 2010 about 65,000 young people will search for employment, it is the manifested public interest to accelerate private sector development, company growth and support businesses in overcoming prevailing constraints. The captioned framework ultimately does not only justify but require government co-financing of MSME development schemes. For government the value added of the Cost Sharing Facility (CSF) is indirect in form of accelerated enterprise growth, additional employment opportunities, and subsequently higher tax payments to RGoB. Project monitoring will quantify captioned factors and evaluate the benefits of the facility.

**6. BDS Increase Competitiveness of MSMEs:** International experience shows that competitiveness depends on the speed at which an MSME is able to build within itself the different skills, know-how, expertise, and market understanding required by the fast-changing external economic realities. An effective method for building these capacities within the MSME is to buy in external business development services. The Bhutanese MSME sector is characterized by a generally low usage of external services and a fragmented market for Business Development Services (BDS), which adversely affects the sector's competitiveness and its potential contribution to economic development and employment creation.

**7. Demand Side Constraints:** The major constraints which lead to the indicated low usage of BDS on the demand side are (i) small and especially micro enterprises are mostly unaware of their need for external support services, (ii) micro, small and medium enterprises lack market information on international BDS, (iii) MSMEs needs are not matched with systematic and continuous supply, and (iv) MSMEs are reluctant to invest in services with unproven value.

**8. Supply Side Constraints:** The major constraints for developing a vibrant BDS market on the supply side are (i) a generally small market in a country with about 700,000 inhabitants, (ii) a limited market for commercial providers due to direct provision of BDS by RGoB, (iii) a limited number of commercial providers, mostly catering for medium and large enterprises, and (iv) a lack of information on MSME demand for BDS.

**9. Introduction of CSF:** The CSF will be established to enhance MSMEs' competitiveness and to stimulate the market for BDS from domestic and international sources. In order to encourage the use of BDS, the CSF will provide grants to private MSMEs, including service providers, whose proposals have been approved by the facility. Approved applicant MSMEs will receive grants to cover 50% of the costs of utilizing (or developing) business development services aimed at enhancing enterprise competitiveness. A broad range of services will be covered, including (i) technology upgrading, (ii) market and product development, (iii) international standards, (iii) business and financial planning, (iv) training and skills development, (v) management development, and (vi) general business strategy.

10. **Three Activities of CSF:** The facility will introduce three activities to encourage the development of a dynamic market for BDS and improved development opportunities for MSMEs:

- i. **Service Grants:** Private MSMEs including service providers, whose proposals have been approved, will receive grants to cover 50% of the costs of using or developing business services aimed at enhancing MSME competitiveness. A broad range of services will be covered, including technology upgrading, market development, compliance with international standards, business and financial planning, training and skills development, management development, and general business strategy;
- ii. **Free 'hand-holding' assistance:** The CSF management unit will guide MSMEs to develop business proposals and apply for matching (cost sharing) grants in order to enhance skills and know-how necessary to operate their business. It is intended to build awareness and/or confidence in entering what is, for many MSMEs, the new and unknown activity of buying BDS;
- iii. **Active and Intensive Promotion:** The CSF management unit will be actively promoted, as will the benefits of using external BDS, in order to enhance competitiveness.

## 1.2 Objective, Expected Results and Duration of the CSF

11. **Objective:** The goal of the CSF is to improve competitiveness and enhance the revenue-generating capacity and profitability for its targeted client base.

12. **Expected Results:** MSMEs have improved access to external support by increasing their financial capacity to purchase business development services suitable for their economic development. It is expected that approximately 250 projects will be executed during the three-year implementation period of the facility.

13. **Duration & Exit Strategy:** The CSF will be limited to an initial period of three years, after which it will be evaluated against a set of indicators, elaborated below. In case of a positive cost / benefit ratio it may be prolonged for a further fixed number of years. As the facility is time bound to a three-year implementation period, it has a clear exit strategy. All staff employed will hold corresponding employment contracts.

## 2 Structure and Implementation

### 2.1 Eligible Applicants and Services

14. Cost sharing grants provide opportunities to develop the BDS sector by providing financial incentives to MSMEs to employ a range of services designed to enhance their competitiveness internationally and locally. The key elements to be considered under the cost sharing scheme are:

15. **Eligible Applicants:** The main target group for grants will be MSMEs which cover enterprises with a paid in capital of up to Nu 100 million. MSMEs or groups of MSMEs can apply for grants to co-finance their use of BDS to enhance their competitiveness. Cost-sharing grants will also be available to small and medium BDS providers to enhance their capabilities to provide services. Only private individual MSMEs, recognized groups of MSMEs, individual service providers or recognized groups of service providers are eligible. Both locally-owned and foreign-owned MSMEs or service providers will be equally eligible. Parastatals, government entities and other MSMEs or service providers where the government or its agencies have effective management control, by virtue of being the largest shareholder, or by virtue of having a board majority, are not eligible.

16. **Group Activities:** Group activities covering more than one MSME or service provider, for instance those sponsored by business or trade associations, BCCI or organized clusters, will be supported. Where an application is made on a group basis, that application will be evaluated and processed as a single application.

17. **Eligible Services:** Any usage of an external service or of travel, and which can reasonably be expected to contribute to the achievement of an eligible diversification/development plan, will constitute an eligible service usage. For each eligible service usage for which grant support is being sought, the MSME concerned will be expected to provide at least one "deliverable," the sight of which will verify that the activity has indeed taken place as approved. Depending on the circumstance, a defined deliverable might consist, for instance, of a detailed engineering drawing; a product prototype incorporating quality improvements; a training certificate; or an externally commissioned market report. The following examples of service usage that would normally be eligible under this definition are provided purely for guidance. The list is not intended to be exhaustive.

- In-factory consultancy and short-term contract management services, for example up to three months in duration per introduced expert, would normally be eligible, but new permanent staff appointments would not. The length of time for which temporary contract management could be supported would depend on a case being made as to how long the required transfer of know-how, skills, etc. could reasonably be expected to take;
- The expenses incurred in exposure tours for factory personnel to view alternative techniques and technologies in factories elsewhere would normally be eligible, as would market exploration tours by marketing personnel, to explore new market opportunities.

18. **Eligible Expenditures:** Expenditures on service fees, and expenditures on travel and incidental expenses charged at cost, incurred wholly and exclusively on a CSF-approved service/ travel usage will be eligible for grant support. Salaries for staff employed by MSMEs are not eligible, nor are recurrent costs such as royalty fees and no capital expenditures can be allowed. No single recipient MSME or group of MSMEs may receive total grants in excess of a cumulative limit of USD 25,000 (project costs of USD 50,000) unless expressly approved by PSDC. In this context, MSMEs are considered to be a group if their annual accounts are reported together in one document, or if they are owned by the same entity or under the effective management control of the same board or entity.

## 2.2 BDS Providers

19. **Selection of BDS Providers:** The selection of the BDS provider is the responsibility of the applicant. However, the CSF Management Unit will establish the supplier's competence for the task intended, and ensure that there is a genuine arms-length commercial relationship between the MSME and the BDS provider. The CSF management unit will examine the bona fides of BDS providers and will retain the right to refuse applications from providers where they consider a potential abuse of the facility is likely, or where the CSF is not convinced of the BDS provider's ability to deliver the contracted service(s). The CSF may require the BDS provider to show evidence of assignments of a similar nature in the form of third party references. In the case of new-comers the BDS providers will need to provide CVs of professional staff, indicating that the experience of the consultants is appropriate to the task.

20. **Project Initiation:** Projects may be initiated either by the potential recipient MSME or by a group of MSMEs, or by a BDS provider who may identify a project on behalf of the recipient(s). In all cases applications must include both a recipient and a BDS provider, and the choice of BDS partner is firmly the responsibility of the enterprise. In the case of larger grants or feasibility studies, an international BDS provider may be used if there is no competent local or national provider. National providers may also sub-contract to specialist experts where necessary and work with the specialist to build local capacity.

21. **Expenditure Control:** The CSF management unit will, from time to time, determine maxima or capped expenditures – including fees and daily allowances if applicable - for all contracted BDS inputs. Any expenditure by clients in excess of these capped amounts will be for the account of the client.

22. **Support by the MSME Unit of MTI:** Providers may need assistance in reaching their target market and in modifying their traditional products to meet the needs of the MSME market segment. The MSME unit of MTI will help to fill in this information gap and develop service providers' capabilities. Alternatively the providers may take advantage of the CSF program themselves to develop capacities. The type of support envisaged will include (i) training of trainers, (ii) consultancy skills, (iii) business needs analysis, (iv) promotional techniques, (v) technology support etc.

### 2.3 Subsidy & Disbursement Strategy

23. **Cost Sharing:** The guiding principle of the CSF is one of cost sharing. The beneficiary will be required to finance the approved project from their current cash flow, and the CSF will need to check the beneficiary's ability to do so.

24. **Disbursement:** Grants should only be approved where a long-term strategic benefit is projected. Experience indicates that a fixed maximum expenditure per activity heading is desirable, and removes much unnecessary discussion and pleading of special cases. The source of the applicant's contribution may be through the owners or MSMEs own funds, or through bank loans or equity participation, or a combination of these.

25. **First Come First Served Principle:** Grants will be offered on a 'first-come, first-served' basis, subject to all eligibility criteria being met. In order to attract as broad and diverse applications as possible, the CSF will introduce a flexible approach to grant applications. Grants will be offered to project applications of as low as USD 2,000 (grant of USD 1,000) and up to USD 50,000 (grant of USD 25,000).

### 2.4 Promotion

26. Focused, incremental, and coordinated promotion will be the key method in successfully implementing the CSF program. The main promotional tool will be personal contact, 'word-of-mouth' with the BDS providers sharing the promotion effort, seminars and presentations. The CSF will start with a 'soft' launch whereby applications from an initial batch of clients will be processed, and the attractiveness and worth of the CSF will be established by example. The CSF activities will grow organically from that point. This approach is preferable to a 'big bang' launch which risks attracting hundreds of applications in the initial stage – applications which cannot be processed expeditiously before the CSF staff is trained and all systems are fully operational.

27. To ensure a full and continuous pipeline of applications, the CSF will develop a promotion strategy during the preparatory phase based on actual local experience. The strategy may include direct mail shots, and judicious use of PR will be a useful additional tool. The experience elsewhere is that once awareness of the existence and objectives of the CSF is established, a strong pipeline of applications is ensured.

### 2.5 Performance Evaluation

28. **Impact Assessment:** Conducting an impact assessment is fundamental to ensure that the defined objectives of the CSF will be achieved by the interventions. An assessment will cover impact on MSMEs as recipients and impact on the BDS market as a major development objective. The methodology for impact assessment shall comprise:

- (i) Conducting an MSME market and BDS provider analysis prior to the start of CSF;

- (ii) Conducting a baseline among a random 5% sample of grant recipients across a range of sizes and types of business during the first 6 months of the program and conduct impact monitoring surveys with the sample group 12 months after completion of their individual grant projects; and
- (iii) Conducting a comprehensive external evaluation about 6 months before the finalization of CSF. An appropriate database system will be identified during the preparatory phase.

**29. Overview of Impact Indicators and Sources of Verification:** In order to analyze the impact of CSF on the two target groups MSME and BDS providers, a set of objectively verifiable indicators (OVIs) will be utilized during the baseline and monitoring surveys:

**Table 1: Overview on Impact Indicators and Sources of Verification:**

| OVIs for MSMEs                                |                              |
|---|------------------------------|
| <b>Quantitative Indicators</b>                | <b>Source of Information</b> |
| Increased sales (total)                       | Financial statements         |
| Increased export-related sales                | Financial statements         |
| Growth in profitability                       | Financial statements         |
| Increased employment                          | Guided interviews            |
| OVIs for BDS providers                        |                              |
| <b>Quantitative Indicators</b>                | <b>Source of Information</b> |
| Increased revenues                            | Financial statements         |
| Increased number of clients                   | Guided interviews            |
| <b>Qualitative Indicators</b>                 | <b>Source of Information</b> |
| Increased awareness of potential MSME markets | Guided interviews            |
| Increased range of services offered to MSMEs  | Guided interviews            |

**30. Annual Work Plan:** The annual work plan will specify the activities to be carried out in order to launch and promote the CSF and will set out the disbursement targets and how to manage the program in accordance with Standard Operational Procedures (SOP) and Business Plan. Progress made in achieving the annual plan will be reported to PSDC for each operational quarter, to be submitted within 30 days of the end of each operational quarter.

**31. Performance Measurement (CSF MU):** The performance of the CSF management unit will be measured against targets set in the annual work plan. The following indicators will be applied to measure the program performance quarterly:

- **Effectiveness:** (i) number of cases approved, (ii) number of grants disbursed, and (iii) value of grants disbursed; and
- **CSF momentum effect / speed of implementation:** (i) actual disbursement time for a target number of grants against the plan, (ii) screening time for incoming applications 10 days, and (iii) appraisal time, from receiving complete application form to grant approval.

**32. Operational Systems Audit:** Annual audits will be conducted to assess the internal control and operating systems of the CSF management unit to ensure appropriate checks and balance mechanisms and procedures are in place, in order to avoid conflicts of interest and prevent potential fraud. Terms of Reference for the operational systems audit will be approved by PSDC. Audits will be conducted by an independent team appointed by PSDC. The audit reports will be delivered to PSDC within two months after the end of each twelve-month period. Based on the audit reports, the PSDC will revise existing or establish new regulations in order to improve financial and operational management procedures.

## 2.6 Duration & Exit Strategy

33. The duration of the program and any consequent exit strategy is based on a number of inter-related factors, namely:

- i. the overall size of fund available,
- ii. the rate of disbursement,
- iii. the average grant amounts, and
- iv. progress monitoring and impact.

34. Subject to these criteria fund sponsors may, at their discretion, seek to extend or curtail the program. Where curtailment is envisaged a phased withdrawal will need to be planned in light of prevailing circumstances. Based on international experience and taking into account the prevailing conditions and types of projects likely to be submitted, a three year program will be introduced as an initial commitment (six months preparation plus two and a half years of disbursement).

35. **Risk of misuse of funds:** In any CSF the risk of misappropriation of funds is real. The single most effective preventive measure is to withhold disbursement of grants until evidence of expenditure through a transparent audit trail is available. All applications should include detailed and phased expenditure forecasts as the basis for regular monitoring. The registration of BDS providers affords the opportunity to identify unscrupulous providers, who could be 'black-listed' and barred from practicing on any government or donor supported program, if such action is warranted.

## 3. Organizational Set-up

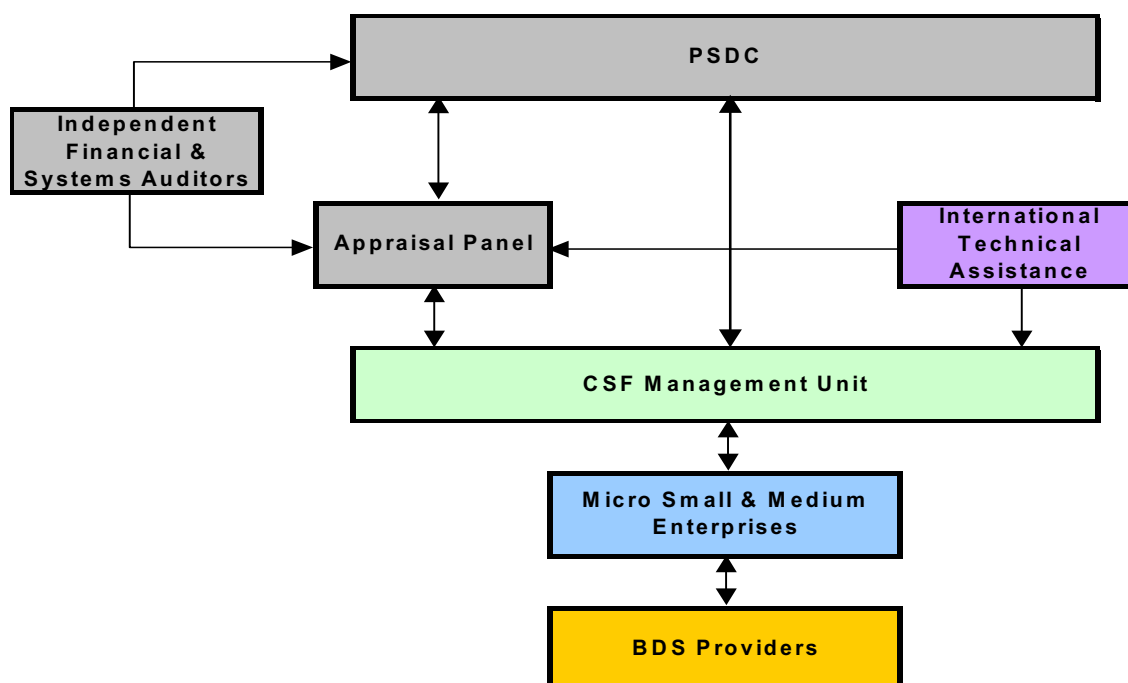
### 3.1 Role of Key Institutions

36. **Institutional Set Up of CSF:** CSF shall be independent from direct government intervention and shall be organized as follows:

- i. **Board of Trustees (BoT):** PSDC functions as Board of Trustees and shall govern the facility. PSDC which is supposed to meet at least at quarterly intervals, shall endorse yearly work plans, budgets and accounts of the management unit;
- ii. **CSF Management Unit (MU):** The MU shall be responsible for marketing, project analysis, financial management and monitoring & evaluation. The management unit shall be accountable to PSDC. The unit shall employ four professional staff, taking over one or more of the following functions: (i) unit management, (ii) marketing, (iii) project appraisal, (iv) financial appraisal, (v) accounting, and (vi) monitoring & evaluation. Staff shall be selected by PSDC and have a strong private sector background to ensure a close affiliation with the private sector and a high understanding of their needs and requirements, regarded essential for appropriate project appraisals. As there is no previous experience in Bhutan with project related grant facilities, it is recommended to have the facility managed by an expatriate expert during its first months of operations. Recommended inputs of international experts are detailed below. The management unit may ideally be integrated as a temporary sub-unit into the MSME unit of MTI to create synergies and reduce overheads by partly utilizing the same facilities, in particular the BPS/RTIOs of MTI.
- iii. **Appraisal Panel (AP):** A five-member Appraisal Panel will be appointed as a sub-committee to PSDC. Its function is to review the CSF grant proposals recommended by the MU. A quorum of three members will be required to approve applications, by majority vote if necessary. The unit manager of the MU shall be a full voting member of the Appraisal Panel.

37. The CSF shall not become a division of meso level institutions, namely BCCI or sector associations, due to (i) a conflict of interest regarding the potential dual role of these institutions as BDS provider and CSF manager, and (ii) a bias of these institutions towards lobbying functions for their own clients. However, an integration of the management unit into the MSME unit of MTI will be appreciated, as synergies are expected to reduce the facilities overheads. Figure 1 and table 1 provide an overview of the proposed institutional set up and functions of the CSF:

**Figure 1: Proposed Institutional Set Up of the Cost Sharing Facility:**



**Table 2: Overview of CSF Functions:**

| Set Up  | Functions   |
|---|---|
| <b>PSDC Private Sector Development Committee</b>      | Appointed by the National Assembly. Twelve members of whom four are private sector members and eight are public sector members. |
| <b>CSF Management Unit</b>                            | Operates the facility. Reports to the PSDC.   |
| <b>Appraisal Panel &amp; Audit Committee</b>          | Appointed as sub-committees of PSDC<br>Present grant applications to the CSF management unit                                    |
| <b>Micro, Small &amp; Medium Enterprises Auditors</b> | Appointed by PSDC to monitor and evaluate CSF   |

38. **Technical Assistance (TA) to CSF:** The consultant proposes to support the CSF with international TA to the extent of 9 person months international expertise over a period of three years. The TA shall mainly assist in setting up the CSF and support in HRD for the MU and AP. As there is no previous experience with project related grant schemes within the business community and RGoB, the consultant recommends to utilize international expertise as follows: 9 person months international intermittent expert to support RGoB in setting up the CSF, e.g. (i) grant scheme management, (ii) HRD, (iii) marketing, and (iv) monitoring & evaluation. Management shall be handed over to the designated MU manager after completion of the assignment. The international expert shall have a background in

economics and/or private sector development, experience in the management of BDS grant schemes, HRD, marketing and M & E systems.

### 3.2 The CSF Management Unit

39. The CSF Management Unit is responsible for the implementation and management of the CSF. The unit will be headed by the unit manager, who will report to PSDC.

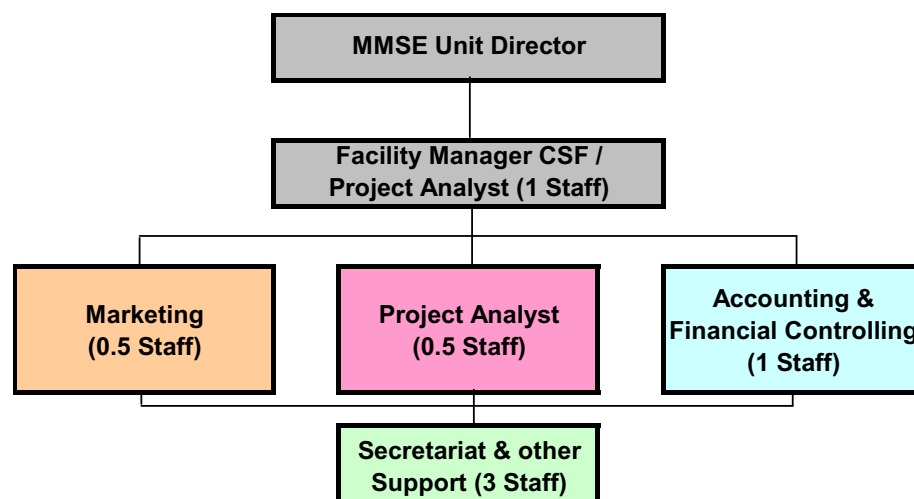
40. **Responsibilities of Head of CSF Management Unit:** The unit manager is responsible for:

- Set-up procedures, including application procedures;
- Establishing eligibility criteria for MSMEs and service providers;
- Recruitment, induction and training of key staff;
- Preparing the CSF launch, and subsequent promotion and marketing campaign;
- Design of data collection and monitoring systems;
- Processing of applications, and preparation and presentation of recommendations to the AP;
- Preparation of contract forms to be used between the CSF and grant recipients;
- Facilitating the CSF impact assessment and evaluation;
- Facilitating installation of Financial Management and system controls of the CSF;
- Quarterly Progress reporting to PSDC.

41. **Size and Staffing of the CSF Management Unit:** When fully operational, the CSF management unit will comprise three professionals, two secretaries and one driver/office boy. Besides managerial functions, the unit manager will take a share in processing the application. The Marketing Manager will be responsible for the marketing and PR of the facility and also take a share in processing applications. One professional staff will be responsible for the financial screening of the project application, financial control and accounting. This function is essential to track and maintain accounting records, and to scrutinize and verify all claims. All staff will be hired in the domestic market. Staff will receive initial training, guidance and line management support from an expatriate intermittent expert within the framework of captioned TA.

42. **Organization of Work:** The ethos of the CSF management unit will be non-hierarchical and it is expected that staff will be flexible and adaptable to whatever working requirements may evolve. Organization and staffing of the CSF management unit is laid out in Figure 2 below.

**Figure 2: Organization of the CSF Management Unit:**





43. It is intended that the CSF management unit will be based at MTI in Thimphu.

44. The following table shows the detailed activities to be undertaken.

**Table 3: Main Activities and Timeframe for the Establishment of CSF:**

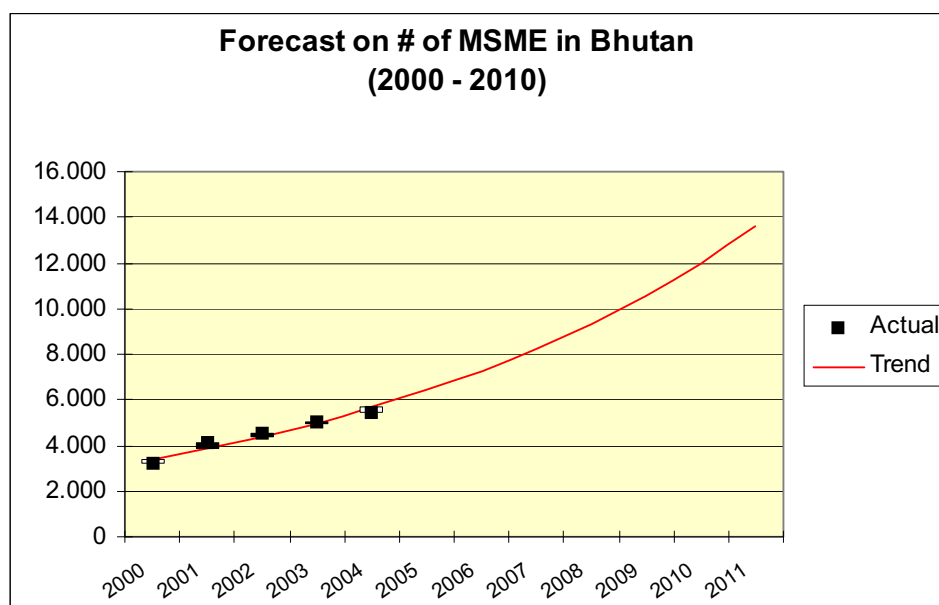
| Activities                                      | Timeframe (by)            |
|---|---------------------------|
| <b>Pre-preparation (phase 0)</b>                | <b>Month</b>              |
| Role of PSDC regarding CSF is confirmed by RGoB | -5                        |
| PSDC endorses BP and SOP                        | -4 to -3                  |
| Staff Contracts Agreed with MSME unit of MTI    | -2 to -1                  |
| <b>Preparatory (phase 1)</b>                    | <b>Month</b>              |
| Appointment of Facility (Unit) Manager          | 1                         |
| Recruitment of Personnel                        | 1 to 2                    |
| Training of Professional Staff                  | on-going                  |
| MIS   | 2 to 4                    |
| Annual Action Plan approved by PSDC             | 3 to 4                    |
| Marketing Strategy developed                    | 3 to 4                    |
| Promotional materials developed                 | 4 to 5                    |
| Pre-Launch Marketing Campaign                   | 6                         |
| Marketing Campaign                              | on-going                  |
| <b>Implementation (phase 2)</b>                 | <b>Month</b>              |
| Program Launch                                  | 7                         |
| Feed-Back Meetings with Stakeholders            | Twice yearly after launch |
| Impact and Completion Evaluations               | 18 and 36                 |
| Annual action plans                             | Yearly                    |

## 4. Financial Projections

45. **Anticipated Demand:** Anticipated demand of MSMEs for grants and average grant size under the CSF was calculated based on:

- The projected total average number of MSMEs during the Program implementation period, calculated based on latest statistics from MTI and using an exponential trend formula;
- Information on the average yearly spending of MSMEs on BDS from the MSME market survey conducted within the framework of this PPTA;
- The analysis of operational costs of comparable operations, based on current market prices in Thimphu; and
- International benchmarks in implementing cost sharing and matching grant schemes in comparable countries around the globe.

**Figure 3: Targets for MSME Development:**



46. **The Potential Market for CSF:** The projection of the total average number of MSMEs during the implementation period was calculated based on latest statistics from MTI and using an exponential trend formula. The trade sector was excluded as it mainly consists of small retail businesses unlikely to become clients of CSF. The consultant arrived at a total average of 9,382 MSME during the implementation period of CSF (2007 to 2010). Based on information from the PPTA market study and discussions with meso level institutions, it was conservatively estimated that 100% of all MSME in manufacturing, 10% of all MSME in construction and 20% of all MSME in the service sector constitute the market for CSF. Using captioned variables, the overall market of potential clients of the CSF was calculated at 4,616 enterprises out of the total of 9,382 MSMEs during the implementation period 2007 to 2010.

47. **Volume and Outreach of CSF:** The total volume of CSF was calculated at USD 1,136,433 with a grant component of USD 875,000 and overheads of USD 261,433. The estimated number of 250 grants during the three year implementation period is based on a market penetration rate of 5.4% of captioned 4,616 potential customers in Bhutan.

48. The estimate of average grant size of USD 3,500 is based on the PPTAs analysis of demand for external services by MSMEs and conservative cost modeling for average anticipated projects, e.g. international consultant support and study / information tours to countries in the region.

**Table 4: CSF Bhutan – Key Figures (prices in USD)**

| Framework Data                                 |             |             |                  |
|--|-------------|-------------|------------------|
| Projected # of MSMEs during CSF implementation |             |             | 9.382            |
| Projected market size CSF (# of MSMEs)         |             |             | 4.616            |
| Total number of grants under CSF               |             |             | 250              |
| CSF outreach (all MSMEs)                       |             |             | 2,7%             |
| CSF coverage of projected potential customers  |             |             | 5,4%             |
| A'ge size of project                           |             |             | 7.000            |
| A'ge size of grant                             |             |             | 3.500            |
| A'ge overhead per grant                        |             |             | 1.046            |
| Ratio overhead / grant                         |             |             | 29,9%            |
| Costing Category                               | # of Grants | A'ge Amount | Total            |
| Small grants                                   | 225         | 2.500       | 562.500          |
| Large grants                                   | 25          | 12.500      | 312.500          |
| Total grants                                   | 250         | 3.500       | 875.000          |
| Overheads                                      |             |             | 261.433          |
| <b>Total cost of CSF</b>                       |             |             | <b>1.136.433</b> |

**Source:** MTI Statistics, 2004; Own Calculations

**49. Comparison of CSF with International Benchmarks:** Comparing economic performance benchmarks across the border is considered difficult due to different market sizes and the level of economic development. However, in general terms international benchmarks can help to set appropriate parameters for Bhutan's cost sharing facility. Comparing the level of economic development, Bhutan is much closer to Kenya than Mauritius, explaining the average size of grant being slightly higher than in Kenya but significantly lower than that of Mauritius. However, comparing the ratio of population to total number of grants, Bhutan's CSF is about in line with the MGF in Mauritius. The combination of a low level of economic development and a small market in Bhutan results in an unfavorable overhead / grant ratio of about 30% for the CSF, compared to about 20% for the MGF in Mauritius, but still 10% lower than those of the MGF in Kenya. However, comparing the three facility's average overhead costs per grant, it becomes obvious that CSF will be a lean operation. As proposed with the CSF for Bhutan, the matching grant schemes in Mauritius and Kenya adopted a cost sharing ratio of 50% to limit applications to serious project proposals and encourage a high degree of project ownership with successful applicants.

**Table 5: CSF Bhutan – Benchmark Indicators (prices in USD)**

| Category                                  | CSF Bhutan | MGF Mauritius | MGF Kenya |
|---|------------|---------------|-----------|
| Population (in Mio.)                      | 0,7        | 1,2           | 32,8      |
| Size of facility (incl. operational cost) | 1.136.433  | 2.520.000     | 2.000.000 |
| Grant volume                              | 875.000    | 2.030.028     | 1.200.422 |
| Operational cost                          | 261.433    | 489.972       | 799.578   |
| Total number of grants                    | 250        | 266           | 603       |
| Cost Sharing Ratio                        | 50%        | 50%           | 50%       |
| A'ge size of grant                        | 3.500      | 9.474         | 3.317     |
| A'ge overhead per grant                   | 1.046      | 1.842         | 1.326     |
| Ratio overhead / grant                    | 29,9%      | 19,4%         | 40,0%     |

**Source:** Own Calculations; World Bank "Implementing the Market Approach to Enterprise Support: A Comparative Evaluation of Matching Grant Schemes", 2000

**50. Operational Expenditures of CSF:** The operational expenditures of CSF were calculated with the valuable input of BCCI and local consultants, based in Thimphu. Costs are calculated in USD, allowing for a yearly inflation in USD terms of 3%. Salaries are

calculated based on the assumption of employing highly professional and senior staff, working on a three year time contract from a separate CSF office in the capital Thimphu. Table 6 shows the detailed cost position over the three year implementation period.

**Table 6: Yearly and Total CSF Operational Expenditure (in USD):**

| Expenditure                                 | Per Month / Unit | 2007           | 2008          | 2009          | Total          |
|---|------------------|----------------|---------------|---------------|----------------|
| <b>(I) STAFF COST</b>                       |                  |                |               |               |                |
| Facility Manager / Project Analyst          | 900              | 10.800         | 11.124        | 11.458        | 33.382         |
| Marketing Manager / Project Analyst         | 800              | 9.600          | 9.888         | 10.185        | 29.673         |
| Financial Analyst / Accountant              | 750              | 9.000          | 9.270         | 9.548         | 27.818         |
| Secretary                                   | 400              | 4.800          | 4.944         | 5.092         | 14.836         |
| Front Desk                                  | 150              | 1.800          | 1.854         | 1.910         | 5.564          |
| Driver (1)                                  | 180              | 2.160          | 2.225         | 2.292         | 6.676          |
| <b>Sub-Total (I)</b>                        | <b>3.180</b>     | <b>38.160</b>  | <b>39.305</b> | <b>40.484</b> | <b>117.949</b> |
| <b>(II) OVERHEADS</b>                       |                  |                |               |               |                |
| Premises Rent                               | 300              | 3.600          | 3.708         | 3.819         | 11.127         |
| Utilities                                   | 75               | 900            | 927           | 955           | 2.782          |
| Office Consumables                          | 120              | 1.440          | 1.483         | 1.528         | 4.451          |
| Marketing Expenses                          |                  | 10.000         | 10.000        | 5.000         | 25.000         |
| Vehicle Running Cost & Maintenance          | 350              | 4.200          | 4.326         | 4.456         | 12.982         |
| Vehicle Purchase (2 Toyota Hilux)           | 0                | 45.400         | 0             | -31.780       | 13.620         |
| Travelling / Accommodation                  | 650              | 7.800          | 8.034         | 8.275         | 24.109         |
| Telecommunication                           | 150              | 1.800          | 1.854         | 1.910         | 5.564          |
| Maintenance                                 | 100              | 1.200          | 1.236         | 1.273         | 3.709          |
| Appraisal Panel Cost (Price per Appraisal)  | 36               | 1.350          | 3.555         | 4.095         | 9.000          |
| Financial & Operational Audit (Royal Audit) |                  | 1.000          | 1.030         | 1.061         | 3.091          |
| Impact & Performance Assessment             |                  | 0              | 4.000         | 5.000         | 9.000          |
| <b>Sub-Total (II)</b>                       | <b>1.781</b>     | <b>78.690</b>  | <b>40.153</b> | <b>5.591</b>  | <b>124.434</b> |
| <b>(III) CAPITAL EXPENDITURE</b>            |                  |                |               |               |                |
| Computers / Printers / Software             |                  | 9.950          |               |               | 9.950          |
| Office Equipment                            |                  | 2.100          |               |               | 2.100          |
| Renovation / Furniture                      |                  | 6.000          |               |               | 6.000          |
| Telephone Switchboard & Connection          |                  | 1.000          |               |               | 1.000          |
| <b>Sub-Total (III)</b>                      | <b>0</b>         | <b>19.050</b>  | <b>0</b>      | <b>0</b>      | <b>19.050</b>  |
| <b>GRAND TOTAL</b>                          | <b>4.961</b>     | <b>135.900</b> | <b>79.458</b> | <b>46.075</b> | <b>261.433</b> |

**51. CSF Grant Disbursement:** Given demand structures show a clear distinction between micro and small enterprises, on the one hand, and medium enterprises, on the other. In order to better estimate administrative capacities, grant disbursement was classified into small and large projects. The breakdown of grant disbursement over the three year program takes a 6 months preparation and 6 months disbursement period during year 1 and 12 months disbursement periods during year 2 and year 3 into consideration and is as follows:

**Table 7: Yearly Grant Disbursement:**

| Category     | Year 1 | Year 2 | Year 3 | TOTAL |
|--------------|--------|--------|--------|-------|
| Large Grants | 4      | 9      | 12     | 25    |
| Small Grants | 34     | 90     | 101    | 225   |

## 5 Project Phasing – Work Plan

| Activity                                      | Phase 0 (months)           |   |   |   |   |   | YEAR ONE |   |   |   |   |   |            |   |   |    |    |    | Implementation Phase (months) |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
|---|----------------------------|---|---|---|---|---|----------|---|---|---|---|---|------------|---|---|----|----|----|-------------------------------|---|---|---|---|---|---|---|---|----|----|----|-----------|---|---|---|---|---|---|---|---|----|----|----|--|--|--|--|--|--|--|--|
|   | Preparation Phase (months) |   |   |   |   |   | YEAR TWO |   |   |   |   |   |            |   |   |    |    |    | YEAR THREE                    |   |   |   |   |   |   |   |   |    |    |    | Phase Out |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
|   |                            |   |   |   |   |   | YEAR TWO |   |   |   |   |   | YEAR THREE |   |   |    |    |    | Phase Out                     |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
|   | 1                          | 2 | 3 | 4 | 5 | 6 | 1        | 2 | 3 | 4 | 5 | 6 | 7          | 8 | 9 | 10 | 11 | 12 | 1                             | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 1         | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 |  |  |  |  |  |  |  |  |
| 0 Pre-preparation                             |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 1 PSDC to select nomination panel             |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 2 Select potential trustees                   |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 3 Confirm ORG set up                          |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 4 Agree on SOPs                               |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 5 Staff contracts agreed                      |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 6 MIS designed and tested                     |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 7 Preparation                                 |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 8 Facility manager confirmed                  |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 9 Recruitment of personnel                    |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 10 Training of professional staff             |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 11 Develop action plan and gain PSDC approval |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 12 Develop marketing strategy                 |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 13 Develop promotional materials              |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 14 Commence national awareness campaign       |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 15 BDS awareness meetings                     |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 16 Intensive pre-launch marketing campaign    |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 17 Implementation                             |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 18 Program launch                             |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 19 Feed-back meetings with stakeholders       |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 20 Monitoring                                 |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 21 Marketing campaign                         |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 22 Mid-term evaluation and reports            |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 23 Final evaluation and reports               |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |
| 24 Project completion                         |                            |   |   |   |   |   |          |   |   |   |   |   |            |   |   |    |    |    |                               |   |   |   |   |   |   |   |   |    |    |    |           |   |   |   |   |   |   |   |   |    |    |    |  |  |  |  |  |  |  |  |

## **C APPENDICES**

## Appendix 1: CSF – Job Descriptions of Key Personnel

| Title                             | Facility Manager / Analyst  |
|-----------------------------------|---|
| Responsible to:                   | Private Sector Development Committee (PSDC)   |
| Key Task:                         | To manage the day to day operations of the CSF in accordance with performance guidelines set out in conjunction with the PSDC.  |
| Home Base:                        | MTI with occasional travel to the regions.  |
| Main duties and responsibilities: | <ul style="list-style-type: none"> <li>• Select key personnel.</li> <li>• In association with PSDC, and international technical assistance, develop the CSF concept for Bhutan.</li> <li>• Manage staff in the CSF Unit.</li> <li>• Supervise program implementation and administration.</li> <li>• Supervise grant application process.</li> <li>• Analyze grant application together with Analyst.</li> <li>• Develop promotion activities with Marketing Manager.</li> <li>• Approve all expenditures.</li> <li>• Ensure financial accounts are maintained to international accounting standards.</li> <li>• Report to PSDC and provide secretariat support to PSDC meetings.</li> <li>• Facilitate internal 'case' meetings.</li> <li>• Read and analyze CSF business proposals, forwarded by Accountant.</li> <li>• Evaluate content and financial projections of the CSF proposals.</li> <li>• Check the accuracy of the information provided.</li> <li>• Question and confirm the information with the principal MSME applicants and BDS providers.</li> <li>• Appraise the risks and assumptions in the proposal.</li> <li>• Estimate the potential impact of the proposal to the applicant and the wider economy.</li> <li>• Prepare a concise summary of the proposal.</li> <li>• Where necessary, interview the principal applicant, and BDS provider and judge the capacity of both parties to successfully implement the project.</li> <li>• Initiate and attend 'case' meetings with the management team.<sup>2</sup></li> <li>• Suggest amendments to the proposals (where applicable).</li> <li>• Attend appraisal panel meetings, and make recommendations for decisions.</li> <li>• Support Account Executive in project monitoring.</li> </ul> |

<sup>2</sup> Case meetings are meetings of the professional team where complex or unusual projects are discussed. They provide an opportunity to exchange experience and opinions and seek advice from the peer group.

| Title                             | Marketing Manager / Analyst  |
|-----------------------------------|--|
| Responsible to:                   | Facility Manager   |
| Key Task:                         | To develop and implement the promotion strategy for the CSF to achieve pre-defined performance targets.  |
| Home Base:                        | MTI with travel to the regions   |
| Main duties and responsibilities: | <ul style="list-style-type: none"> <li>• With Facility Manager, develop overall promotion strategy for the program.</li> <li>• Analyze potential market for CSF and suggest marketing solutions for different market segments.</li> <li>• Supervise the development of promotional materials.</li> <li>• Contract with material suppliers, media etc.</li> <li>• Approve marketing expenditures.</li> <li>• Liaise with provisional offices to organize and co-ordinate local marketing efforts.</li> <li>• Training of BPS/RTIO personnel in the provinces to do initial marketing and create awareness of the CSF.</li> <li>• Liaise with other stakeholders including business organizations to create awareness of and seek their cooperation in promoting the CSF.</li> <li>• Seek speaking opportunities and attend business exhibitions, events, conferences etc.</li> <li>• Read and analyze CSF business proposals, forwarded by Accountant.</li> <li>• Evaluate content and financial projections of the CSF proposals.</li> <li>• Check the accuracy of the information provided.</li> <li>• Question and confirm the information with the principal MSME applicants and BDS providers.</li> <li>• Appraise the risks and assumptions in the proposal.</li> <li>• Estimate the potential impact of the proposal to the applicant and the wider economy.</li> <li>• Prepare a concise summary of the proposal.</li> <li>• Where necessary, interview the principal applicant, and BDS provider and judge the capacity of both parties to successfully implement the project.</li> <li>• Suggest amendments to the proposals (where applicable).</li> <li>• Attend appraisal panel meetings, and make recommendations for decisions.</li> <li>• Attend internal case meetings.</li> </ul> |



| Title:                            | Financial Analyst / Accounts Manager  |
|-----------------------------------|---|
| Responsible to:                   | Facility Manager  |
| Key Task:                         | To provide guidance to applicants and BDS providers, to analyze the financial implications of project proposals, to submit viable proposals, and to monitor the progress of projects.   |
| Home Base:                        | MTI with travel to the regions.   |
| Main duties and responsibilities: | <ul style="list-style-type: none"> <li>• Maintain financial records for the program as a whole.</li> <li>• Provide guidance to grant applicants and BDS providers to develop proposals.</li> <li>• Confirm the financial status of the MSMEs and BDS providers.</li> <li>• Ensure that the financial resources are available and sufficient to fund the life of the project.</li> <li>• Screen applications in terms of basic criteria prior to submission to the analysts for evaluation.</li> <li>• Check the accuracy of the information provided.</li> <li>• Suggest amendments to proposals to increase the possibility of acceptance.</li> <li>• Question and confirm the information with the principal MSME applicants and BDS providers.</li> <li>• Make recommendations to disburse grant monies.</li> <li>• Prepare the contract agreements and arrange the disbursement of grants.</li> <li>• Liaise with analysts and provide additional information when requested.</li> <li>• Attend case meetings.</li> <li>• Maintain contact with applicants.</li> <li>• Monitor progress of projects up to completion and milestone activity in case of phased payments for large grants.</li> </ul> |

## **Appendix 2: Financial Summary**

### **General**

The financial summary is expressed in US Dollar (USD) and assumes an inflation rate of 3% p.a. The first year begins on appointment of PSDC as Board of Trustees for CSF.

### **Staff Costs**

Staff costs are estimated on the number of staff required within the Central CSF to process anticipated grant applications, and disburse and monitor the grants awarded. They assume a centrally administered system by a dedicated management team based in Thimphu, and that the regional Business Support Units (BPS) within MTI's RTIOs will absorb any additional outreach costs as part of their day-to-day function, i.e., program marketing, project identification, first line screening etc. Functions of key personnel are described in annex 1. The first year assumes a four-month preparation phase, and eight months of operation.

The salaries were discussed with various parties including BCCI, familiar with the salary structures and reflect payments for broadly similar positions, duties and responsibilities in Bhutan.

Initially three professional members will be employed; the Facility Manager / Project Analyst, Marketing Manager / Project Analyst, and Financial Analyst / Accounts Manager, who will receive training through international TA. Salaries are calculated on an twelve-month year.

### **Overheads**

- Premises Rent: assumes 80 square meters (sqm) for the facility, at a monthly rate of USD 4 per sqm, the current rental for mid-quality office space in Thimphu.
- Utilities: based on comparable per capita consumption in offices in Thimphu.
- Office Consumables: based on current per capita consumption in BCCI.
- Marketing Expenses: it is expected that the main marketing tool will be 'word-of-mouth' and promoted primarily by the BDS providers, who gain by the development of the program, at nil cost. However, there will need to be an initial launch, and a continuing awareness campaign via radio and newspaper, explanatory brochures, presence at MSME events etc. The summary provides a 'budget' figure frontloaded during the first two years of the facility.
- Vehicle Costs: The cost of fuel, vehicle maintenance and insurance for two vehicles, assuming a mileage of 12,000 kilometers per car per annum.
- Vehicle Purchase: Two vehicles (example Toyota Hilux), purchased at current commercial rates in Bhutan. It is assumed that the Facility Manager will have a car, plus one pool vehicle for Marketing Manager and Accountant. It is assumed, that the cars will be sold after completion of CSF for a residual value of 70% of the purchasing price.
- Traveling/Accommodation: Visits to meetings, promotional events, random monitoring. Based on three journeys of one person and driver per month.
- Telecom: Based on average per capita expenditure of BCCI staff for telephone and internet usage.
- Maintenance: Computer and equipment maintenance and support USD 50 per month, general maintenance and cleaning USD 50 per month.

### Capital Expenditure Schedule

All prices in USD, based on current trade prices in Bhutan.

| Category                      | Description                 | Number | Price | Total |
|-------------------------------|-----------------------------|--------|-------|-------|
| Computers/Printers + Software | Laptop                      | 3      | 2000  | 6,000 |
|                               | Desktop                     | 1      | 1,500 | 1,500 |
|                               | Printer/Fax/Scanner         | 1      | 550   | 550   |
|                               | Printer                     | 1      | 300   | 300   |
|                               | Software                    | 4      | 400   | 1600  |
| Office Equipment              | Photocopier                 | 1      | 2,000 | 1,500 |
|                               | UPS                         | 2      | 300   | 600   |
| Renovation/Furniture/Heaters  | Flat rate                   |        |       | 6,000 |
| Telephone Connection          | Switchboard & Extension (5) | 1      | 1000  | 1000  |

## **Appendix 3: Terms of Reference for PSDC Involvement in CSF**

### **General Tasks for CSF**

- Approve Business Plan and Standard Operating Procedures;
- Continually review and propose amendments to the SOP to the ADB;
- Approve staff service contract formats for the establishment and implementation of CSF;
- Take appropriate action in case of non-performance and non-compliance with SOP by the service contractors for CSF;
- Approve the Terms of References for program evaluations and review the results in consultation with ADB;
- Approve detailed concept and concept adjustments based on program reviews and evaluations;
- Ensure transparency in the implementation of the facilities;
- Appoint third party auditors, and ensure compliance with international accounting standards;
- Audit program compliance according to the SOP and performance monitoring framework;
- Confirm the appointments of the designated facility managers;
- Arrange all necessary bank accounts and mandates as per the SOP;
- Disbursement of funds based on request of the facility managers;
- Approve Yearly Plan of Operation and budgets;
- Represent and promote the facilities towards stakeholders
- Maintain regular dialogue with the ADB;
- Report regularly to the RGoB according to agreement between RGoB and ADB.

### **Specific Tasks**

- Approve the detailed concept and concept adjustments based on the CSF business plan;
- Supervise all activities of the CSF Management Unit;
- Appoint the Appraisal Panel;
- Approve proposals for grants in exceptional cases;
- Supervise the management of the grant fund.

## **Appendix 5**

### Institutional Assessment BDFC

## **Bhutan Development Finance Corporation (BDFC)**

1. **Legal Framework and Basic Objectives.** The Bhutan Development Finance Corporation (BDFC) was established in 1988 with assistance from the ADB and equity participation of the RGoB and the other financial institutions to act as the development finance institution for providing credit to both small and medium scale industrial and agricultural activities in Bhutan. Besides providing loans for the private sector development, BDFC's main function is to provide loans to the rural area, which is characterized by extreme physical conditions, low population density and lack of market infrastructure.
2. **Ownership and Management.** BDFC's initial capital structure consists of Nu. 100 million paid-up equity shares of which RGoB holds 87%, BOB 7.5%, RICB 3% and BNB 2.5%. BDFC is governed by a Board of Directors chaired by the Secretary of Finance. The board consists of representatives from the Ministry of Finance, Ministry of Trade and Industry, Ministry of Agriculture, as well as a representative from Dzongkhag Administration and a Geog. The management consists of the Managing Director, who is appointed by the Government and four General Managers, who are responsible for Finance, Credit Operations, Branch Operations and Central Support, respectively. In 2003, BDFC revised its strategy with assistance from the ADB and developed the 9<sup>th</sup> Five Year Business Plan (2003-2007). The business plan has not been fully implemented or revised during the last three years and is therefore outdated.
3. **Organization and Staffing.** The operational consequences of the political mandate for BDFC have been that an extensive branch network has been established to serve rural lending purposes. From its head office in Thimphu, BDFC operates 3 regional offices, 22 branches and a mobile banking facility, which is already operational in 120 gewogs. The operational costs of this network are relatively high compared to the profitability of BDFC's rural lending operations, especially since the network is not utilized to the extent possible. The organization has 147 employees, of which 65 working at the head office. An HRD division was established in 2003 to obtain and secure sufficient staff through adequate HRM, however as of now the division is only equipped with limited authority. The division is primarily providing administrative support while all decisions related to HR and training are still taken by the Management Committee.
4. **Lending Policies and Procedures.** BDFC provides term loans with different maximum maturities depending on sector (e.g. manufacturing for up to 10 years, handicraft/cottage up to 5 years) at an average term of 3.16 years and an average size of about Nu. 100,000. Branches and regional offices have loan approval authority ranging up to Nu 30,000 and Nu 100,000 respectively, while headquarters approves all bigger loans. Loans are primarily approved on the basis of collateral. There is no formal policy for offering differential interest rates based on the client's credit rating, term, but for type of lending. The interest rates charged lie between 12 and 15%, with the exception for group lending where the interest rate charged is only 10%. BDFC's portfolio quality has been affected by (i) weak loan appraisal and monitoring systems, (ii) weak credit risk management, and (iii) inadequate internal control and audit. It is assumed that portfolio quality will not improve significantly unless a significant change is introduced.
5. **Resource Mobilization.** As a non-bank financial institution, BDFC is not allowed to mobilize savings from the public. However, since 2005 BDFC is entitled to mobilize savings within the framework of its rural finance operations. The main sources of funds are therefore

external concessional loans and grants from international agencies, such as ADB, KFAED and IFAD. Recently, BDFC received a loan of Nu. 500 Million with a tenor of 10 years from BOB. BDFC's loan portfolio growth projections for the next 5 years however already exceed the organization's current funding resources. The main problem with BDFC is therefore a lack of long-term funds.

6. **Outreach.** According to its mandate, BDFC is required to maintain an extensive rural finance outreach. Rural areas cover about 85% of the country's approximate 670,000 population with an estimated 86,000 rural households. As of end 2005, BDFC had 14,764 active clients in rural areas or 17.2% of the total rural households. Even though BDFC accounts for over 90% of the rural lending in Bhutan, this market is currently not sufficiently covered by supply of finance.

A. **Table 1: BDFC Summary of Assets and Liabilities**

|                                    | 2003                 | 2004                 | 2005                 |
|------------------------------------|----------------------|----------------------|----------------------|
| <b><u>TOTAL ASSETS</u></b>         | <b>1,234,770,216</b> | <b>1,266,643,060</b> | <b>1,410,313,615</b> |
| Current Assets and Advances        | 110,296,228          | 105,248,449          | 71,186,828           |
| Loans Receivable                   | 1,114,064,862        | 1,151,085,940        | 1,325,681,440        |
| Investments                        | 1,381,000            | 1,381,000            | 1,381,000            |
| Net Fixed Assets                   | 9,028,126            | 8,927,671            | 12,064,347           |
| <b><u>TOTAL LIABILITIES</u></b>    | <b>1,234,770,216</b> | <b>1,266,643,060</b> | <b>1,410,313,615</b> |
| Current Liabilities                | 33,093,883           | 33,470,945           | 44,818,373           |
| Provision for Non-Performing Loans | 134,198,265          | 155,340,331          | 161,175,493          |
| Long-term Liabilities              | 599,001,738          | 550,138,284          | 598,624,157          |
| Issued Capital                     | 100,000,000          | 100,000,000          | 100,000,000          |
| Reserves & Surplus                 | 334,657,163          | 394,946,733          | 474,395,341          |
| Interest in Suspense               | 33,819,166           | 32,746,767           | 31,300,251           |

Source: BDFC – Auditors' Report 2005

7. **Loan Portfolio Analysis.** The loan portfolio of BDFC has experienced a significant growth in recent years. In 2005 it was 15% and between 2001 and 2003 over 20% p.a. Only in 2004 the growth reduced because of lack of funds. Rural lending makes 32% of total loans. Housing and service industry are the biggest sectors, with 28%, respectively 20% of total. The NPL ratio is still very high, even though BDFC in 2005 managed to decrease its NPL ratio from 21.7% to 18.7%. The NPL ratio for branch operations is even higher with 23.2% (27.5% in 2004), and 6 branches have an NPL ratio exceeding 30%. NPLs for personal loans (76%), tourism (32%) and agriculture (32%). The trend in the Reserve Ratio (ratio of Loan Loss Reserve to Loans Outstanding) indicates that from a ratio of 12% in 2003, the expected unrecoverable loans rose to 13.5% of the total loans outstanding (principal) in 2004, before slightly declining to 12.1% in 2005. Total outstanding loans (principal) grew by 15% in 2005.

8. **Profitability.** BDFC recorded a steady increase in its Return on Assets (ROA) from 3.3% in 2003 to 5.5% in 2005. During 2005, BDFC reported a net profit of Nu. 77 million. A substantial portion of the profit was generated from interest income.

**B. Table 2: BDFC Profitability**

| Item                                | Jan–Dec 2003 | Jan–Dec 2004 | Jan–Dec 2005 |
|-------------------------------------|--------------|--------------|--------------|
| Interest on Loans                   | 127,729,890  | 149,111,876  | 163,219,420  |
| Interest & Dividend on Investments  | 527,692      | 548,763      | 392,433      |
| Other Income                        | 2,952,930    | 3,672,298    | 3,246,998    |
| Operating Expenses                  | 35,897,686   | 37,283,892   | 48,900,895   |
| Financial Expenses                  | 30,329,638   | 31,901,879   | 31,566,386   |
| Write Off Provisions                | 24,630,341   | 22,724,138   | 8,740,222    |
| Net Profit/Loss                     | 40,351,515   | 61,804,028   | 77,667,003   |
| Return on Total Assets <sup>b</sup> | 3.3%         | 4.9%         | 5.5%         |

Source: BDFC – Auditors' Report 2005

9. **Accounting and Management Information System (MIS).** BDFC follows accounting standards consistent with the requirements for the banking industry and is in compliance with the RMA statutory requirements. The current MIS and information technology (IT) platform are outdated. A fully automated banking system has been purchased and is planned to be implemented by the end of 2006. BDFC contracted Southtech Limited, Bangladesh, to implement the Southtech Millennium Banking System. The new software will be able to accommodate for the needs of BDFC's internal reporting and MIS requirements.



## **Appendix 6**

### Development Coordination Matrix

## DEVELOPMENT COORDINATION MATRIX

| Project/Program   | Source     | Timing      | Rationale and Demand for Assistance  | Cost  |
|---|------------|-------------|--|---|
| <b>MSME Policy Framework</b>                                |            |             |  |   |
| Trade Capacity Building Programme                           | EU         | 2003 - 2007 | TA, capacity building and awareness-raising for trade promotion and export development, incl. strengthening the capacity of the Bhutan Export Promotion Center and sector-specific support to the private sector. Support for preparation of WTO accession.  | EC € 1,200,000<br>Bhutan € 50,000<br>ITC € 80,000<br>UNESCAP € 40,000<br><b>Total Cost € 1.37 million</b> |
| Planning Information Networks for Good Governance in Bhutan | UNDP       | 2002 - 2004 | Strengthening grassroots planning through block grants to selected gewogs for local-level development and implementation of small-scale socioeconomic activities, social infrastructure, and natural resource management systems, capacity building for district and block development committees; development concept of database for central and local level, support to ongoing review of the decentralization process. | US\$ 400,000  |
| <b>Legal and Regulatory Framework</b>                       |            |             |  |   |
| Development Policy Grant I                                  | World Bank | 2006 - 2010 | Support to the reform agenda related to private sector development, incl. implementation of flexible labor laws and employment policies; preparation and initial implementation of a comprehensive private sector development strategy; establishment of an efficient system for business registration; and changes to the pricing structure of the tourism sector.  | US\$ 14.7 million (multi-sectoral)  |
| Business Enabling Environment Program                       | SEDF       | 2003 - 2006 | Review of legal and regulatory environment relevant to the private sector and establishment of BCCI's - Knowledge Center, a one-stop-shop for local SMEs and service providers for business resources and training.  | n.a.  |
| Support to Business Registration                            | SEDF       | 2005 - 2006 | Support the reform of regulatory processes related to start up registration, closing a   | n.a.  |

| Project/Program   | Source | Timing      | Rationale and Demand for Assistance   | Cost                |
|---|--------|-------------|---|---------------------|
| Good Governance and Public Administrative Reforms Programme, Phase II | DANIDA | 2003 - 2008 | business (winding up) and protecting investors (corporate governance) in Bhutan. This project aims to decrease the time necessary for business registration, improve the capacity in the Office of the Registrar of Companies, and reduce the cost of Doing Business in Bhutan. TA for strengthening decentralization process, legislation and rule of law, media and core fiscal institutions. | DKK 44.5 million    |
| <b>Access to Market-Based Finance</b>                                 |        |             |   |                     |
| Financial Sector Program for local financial institutions in Bhutan   | SEDF   | 2003 - 2004 | Training to RMA, BNB, BDFC, BOB, RICBL and NPPF in credit appraisal for SMEs, reconstruction of financial statements and credit scoring for SMEs, HR tools and techniques, sales leadership, as well as leasing and factoring.  | n.a                 |
| Financial Sector Program for local financial institutions in Bhutan   | SEDF   | 2006 - 2007 | TA and training to RICBL and BOB for developing and strengthening their SME lending operations, incl. strategic business planning, raising funds, risk management, business diversification and product development, and ALM.   | n.a                 |
| Market Access for the Poor (MAP)                                      | SNV    | 2000 - 2006 | TA support to strengthen capacities for sustainable microfinance in BDFC through capacity strengthening, incl. support for financial products and services, branch profitability concept, portfolio quality, development of HR procedures and manual, and banking software/MIS.   | € 500,000           |
| Second Eastern Zone Agricultural Program (SEZAP)                      | IFAD   | 2002 - 2042 | Credit Line to BDFC for rural credits or Eastern Bhutan.  | SDR 510,000         |
| Agriculture, Marketing and Enterprise Promotion Programme (AMEPP)     | IFAD   | 2007 - 2009 | Credit Line to BDFC for on-lending to rural populations of the Eastern Dzongkhogs to enable them to improve their production conditions beyond the subsistence level.   | US\$ 1 million      |
| Kuwait Fund for Arab  | KFAED  | 1992 - 1997 | Credit Line to BDFC for industrial lending.   | Kuwaiti Dinar 1.493 |

| Project/Program   | Source       | Timing      | Rationale and Demand for Assistance   | Cost                                  |
|---|--------------|-------------|---|---------------------------------------|
| Economic Development (KFAED)                                      |              |             |   | million                               |
| Guarantee Scheme  | Helvetas/SDC | 2006 - n.a. | Not yet signed.   | Swiss Franc 1.0 million               |
| <b>Business Development Services</b>                              |              |             |   |                                       |
| Private Sector Development Programme                              | Danida       | n.a         | Twinning arrangement between Danish and Bhutanese enterprises and support to trade fair participation of Bhutanese enterprises.   | Arranged by Danida & no figures given |
| Promotion of the Vocation Education and Training System.          | GTZ          | 2003 - 2006 | Promotion of the Vocation Education and Training System.  | US\$ 2.5 million                      |
| Export Business Intensification Program for Bhutan SME Sector     | SEDF         | 2005 - 2006 | Development of Bhutan's export activity in selected sectors and fostering industrial collaboration between Bhutanese companies and enterprises in extra regional markets. This program is especially targeted at SMEs.  | n.a                                   |
| Tourism Development Programme                                     | Austria      | 2006 - 2014 | Hotel & Tourism Management Training Institute (H&TMTI) Capacity Development Project: (i) Development of Curricula and Learning Material for the H&TMTI; (ii) teacher/instructor Training H&TMTI; (iii) technical and organisational development support and, (iv) deployment of international lecturers through partnership programmes with H&TMTI. | EC € 2.963 million                    |
| Agriculture, Marketing and Enterprise Promotion Programme (AMEPP) | IFAD/SNV     | 2000 - 2008 | Strengthening private sector development in the 6 eastern Dzongkhags of Bhutan through training of extension agents in enterprise development for MSMEs, establishing market channel studies, and assisting Renewable Natural Resource research MSME opportunities.   | EC € 300,000                          |
| Private Sector Development Project                                | World Bank   | 2007 - 2011 | Infrastructure support for selected industrial estates and a Distance Learning Center / ICT Park; institutional and policy support to   | US\$ 8 million                        |

| <b>Project/Program</b>                 | <b>Source</b> | <b>Timing</b> | <b>Rationale and Demand for Assistance</b>   | <b>Cost</b>   |
|--|---------------|---------------|--|---------------|
| Pro-Poor Sustainable Tourism (PPST)    | SNV           | 2003 - 2008   | government agencies dealing with private sector development; capacity building to strengthen the advocacy role of private sector associations; and promotion of financing mechanisms to foster private sector activities.<br>Development of the private sector through tourism, incl. development of research cell at DoT, capacity strengthening of Association of Bhutan Tour Operators and DoT; and development of community-based tourism. | € 400,000     |
| The Rural Enterprise Development (RED) | SNV/UNDP      | 2002 - 2007   | Capacity development of BDS providers at the regional and district levels and direct support to rural enterprises to increase market access through: market information systems, product value enhancement, market brokering and development, business planning, empowerment of community organizations and PPP, establishing the rural enterprise grant scheme and assistance in establishing RTIOs in six districts.                         | € 1.5 million |

## **Appendix 7**

### Action Plan

## ACTION PLAN

Development Goal: Fostering an enabling policy and regulatory environment, eliminating structural barriers constraining small enterprises (MSMEs) access to key resources - credit and of non-financial business development services (BDS), supporting BDS providers market entrance, and providing capacity building for the Bhutan Development Finance Corporation (BDFC).

| 1 <sup>st</sup> Phase   | 2 <sup>nd</sup> Phase   | 3 <sup>rd</sup> Phase  |
|---|---|--|
| <b>I. Developing an Institutional Framework for MSME Program Formulation and Implementation</b>   |   |  |
| (A) Establishing the Government's Policy and Institutional Framework for MSME Development through a coordinated plan for MSME development, based on strong involvement of the private sector. |   |  |
| (1-1) The Minister of MTI to issue a decree assigning PPD/MTI to draft a three-year multi-sectoral and inter-ministerial MSME development action program.                                     | (2-1) RGoB to approve the completed MSME development action plan detailing concerned government agencies action and relevant budgets.   | (3-1) More than 40% of the members of PDSC belong to the private sector. |
| (1-2) The Minister of MTI to issue a decree for establishing a specialised MSME unit.   | (2-2) PPD/MTI to publish a White Paper on Small Enterprise Development, which includes sound analyses of sector development based on reliable and up-to-date statistical data and discussions with representatives of the private sector. |  |
| (1-3) RGoB to approve budget plans for DoI, PPD and RTIOs reflecting incremental staffing (contracted or permanent) requirements.   |   |  |
| (1-4) National Assembly to assign MSME policy monitoring function to PSDC.  | (2-3) MSME Unit/MTI and BPS/RTIOs to sign joint work plans to coordinate BDS facilitation.  |  |

| II. Developing an Enabling Legal and Regulatory Framework |   |       |  |
|---|---|-------|--|
| (B)   | Enhancing business laws and regulations as well as strengthening the rule of law with strong involvement of the private sector.   |       |  |
| (1-5)   | PSDC issues a formal decision to include four business laws in a pilot regulatory impact assessment (RIA) exercise.   | (3-2) | PSDC to submit recommendation for the institutionalisation of RIA and the establishment of a RIA unit to the Prime Minister/National Assembly. |
| (1-6)   | PPD/MTI to establish working group to supervise pilot implementation of RIA.  |       |  |
| (C)   | Simplification and acceleration of business formalization.  |       |  |
| (1-7)   | MTI to successfully complete the reform of the trade licensing regime started by April 1 <sup>st</sup> , 2006.  | (2-4) | MTI to implement fast track solutions and reduction of license fees, also in the manufacturing and services sectors.                           |
| (1-8)   | MTI to reduce overall time involved in business formalization from 62 to 47 days.   | (3-3) | MTI to further reduce overall time of business formalization to 30 days, against good practice of 21 days.                                     |
| (D)   | Increasing administrative efficiency of RTIOs/One Stop Services (OSS) through monitoring and benchmarking.  |       |  |
| (1-9)   | MTI to provide a widely accessible web site with complete information on the business formalization process and to disseminate brochures with detailed information about the license process and time and costs involved. | (2-5) | MTI to endorse the introduction of a hands-on monitoring system for RTIO/OSS performance.  |
|   |   | (3-4) | MTI to disseminate RTIOs' performance benchmarks and other related information to the public.  |



| III. Increasing Access to Market-Based Finance for MSEs |  |       |   |
|---|--|-------|---|
| (E)   | Enhancing access to medium- and long-term finance for MSEs as well as institutional strengthening of BDFC to become a sustainable institution dedicated to MSEs. |       |   |
| (1-10)  | BDFC to approve the strategy and 5-year business plan.   | (2-6) | BDFC to implement its strategy and business plan according to performance target.   |
| (1-11)  | BDFC to have in place corporate governance structure and policies.   | (2-7) | Tripartite meeting to issue a review report on the loan conditions and recommended suitable action.   |
| (1-12)  | BDFC to reduce the non-performing loan ratio to 16%.   | (2-8) | The CIB to be established based on detailed operational guidelines, which entails (i) the voluntary exchange of credit information among participants through an independent computerized database, and (ii) security features to protect the database. |
| (1-13)  | MoF to approve the legal set-up for a Credit Information Bureau.   | (3-5) | BDFC to implement its strategy and business plan according to performance target.   |

| IV. Enhancing Competitiveness of Bhutanese MSMEs through Improved Access to Qualified Business Development Services |  |   |   |   |
|---|--|---|---|---|
| (G) Improving competitiveness of Bhutanese MSMEs.   |  |   |   |   |
| (1-14)  | RGoB to appoint 5 members to the Appraisal Panel of the Cost-Sharing Facility (CSF), at least two of the private sector. | (2-9) Annual performance of CSF is according to business plan.                          | (3-6) Annual performance of CSF is according to business plan.                    | (3-7) MTI, PSDC and MOF to issue decision paper on the future of the CSF.       |
| (1-15)  | PSDC to endorse the business plan of CSF and appoint a head for the CSF.   |   |   |   |
| (H) Improving the quality of BDS Services.  |  |   |   |   |
|   |  | (2-10) PSDC to review the number of eligible CSF providers.                             | (3-8) PPD/MTI to commission surveys on enhancement of CSF providers' performance. |   |
| (I) Extending the outreach of BDS services.   |  |   |   |   |
| (1-16)  | DI/MTI to approve action plans for an interactive radio program and a TV program.  | (2-11) DI/MTI to approve action plans for innovative cluster and supply chain programs. | (3-9) PPD/MTI to commission reports on radio/TV program performance.              | (3-10) PPD/MTI to commission reports on achievements of MSME unit BDS programs. |
|   |  | (2-12) MoF to approve budgets for the above programs.                                   |   |   |

## **Appendix 8**

### Minutes of 2<sup>nd</sup> Tripartite Meeting

### **Tripartite Meeting**

#### **Minutes of Meeting**

|                                |  |
|--------------------------------|--|
| Place:                         | Thimphu, Department of Industries,<br>Ministry of Trade and Industry   |
| Date:                          | 24 <sup>th</sup> March 2006  |
| Time:                          | 10 am – 2 pm   |
| Participants:                  |  |
| Asian Development Bank         | Mr. Abid M. Hussain, South Asia Department<br>Ms. Chia-Hsin Hu, South Asia Department<br>Mr. Cuong Van Vo, South Asia Department   |
| Ministry of Trade and Industry | Mr. Dasho Karma Dorjee, First Secretary<br>Mr. Rinzin Dorji, Deputy Secretary, PPD<br>Mr. Loknath Chapaghai, Joint Director, DOI<br>Mr. Dhanrai Subbha, Deputy, DOI<br>Ms. Yeshey Wangmo, SME Coordinator, PPD<br>Mr. Om P Nirola, Head, EPC<br>Mr. Phuntsho Gyeltshen, Planning Officer,<br>Department of Tourism |
| Ministry of Finance            | Mr. Sonam Wangchuk, Director General,<br>DADM<br>Mr. Tsewang Norbu, Deputy Chief Program<br>Officer, DADM  |
| Royal Monetary Authority       | Ms. Eden Dema, Chief Financial Institutions<br>Supervisor Division   |
| BDFC                           | Mr. Nawang Gyetse, Managing Director   |
| GFA Consulting Group           | Dr. Klaus Altemeier (PTL)<br>Ms. Ulla Törnroos<br>Ms. Marret Schadwinkel   |

1. The tripartite meeting reviewed the intended scope under the ADB SME Development Loan for implementing a consistent and well-integrated private sector development program in Bhutan. Importantly, the views of all parties were detailed and a general consensus agreed as to the direction to be taken under the ADB SME Development Loan.

2. The First Secretary welcomed the participants and appreciated the support provided by ADB in the area of private sector development. ADB underlined the importance of MSMEs as the backbone of economic growth in Bhutan and to promote MSME development from a holistic approach.

3. The presentation (presentation attached) of the ADB PPTA team was provided by the Team Leader, Dr. Klaus Altemeier, and the financial sector consultant, Ms. Ulla Törnroos. The presentation covered the areas: (i) Enabling Business Environment (EBE), (ii) Access to Market Based Finance and (iii) MSE Development Strategy and Business Development Services.

#### **I. Enabling Business Environment**

4. There was a general consensus that the institutionalisation of regulatory impact assessments (RIA) would provide a framework that reduces regulatory risks for the government and even more importantly minimizes deleterious impacts on private business and commercial markets. Considering the long pipeline of new laws and regulations to be implemented, it was agreed that the introduction of RIA would be of high priority to facilitate private sector activities by lightening the regulatory burden for MSEs. Approach-wise the participants achieved an agreement to start with a pilot phase of RIA. During this pilot phase 4 laws are recommended to be reviewed and a final decision on institutionalisation will be based on the experiences made during the pilot phase. The final decision on the laws to be reviewed during the pilot phase shall be made shortly before the start of the program as two of the proposed laws (Labor and Employment Act and Industries and Investment Act) are still not approved by the National Assembly.

5. It was further agreed that part of the streamlining of the business start-up process would be of minor priority under the ADB SME Development Loan as it is already covered by the new World Bank Policy Grant. Under this program the government is targeting to reduce the number of days required for a business start-up process to the regional average of 47 days (21 days is international best practice). The streamlining of the trade license regime as also proposed in the Mid-Term Report of this PPTA is currently underway. As of April 1st, 2006 the present single-activity license will be replaced by a multi-activity license. Micro establishments with a turnover of less than Nu. 1 Million will not pay a license fee and simply register at the Regional Trade and Industry Offices. MTI also considers to speed up the formalization process for micro establishments in other sectors.

6. The promotion of One-Stop-Services (OSS) was generally acknowledged by the participants as it is already practised to some extent at the regional offices. As the implementation of OSS is impeded by manpower and capacity building constraints, capacity building for strengthening the RTIOs is seen as the main bottleneck, which needs to be addressed under the ADB SME Development Loan.

7. Support to the development of a national policy on standards, metrology, testing and quality (SMTQ) was not considered to be a priority under the ADB SME Development Loan as this is a prerequisite for WTO accession and will be supported from other sources.

## **II. Access to Market Based Finance**

8. The mid-term report proposed a number of interventions for consideration to improve financial access for MSMEs. These are (i) establishment of a Credit Information Bureau (CIB), (ii) establishment of a Credit Guarantee Fund (CGF), (iii) introduction of leasing, (iv) strengthening of BDFC, (v) support in specific MSME lending techniques, (vi) a credit line for MSME lending and leasing, and (vii) improving the regulatory environment for MSMEs.

9. The financial sector consultant conducted several follow-up meetings with all relevant stakeholders in the financial sector since her arrival on March 18. As a lot of changes had taken place between November 2005 and March 2006, financial sector consultant in consultation with the various stakeholders in the financial sector revised the line of actions to be taken under the ADB SME Development Loan. During her presentation, the consultant therefore proposed the following interventions as high priority: (i) establishment of a credit information bureau, (ii) institutional strengthening and capacity building of BDFC and (iii) a credit line for MSE lending.

10. There was a general consensus that CIB would facilitate the cost-effectiveness of credit risk decisions made by FIs (e.g. by cutting down on time during the appraisal process and requiring less collateral) and this in turn would result in improved access to financial services for MSEs. Because of its importance and urgency, ADB will provide support to the establishment of CIB under the ADB Financial Sector and NBFIR Reform.

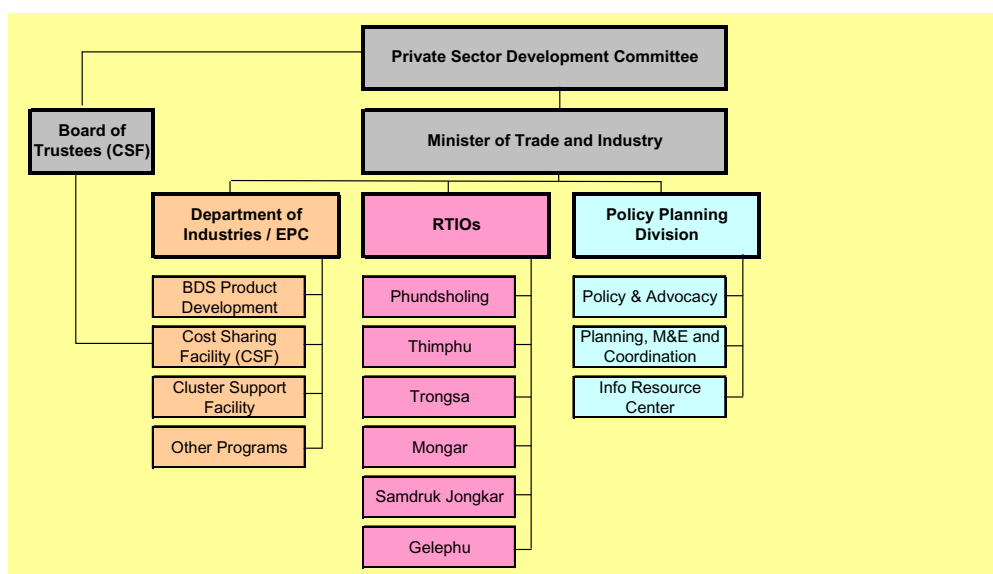
11. Institutional Strengthening and Capacity Building of BDFC was well acknowledged by the participants as BDFC is the only FI in Bhutan addressing the needs of MSMEs in rural areas. In addition to the proposed TA in MSE lending techniques and product development, the need for in-country training and MIS support was stressed.

12. It was further agreed that prior to the disbursement of the credit line, there is a need for the institutional strengthening of BDFC to ensure effectiveness of the financing component. The TA would focus on (i) establishing and implementing corporate governance structure and policies, (ii) developing and implementing a strategy and business plan, and (iii) developing and implementing appropriate procedures.

13. A Credit Line of USD 5 million (Nu. 225 million) with a tenor of up to 10 years was proposed for facilitating access to finance for MSEs. The proposed terms for the Credit Line, in particular the maximum loan amount of Nu. 2 million, were discussed intensively and it was finally agreed that the terms would be reviewed during implementation for possible adjustments. The proposed definition of MSEs under this Credit Line is supposed to take into account the existing Bhutanese definition of MSMEs in terms of capital invested rather than turnover. The exact on-lending interest rate charged by the RGoB will be further discussed and agreed upon between the government and BDFC. ADB is providing the loan for 1.5% p.a.

### III. MSE Development Strategy & Business Development Services

14. The introduction of an MSE Development unit as an instrument to underline Government's role as a facilitator of MSE development was discussed intensively. As the role and tasks of the proposed MSE Development unit are seen to be partly overlapping with the tasks of the Private Sector Development Committee (PSDC) and the Technical Committee (TC), it was agreed that the proposed structure with its function would be aligned to the Ministry of Trade and Industry under the Department for Industries and the Policy Planning Division.



15. In this context it was further agreed that PPD will be in charge of the elaboration of an SME White Book which would demonstrate overall progress in SME development to the Government and the public.

16. The proposed pilot cost-sharing facility was discussed extensively and partly controversially. A general consensus was reached that the proposed cost-sharing facility would boost the competitiveness of Bhutanese MSMEs through access to demand driven BDS and thus perpetuate the development of MSE and the market for commercial BDS. It was agreed that MTI would seriously consider and internally discuss the implementation of a CSF. The consultant stressed that during stakeholder workshops and field interviews the business community unanimously welcomed a CSF and that the proposed size for the first CSF in Bhutan is very small and has to be considered as a pilot. ADB also stressed that the role of cost-sharing facilities in other countries has been important in further increasing MSE's competitiveness. Concerning the scope of CSF subsidized activities ADB and the consultants clearly spoke out that in line with international best practices, the financing of capital investments will not be part of the cost-sharing facility.

However the cost- sharing facility would be there to support the sound preparation of capital investments to be financed under the proposed BDFC credit line.

17. The proposed radio program for rural enterprise development was acknowledged as an important tool for business information and advocacy and it was further proposed to widen the scope by also considering a TV program. The proposed TA of international expertise however was not seen necessary as the know-how in implementing radio information programs is available in Bhutan. It was agreed that the PPTA team will provide an estimation of the costs involved, including a TV program.

**General Issues:**

18. The extent to which the proposed TA interventions will be financed out of the ADB SME Development Loan is still subject to discussion.

19. ADB will provide additional TA to complete the financing component focussing on preparing a business plan for BDFC, establishing and implementing corporate governance structure and policies, and strengthening BDFC's institutional capacity by developing and implementing appropriate procedures.

20. Finally, it was agreed that the draft final report shall be disseminated by mid April to the Government for confirmation on the final program design.



## **Appendix 9**

### Summary Poverty Reduction and Social Strategy

## SUMMARY POVERTY REDUCTION AND SOCIAL STRATEGY (SPRSS)

### A. Linkages to the Country Poverty Analysis

|  |  |   |  |
|--|--|---|--|
| Is the sector identified as a national priority in country poverty analysis?   | <input checked="" type="checkbox"/> Yes<br><input type="checkbox"/> No | Is the sector identified as a national priority in country poverty partnership agreement? | <input checked="" type="checkbox"/> Yes<br><input type="checkbox"/> No |
| <b>Contribution of the sector /subsector to reduce poverty in Bhutan:</b><br><p>In the past RGoB has been hesitant to embark on an own PRSP as for a small country with capacity constraints the PRSP process would involve unreasonably high costs. However the Vision 2020 exercise supported by UNDP has, among others, already developed an overall strategy of growth and equitable development. In Bhutan, MSME development is regarded as a vehicle to promote a more even distribution of wealth, both socially and regionally, and to reduce poverty. It shall specifically contribute to (i) the creation of new jobs in rural areas in order to reduce migration from rural to urban areas and, (ii) the reduction of increasing youth unemployment in rural and urban areas. Challenges in reaching RGoB's labor market objectives are stunning. A World Bank survey estimates that between 2005 and 2010 approximately 65,000 persons will enter the labor market. The number of persons leaving the labor market will not significantly ease this critical situation, as, according to the 2004 labor market survey, about 75% of the current work force is still below 50 years of age. Labor productivity in the agricultural sector is already low and it must be assumed that agriculture will not create additional employment over the coming years. Though some additional employment will be created in the public sector, as government capacities need to grow in parallel to the development of the private sector, the public sector is largely saturated and the vast majority of the mostly young entrants will have to be absorbed by the private sector and in particular labor intensive MSMEs.</p> |  |   |  |

### B. Poverty Analysis Others

### Poverty Classification:

|   |
|---|
| <b>Introduction</b><br><p>The goal of the MSME development program is to foster an enabling policy and regulatory environment, eliminating structural barriers constraining small enterprises (MSMEs) access to key resources - credit and of non-financial business development services (BDS), supporting BDS providers market entrance, and providing capacity building for the Bhutan Development Finance Corporation (BDFC). Elimination of structural barriers which constraint small enterprise development is particularly relevant for Bhutan where rural urban migration and increasingly lacking job opportunities for young people may lead to increased poverty and result in social and economic unrest. The program components in its combination are essential for a successful development of the MSME sector and cannot be implemented as stand-alone measures. The components are reviewed in terms of their outcomes and expected economic and social impacts as follows.</p> <p><b>I. Foster an Enabling Policy and Regulatory Environment</b></p> <p>Policy actions proposed for developing an enabling policy and regulatory environment for MSMEs fall under two components: (A) establishing the Government's policy and institutional framework for MSME development through a coordinated plan based on public-private partnership and (B) enhance public governance and business regulations. Policy actions under component (A) aim to strengthen RGoB with regards to MSME policy formulation and implementation and in particular to strengthen MTI which acts as a permanent secretariat to the Private Sector Development Committee and therefore provides the basis or gives food for thought for PSDC recommendations to the National Assembly. A better informed PSDC in particular with regards to the cross-cutting development needs of MSMEs is expected to contribute to a more effective formulation and implementation of MSME policies across Government agencies. To enhance information base on MSMEs, component (A) also supports the elaboration of an annual MSME white book which will significantly improve the statistical knowledge on MSMEs and cater for more effectively targeted and executed policies and programs, availability of comprehensive information for MSMEs, and heighten public awareness of the SME sector. Cost for accessing information on regulations relevant to MSMEs, and programs and services available to MSMEs will be minimum and will be affordable to the poor.</p> <p>Policy actions under component (B) include making better business laws and regulations by revealing the costs and benefits of respective laws and regulations, simplification and acceleration of business formalization removing unnecessary requirements for both business registration and licensing and, increasing accountability and administrative efficiency of Regional Trade and Industry Offices by installation of effectively monitored and benchmarked one stop shops. Ex ante regulatory impact assessments will ensure that unnecessary laws and regulations that discourage MSME establishment and growth are reconsidered, while ex post review will provide feedback to policymakers on measures adopted for improvement. A simple and transparent regulatory regime will reduce the costs for self employment, establishing businesses and complying with statutory rules and regulations.</p> |
|---|

This will help accelerate the growth of the MSME sector and create new employment opportunities, including those for the poor. The proposed introduction of benchmarked one stop shops will prevent from arbitrary administrative procedures and support the ongoing decentralisation process, promote good governance, reduce transaction costs for MSMEs, and increase accessibility. All captioned policy actions will also support good governance acknowledged as crucial in fighting poverty.

## **II. Improved Access to Formal Sources of Finance**

Policy actions proposed for increasing MSE's access to formal sources of finance fall under two components: (A) implementation of an MSE credit line to meet the supply gap of funds available to MSEs; and (B) institutional strengthening and capacity building support to BDFC to enable the institution to effectively intermediate financing to private MSEs.

Policy actions under component (A) aim at ensuring the effective channelling of funds to MSEs and thereby stimulating growth within the private MSME sector in Bhutan. Sub-loans from the credit line have a positive impact on local economic situation and employment level as micro and small enterprises, which are the backbone of the economy, are enabled to grow and develop further. The extension of the MSE credit line to rural areas will help to ease regional and economic inequalities.

The capacity building support to BDFC under component (B) promotes institutional development and will contribute to the strengthening of the overall financial sector. Enhanced institutional capabilities will reduce transaction costs making financial services affordable for the poor. Cash-flow based lending will reduce collateral requirements which will significantly improve access to financial services to MSEs.

## **III. Enhanced Competitiveness of Bhutanese MSMEs through Access to Qualified BDS**

Policy actions proposed for enhancing competitiveness of Bhutanese MSMEs fall under three components: (A) establishment of a Cost Sharing Facility (CSF); (B) broad dissemination of business information also to hardly accessible parts of the country and; (C) the facilitation of Government driven cluster and supply chain initiatives.

Policy actions under component (A) aims at increasing competitiveness of Bhutanese MSMEs through demand driven access to BDS. A market survey carried out during ADB Ta 4412-Bhu shows that Bhutanese MSMEs lack competitiveness because of delayed investments of MSME in particular in technological know-how and skills development due to the small profit margins of Bhutanese MSMEs operating under high cost conditions. This in turn heavily impedes on the growth of businesses, the growth of the economy, and may finally lead to an irreversible fallback in international competition. Keeping in mind that between 2005 and 2010 about 65,000 young people will search for employment in the private sector, it is the manifested public interest to accelerate company growth and support businesses in overcoming their prevailing constraints. Though this intervention has no direct impact on the reduction of existing poverty in Bhutan, it prevents Bhutan from a serious further fallback in international competition and an increase of unemployment which may end in social unrest and increasing poverty.

Policy action under component (B) foresees the implementation of an interactive TV/radio program for rural development as business start-ups and MSME in rural areas face significant impediments due to lack of information on business ideas, markets, technologies, financing facilities and business support services. TV/Radio programs on basic entrepreneurial skills, technological and market opportunities in Bhutan's three native languages will support the accelerated growth of enterprises also in economically disadvantaged areas. Through TV/radio BDS services will be made available and affordable to the poor.

Policy action under component (C) is the development of new government driven and fully subsidized pilot BDS programs such as cluster and value chain development initiatives based on the results of investment studies carried out during the 9th plan, fiscal year 2006/07. Similar to policy action under (b) this action targets in particular at the economic development and commercialization of currently disadvantaged rural areas and at connecting these areas to international standards and markets through value chain development. As most of the poor live in rural areas policy action under this component will positively affect the poor by increased job opportunities and income.

## **Conclusion**

The impacts of the MSME development program on economic growth and employment generation are assessed to be significantly positive. No adverse impact requiring mitigating measures was identified.

Given the current limitations on data collection, quantifying the impact of the Program and the proposed policy actions on the poor is extremely difficult. This serious obstacle in monitoring the economic and social impact of the Program will be overcome through the elaboration of an MSME white book supported under the Program. The Program will closely monitor outcomes, and economic and social impacts throughout its implementation to ensure that there are no adverse impacts to the poor and the vulnerable.

## **Appendix 10**

### Proposed Technical Assistance

## TOR for Institutional Capacity Building Technical Assistance

### A. Purpose and Outputs

1. A major objective of the proposed technical assistance (TA) is to assist the Royal Government of Bhutan in developing a business environment conducive to small enterprises (MSMEs) development, in conjunction with the Micro, Small and Medium Enterprise Development Program (the Program). The major outputs and deliverables are (i) technical and financial support to the Government and relevant private sector institutions in its efforts to undertake the reforms; (ii) capacity-building support to the Government through workshops, roundtable discussions, and formal/informal discussions; and (iii) support for consensus building and information dissemination, which will be conducted through a series of workshops and other related events to foster consensus building and information dissemination.

2. The TA will focus on capacity building measures to guarantee the achievement of four major outputs (i) a policy coordination framework on MSME development; (ii) improved business regulatory environment; (iii) enhanced MSEs' access to market-based finance and (iv) enhanced MSMEs' access to non-financial business development services (BDS). These components aim to help the Bhutanese Government to increase private sector activities in the labour intensive MSME segment of the economy leading to the creation of jobs for Bhutanese for the increasing number of new entrants into the labour market. More specifically, the proposed TA will support the achievement of the following expected outputs:

- (i) **The MSME development framework.** Outputs include support for the implementation of the MSME development framework for coordinating MSME activities across ministries, including an institutional mechanism for supporting the development of MSMEs.
- (ii) **Business Laws and Business regulation reform.** Outputs include the pilot implementation of regular impact assessments on pre-selected business laws, the further simplification and acceleration of business formalization and capacity building for the Regional Trade and Investment Offices in order to improve administrative efficiency .
- (iii) **Access to Market-Based Finance.** Outputs include the implementation of a credit line to provide MSEs with access to medium- and long-term finance and capacity building support to enable BDFC to become a sustainable institution operating on sound banking practices and fully exploit its potential to effectively intermediate financing to MSEs.
- (iv) **Business Development Services.** Outputs include a cost sharing facility to improve competitiveness of Bhutanese MSEs and an interactive radio/TV program to encourage self employment in rural areas and fill the information gap of rural start ups and existing rural MSMEs against the backdrop of the difficult accessibility of large parts of Bhutan and the lack of business services at a reasonable distance to a vast number of (potential) enterprises.

### B. Methodology and Key Activities

3. The TA will fund consultants with expertise in the MSME sector and related areas (para. 2) who will conduct in-depth consultations with the Government and private sector stakeholders. A consultative approach is a critical part of the process to produce targeted outputs, and will be followed by a number of roundtable discussions and workshops for knowledge transfer needed

to implement the policy conditions under the Program. The Asian Development Bank (ADB) will monitor the process closely to ensure the quality of outputs, including training.

### C. Cost Estimates

4. Activities under the proposed TA are estimated to cost a total of US\$ 5.3 million equivalent, comprising a foreign exchange cost of US\$ 3.4 million and a local currency cost of US\$ 1.9 million equivalent. The cost estimates and the financing plan are in Table A9. Procurement under the TA will be in accordance with ADB's *Guidelines for Procurement*.

**Table A9: Cost Estimates and Financing Plan (\$)**

| Item  | Foreign Exchange | Local Currency   | Total            |
|---|------------------|------------------|------------------|
| <b>Royal Government of Bhutan Financing</b>                 |                  |                  |                  |
| <b><u>1. Consultants</u></b>                                |                  |                  |                  |
| a. Remuneration & Per Diem                                  |                  |                  |                  |
| i. International Consultants                                | 2,160,000        |                  | 2,160,000        |
| ii. Domestic Consultants                                    |                  | 136,000          | 136,000          |
| b. International and Local Transportation                   | 100,000          | 188,000          | 288,000          |
| c. Office, Secretarial, and Related Services, Communication | 3,000            | 137,000          | 140,000          |
| d. Equipment & Materials                                    | 17,000           | 42,000           | 59,000           |
| e. Contingency  | 167,000          | 50,000           | 217,000          |
| <b>Sub Total 1</b>  | <b>2,447,000</b> | <b>553,000</b>   | <b>3,000,000</b> |
| <b><u>2. OSS Benchmarking System</u></b>                    |                  |                  |                  |
| Computer Equipment  | 170,000          |                  | 170,000          |
| Software  | 50,000           |                  | 50,000           |
| IT advise, Training, Workshops                              |                  | 130,000          | 130,000          |
| Local Travel  |                  | 50,000           | 50,000           |
| Contingency   | 50,000           | 50,000           | 100,000          |
| <b>Sub Total 2</b>  | <b>270,000</b>   | <b>230,000</b>   | <b>500,000</b>   |
| <b><u>3. Streamlining Business Formalization</u></b>        |                  |                  |                  |
| Computer Equipment  | 120,000          |                  | 120,000          |
| Software  | 50,000           |                  | 50,000           |
| IT Advise, Training, Workshops                              | 80,000           | 100,000          | 180,000          |
| Local Travel  |                  | 50,000           | 50,000           |
| Contingency   | 50,000           | 50,000           | 100,000          |
| <b>Sub Total 3</b>  | <b>300,000</b>   | <b>200,000</b>   | <b>500,000</b>   |
| <b><u>4. Introduction of RIA</u></b>                        |                  |                  |                  |
| Fees to Local Lawyers                                       |                  | 150,000          | 150,000          |
| Seminars and Workshops                                      |                  | 120,000          | 120,000          |
| Conferences   |                  | 30,000           | 30,000           |
| Local Travel  |                  | 100,000          | 100,000          |
| Contingency   |                  | 100,000          | 100,000          |
| <b>Sub Total 4</b>  | <b>0</b>         | <b>500,000</b>   | <b>500,000</b>   |
| <b><u>5. TV/Radio Capacity Building</u></b>                 |                  |                  |                  |
| Trainings Abroad  | 100,000          |                  | 100,000          |
| Study Tours   | 100,000          |                  | 100,000          |
| Seminars and Workshops                                      |                  | 40,000           | 40,000           |
| Conferences   |                  | 70,000           | 70,000           |
| Local Travel  |                  | 90,000           | 90,000           |
| Contingency   | 50,000           | 50,000           | 100,000          |
| <b>Sub Total 5</b>  | <b>250,000</b>   | <b>250,000</b>   | <b>500,000</b>   |
| <b><u>6. Cluster &amp; Supply Chain Development</u></b>     |                  |                  |                  |
| Study Tours   | 150,000          |                  | 150,000          |
| Local Workshops, Training                                   |                  | 90,000           | 90,000           |
| Contingency   | 30,000           | 30,000           | 60,000           |
| <b>Sub Total 6</b>  | <b>180,000</b>   | <b>120,000</b>   | <b>300,000</b>   |
| <b>Total</b>  | <b>3,447,000</b> | <b>1,853,000</b> | <b>5,300,000</b> |

Source: Consultants' estimates.

## **D. Implementation Arrangements**

5. The Ministry of Trade and Industry (MTI) will be the Executing Agency. The implementing agencies are MTI, Ministry of Finance, Royal Monetary Authority of Bhutan (RMA), Ministry of Labor and Human Resources (MLHR), Ministry of Agriculture (MOA), National Environment Commission (NEC), and Bhutan Development Finance Corporation (BDFC). The Government will fully participate in the TOR formulation/implementation to ensure proper ownership. The Private Sector Development Committee (PSDC) will act as the program steering committee and monitor and support the capacity building activities under the TA. The private sector, including the Bhutan Chamber of Commerce (BCCI) and various business associations, is part of the PSDC and has been consulted for its views on MSME development.

6. The consultants will prepare a detailed work plan before the start of services, which will include a timetable for deliverables defined under each TA component. All reports will conform to ADB format and will be reviewed by MTI, the implementing agencies, and ADB. Draft final reports will be submitted within the deadline specified in the work plans after incorporation of feedback from MTI, the implementing agencies, and ADB. Tripartite meetings will be held before finalization of the draft final reports. The final report, incorporating comments of MTI, the implementing agencies, and ADB during and after the tripartite meetings, should be submitted upon completion of services. The TA is scheduled to commence in January 2008 and to be completed by December 2010.

## **E. Terms of Reference for Consultants**

7. The work plan and consultant selection are subject to refinement by ADB, based on the needs of ADB and the Government agencies.

### **1. International Consultants**

#### **a. International SME/MSME Policy Specialist (15 person-months intermittent)**

8. The policy specialist will have a university degree in economics or political science or related fields and extensive working knowledge of (i) small enterprise development, its policy framework, and applicable international experiences especially in small countries; (ii) demonstrate good understanding of the history and development of the Bhutanese MSME sector and the development stage of the country's legal and regulatory, under which MSMEs operate including promotion policies, legal reforms, and capacity-building measures for MSMEs. Tasks and responsibilities include consultancy, training and preparing the reports on the following activities:

- (i) Based on in-depth consultation with the PSDC and other relevant agencies, help implement ADB SME/MSME Development Program Loan by drafting and regularly reviewing a detailed work program for the Program & Policy Division (PPD) and the Department of Industries of MTI in coordination with the BDS advisor (see below).
- (ii) In coordination with the BDS advisor assist the MTI in procurement activities related to cluster and supply chain development.
- (iii) Based on consultation with PPD and the National Statistics Bureau, draft a plan for collection of information on the MSME sector.
- (iv) Assist PPD in commissioning of sector studies and MSME sector analysis<sup>1</sup> as qualified inputs to the formulation of MSME White Papers and coherent inputs to

<sup>1</sup> E.g. to qualified service providers and institutes including RIM, BCCI, sector associations, Universities.

the formulation of MSME policies and program interventions of PSDC and its technical committee.

- (v) Assist PPD to monitor and evaluate existing MSME support programs and regulations governing the sector, as well as propose future support measures. In this context assist PPD to organise round tables with the private sector on MSME support programs and help to enter stakeholder feedbacks and the results of systematic sector analysis into policy discussions and the formulation of MSME support programs.
- (vi) Based on consultation with relevant stakeholders assist PPD to further simplify and accelerate business formalization.
- (vii) Help ADB missions with related activities, as well as conduct discussions and workshops with the relevant stakeholders for effective Program implementation.
- (viii) Hold workshops and other dissemination events to inform stakeholders and raise public awareness of the MSME development framework and reform of business laws and regulations.

**b. International Legal Specialist (18 person-months intermittent)**

9. The specialist will have a university degree in law and extensive working knowledge of (i) conducting Regulatory Impact Assessments (RIA) and the establishment of RIA units, (ii) as well as elaboration of management and benchmarking systems for One Stop Services; and (iii) demonstrate good understanding of the history and development of the Bhutanese MSME sector and the development stage of the country's legal and regulatory system, under which the MSMEs operate. Tasks and responsibilities include consultancy, training and preparing reports concerning the following activities:

- (i) In close cooperation with PSDC/PPD review the suggestions of the ADB PPTA and select four business laws to become part of pilot RIAs.
- (ii) In close cooperation with PSDC/PPD establish an inter-ministerial working group.
- (iii) In consultation with the working group and involved agencies select qualified ministerial staff to carry out RIA pilots.
- (iv) Develop and implement training modules and on-the-job training measures for RIA staff.
- (v) In close consultation with PSDC/PPD develop concept and advocate institutionalization of RIA.
- (vi) Supervise ongoing RIA activities.
- (vii) In close cooperation with PPD/RTIOs develop concept and benchmarks for RTIO operations in the business formalization process.
- (viii) Establishment of One Stop Units and a monitoring system for One Stop Units in close cooperation with PPD/RTIO.
- (ix) Assist with procurement of IT equipment and software for the OSS benchmarking and streamlining business registration on national and regional level.



**c. International Development Banking Specialist** (12 person-months intermittent)

10. The development banking expert must have (i) a degree in development economics, business administration or related field with evidence of further qualification in banking operations; (ii) at least 10 years actual experience in senior level positions of development banking/microfinance, preferably in the ASEAN region; and (iii) substantial expertise in strategy, business plan and policy development and implementation. The specific duties and responsibilities are, but not necessarily limited to, as follows:

- (i) Assist BDFC in establishing and implementing corporate governance structure and policies;
- (ii) Assist BDFC in developing and implementing a strategy and business plan;
- (iii) Assist BDFC in establishing and implementing appropriate internal control systems at all levels and business areas;
- (iv) Assist BDFC in developing/improving and implementing appropriate policies, such as (i) funding and ALM policy; (ii) general risk management policy; (iii) credit risk management policy; and (iv) financial policies.

**d. International MSE Lending Specialist** (12 person-months intermittent)

11. The international MSE lending specialist should have the following key qualifications: (i) at least 5 years of demonstrated experience in cash-flow based lending; (ii) experience in micro and small loan/lease appraisal, supervision and monitoring technology; and (iii) good knowledge of the banking system in countries in transition, preferably in the ASEAN region. The consultant's main objectives and responsibilities will be as follows:

- (i) Streamline or strengthen credit approval procedures and management practices needed to develop a well performing MSE portfolio;
- (ii) Train BDFC's personnel with respect to best practice in micro and small loan/lease appraisal, supervision and administration skills;
- (iii) Develop demand driven products, e.g. leasing;
- (iv) Improve MIS specifically geared towards MSE portfolio;
- (v) Strengthen BDFC's marketing of micro and small loans/lease financing.

**e. International BDS Product Development Specialist** (12 person-months intermittent)

12. The specialist will have a university degree in economics or related fields and extensive working knowledge in the field of business development services (BDS); and should demonstrate good understanding of the history and development of the Bhutanese MSME sector and the development stage of the country's BDS sector. The tasks and responsibilities include consultancy, training and preparing reports concerning following activities:

- (i) Assist the SME/MSME Policy Specialist in the elaboration and review of work plans for the implementation of the ADB SME Development Loan under MTI.
- (ii) Assist the SME/MSME Policy Specialist in procurement activities related to cluster and supply chain development.

- (iii) Assist MTI/Department of Industries (DI) in the implementation and evaluation of a comprehensive BDS supply and demand study and the dissemination of the results.
- (iv) Based on the study results and further round tables with MSMEs exploit the possibility and eventually develop standard BDS to be marketed under the cost sharing facility in close cooperation with the MTI/DI.
- (v) Enhance the capacity of BPS/MTI staff to carry out cluster and value chain analysis and design cluster and value chain projects.
- (vi) Enhance the capacity of the appraisal panel of the CSF in classifying and approve or reject project applications.
- (vii) Based on consultation with BPS staff and representatives of rural MSMEs (i) design and plan local cluster support projects, (ii) assist BPS staff in acquiring financial resources for their implementation and (iii) finally assist also in actual implementation of pilot cluster initiatives.
- (viii) Advise BPS staff how to encourage stakeholders to support local economic development (LED) beyond a cluster context by applying modern up-to-date participatory LED methods.
- (ix) Based on consultation with BPS staff and representatives of rural MSMEs (i) conduct value chain analyses, (ii) assist BPS and MTI staff to identify weak or missing links as well as solutions to overcome these weaknesses, (iii) assist to acquire financial resources for value chain projects and (iii) finally assist also in their actual implementation.

**f. International Matching Grant Specialist (9 person-months intermittent)**

13. The specialist will have a university degree in economics or related fields and extensive working knowledge with (i) the establishment; (ii) marketing and (iii) evaluation of cost sharing or matching grant schemes. The specialist should also demonstrate good understanding of the history and development of the Bhutanese MSME sector and should know the strengths and weaknesses of Bhutanese business sector organisations and private BDS providers. Tasks and responsibilities include the following:

- (i) Implement the proper institutional set-up of the cost sharing facility based on consultation with PDSC and MTI/DI.
- (ii) Assist in the recruitment of the CSF director and other CSF staff.
- (iii) Coach the Director of the cost sharing facility to implement CSF policies and standard operating procedures including strict monitoring and evaluation.
- (iv) Assist the Director in the selection of a first group of BDS providers eligible for providing services under the scheme.
- (v) Conduct staff training including the training of BPS staff and the staff of pre-selected BDS providers to be able to market the CSF to all parts of Bhutan.
- (vi) Enhance capacity of BPS staff and staff of pre-selected BDS providers to draft high quality CSF applications in cooperation with the BDS Product Development Specialist.

**g. International Short Term Expert Pool (15 person-months)**

14. On request short term expertise may be needed in the following areas (i) participatory local economic development; (ii) cluster & supply chain development; (iii) development of standard BDS product designs (iv) direct advise to companies or groups of companies of the food, wood, building materials or tourism sector (v) IT designs for management information systems, and (vi) procurement.

**2. Domestic Consultants****a. Domestic Coordinator (30 person-months)**

15. The domestic coordinator will have a university degree and understand private sector development issues; have experience working with international consultants and ADB; be proficient in English; and provide inputs related to the Program framework, especially for issues related to the implementation of the MSME development policy, including the shift of the role of RGoB from being a BDS provider to a facilitator role. The domestic coordinator will undertake the following tasks:

- (i) Under the guidance of the international policy specialist and the BDS product development specialist, collect and analyze required information and data, and make these available in an organized, readable form.
- (ii) Assist in implementation and gradually start to implement training programs designed by the international policy specialist and international BDS product development specialist.
- (iii) Arrange, organize and gradually start to implement round tables and stakeholder workshops, and assist the international SME policy specialist in preparing materials.

**b. Domestic Legal Specialist (18 person-months)**

16. The domestic legal specialist will have a university degree in law and demonstrate good understanding of the history and development of the Bhutanese MSME sector and the development stage of the country's legal and regulatory system, under which the MSMEs operate. The specialist will undertake the following tasks:

- (i) Under the guidance of the international legal specialist, collect and analyze required information and data, and make these available in an organized, readable form.
- (ii) Assist in implementation and gradually start to implement training programs designed by the international legal specialist.
- (iii) Arrange, organize and gradually start to implement round tables and stakeholder workshops, and assist the international SME policy specialist in preparing materials.

**c. Domestic Short Term Expert Pool (20 person-months)**

A short term pool of domestic experts is needed to support the international short term experts in data collection and in moderation of local workshops. They will also help the international experts to understand the local context. The domestic experts will learn from the international short term experts and take over more and own responsibilities.

## **Appendix 11**

### **Staff Requirements for MSME Program Formulation & Implementation**

**Appendix 12: Staff Requirements for MSME Program Formulation & Implementation**

| Fiscal Year   | 2007/08       | 2008/09       | 2009/10       | 2010/11       |
|---|---------------|---------------|---------------|---------------|
| <b>Additional staff for the newly established MSME Unit in DoI</b>        |               |               |               |               |
| Head MSME/BDS Unit  | 1             | 1             | 1             | 1             |
| Coordinator Unit  | 1             | 1             | 1             | 1             |
| Product Development   | 4             | 4             | 4             | 4             |
| Program Development   | 3             | 3             | 3             | 3             |
| Coordinator Outreach  | 1             | 1             | 1             | 1             |
| Cost Sharing Facility *   | (3)           | (3)           | (3)           | (3)           |
| Accounting & Finance  | 3             | 3             | 3             | 2             |
| HR & Administration   | 2             | 2             | 2             | 2             |
| MIS/IT  | 1             | 1             | 1             | 1             |
| Marketing & PR  | 1             | 1             | 1             | 1             |
| Support Staff   | 8+(3)         | 8+ (3)        | 8+(3)         | 9+(3)         |
| <b>Total MSME Unit *</b>  | <b>25+(6)</b> | <b>25+(6)</b> | <b>25+(6)</b> | <b>25+(6)</b> |
| <b>Additional staff in the region to be coordinated through BPS/RTIOs</b> |               |               |               |               |
| Regional Coordinators   | 6             | 6             | 6             | 6             |
| Dzongka Facilitators  | 12            | 20            | 20            | 20            |
| <b>Total Regional Staff</b>   | <b>18</b>     | <b>26</b>     | <b>26</b>     | <b>26</b>     |
| <b>Additional staff in PPD/MTI</b>  |               |               |               |               |
| Policy Coordinator  | 1             | 1             | 1             | 1             |
| Policy & Advocacy   | 1             | 1             | 1             | 1             |
| M & E   | 0             | 2             | 2             | 2             |
| Support Staff   | 1             | 1             | 1             | 1             |
| <b>Total PPD</b>  | <b>3</b>      | <b>5</b>      | <b>5</b>      | <b>5</b>      |

\* in ( ) additional staff needed for operating of the CSF. See also CSF business plan in Appendix 4.

## **Appendix 12**

### Credit Line Design

# **1 RECOMMENDATIONS FOR THE CREDIT LINE DESIGN**

## **1.1 Rationale**

1. The MSME survey conducted under this PPTA verifies that access to finance is one fundamental constraint for MSEs, as only 25% of the micro enterprises and 77% of the small enterprises interviewed had received a loan from a financial institution. Furthermore, the survey shows that 68% of the MSEs interviewed were in need of a loan, either a first loan or additional external finance, leading to the assumption that loan amounts received were not sufficient. The major reason for not applying (or for having applied, but being declined) was insufficient collateral.

2. Although the majority of MSEs is located in urban centers of the western part of Bhutan (42%) and at the foothills of the Himalayas along the Indian border (26%) where all financial institutions are represented as much as 32% MSEs are located in areas, which can be reached only by the BDFC network.

3. The total number of loan accounts (A/Cs) in the Financial Institutions as of 30.06.2005 was 38,672 (see Appendix 5). When deducting loans to private individuals and farming (agricultural/animal husbandry, housing, staff and personal loans) as well as loans against shares, heavy transport and overdraft only 16% of the accounts remains, with a balance of 6,419 accounts, among which there are still many medium and large enterprises. This shows that about half of the MSEs<sup>1</sup> have not received any loan. It is also important to keep in mind that among those that already received a loan there is no indication of whether the clients received the amount they needed or whether the tenor was sufficient. The manufacturing and service & tourism sectors, the main target group has average loan sizes of Nu. 2.6 million and Nu. 2.5 million respectively.

4. The details per Financial Institution (see Appendix 5) show that BDFC has 44% of total clients, but only 12% of total principal outstanding. This is explained by the much lower average loan size, which as of mid 2005 was Nu. 72,132. When deducting loans to private individuals and farming (agricultural/animal husbandry, housing, staff and personal loans) as well as loans against shares, heavy transport and overdraft only 7 % of the accounts remains, with a balance of 1,986 accounts. The average loan size for MSE loans for all financial institutions is Nu. 794,000 it is for BDFC Nu. 302,000.

5. BDFC currently loans exceeding one million on an average in the manufacturing, mining and tourism sectors. Only 92 or 0.5% of BDFC's clients have received loans exceeding Nu. 2 million and out of these 30% were for housing and mining. The average maturity of the BDFC loan portfolio lies currently at 3.16 years and only 10% of the borrowers have received a loan with a maturity exceeding 5 years.

---

<sup>1</sup> The number of MSEs in Bhutan stood end 2004 at 11,669 (10,820 micro and 849 small enterprises) (see PPTA Final Report).

## 1.2 Recommendations

| Framework Data  |  |              |                   |                 |                      |
|---|--|--------------|-------------------|-----------------|----------------------|
| All Financial Institutions                                  |  |              |                   |                 |                      |
| Projected Growth of # of Loans per Sector                   |  |              |                   |                 |                      |
|   |  | 2005         | 2007              | 2010            | Average<br>2008-2010 |
|   | Trade & Commerce & Transport (Light Vehicle) | 4,850        | 6,303             | 9,338           | 8,238                |
|   | Manufacturing/Industry                       | 851          | 1,106             | 1,639           | 1,446                |
|   | Service & Tourism                            | 718          | 933               | 1,382           | 1,220                |
|   |  |              |                   |                 |                      |
| Projected Growth of Demand for Credit (volume)<br>2005-2010 |  |              |                   |                 |                      |
| Projected Growth of Demand for Credit (volume)<br>2007-2010 |  |              |                   | USD 80 million  |                      |
| Projected Growth of Demand for Credit (volume)<br>2007-2010 |  |              |                   | USD 46 million  |                      |
| Bhutan Development Finance Corporation (BDFC)               |  |              |                   |                 |                      |
| Overall Market Share  |  |              |                   | 12%             |                      |
|   |  | Market Share | Average loan size |                 |                      |
| Trade & Commerce & Transport (light)                        |  | 17%          | USD 1,100         |                 |                      |
| Manufacturing/Industry                                      |  | 65%          | USD 8,400         |                 |                      |
| Service & Tourism   |  | 82%          | USD 12,000        |                 |                      |
| Projected Growth of Demand for Credit (volume)<br>2005-2010 |  |              |                   |                 |                      |
| Projected Growth of Demand for Credit (volume)<br>2007-2010 |  |              |                   | USD 8.8 million |                      |
| Projected Growth of Demand for Credit (volume)<br>2007-2010 |  |              |                   | USD 5.0 million |                      |

6. **Target Group:** The target group for the credit line is micro and small business in urban and rural areas.

7. **Size of Credit Line:** The proposed credit line is supposed to finance the demand of additional MSEs entering the market between 2007 and 2010 with approximately 4,000 MSEs entering the market, which means that BDFC will face a projected credit demand of at least US\$ 5 million. These figures are based on historical data on credit demand of enterprises in the respective segments. Therefore, the PPTA recommends a credit line of US\$ 5 Mill. (Nu. 224 Mill.) for long-term finance and permanent working capital for MSEs with a maximum tenor of 15 years.

8. **Size of Sub-loans:** The PPTA recommends the acceptance of sub-loans for individual borrowers of up to Nu. 2 Mill. (US\$ 48,000), with a grace period of up to 1 year and a maximum maturity of 5 years. Based on historical figures the average MSE loan size in BDFC is Nu. 740,000 (US\$ 15,500) with an average maturity of 3 years. Accordingly about 1,400 rural and urban micro and small businesses will benefit from the credit line.



9. **Eligibility Criteria for Sub-loans:** The credit line is not to be used for housing, equity finance, staff or personal loans. Micro and small enterprises with up to 19 employees and an initial capital investment, which consists by definition of paid in capital and long-term credit<sup>2</sup> (see Appendix 3) of up to Nu. 10 million are eligible.

10. **Review of Sub-loan Criteria:** Upon good performance on credit line the eligibility criteria will be reviewed after one year. Experience will show whether the sub-loan size and maturity should be increased to meet the potential needs of MSE clients.

11. **Interest Rate on Sub-loans:** The PPTA does not recommend any ceiling or cap on the interest rate to be charged for the sub-loans by BDFC. Subsidized interest rates distort the capital market by reallocating investment towards projects with lower return on investment. They increase the risk of misappropriation on final borrower and executing bank levels. Generally easy loan procedures are as important for MSEs as low interest rates, therefore the introduction of appropriate MSE lending techniques is a must. As a consequence, interest rate subsidies for the final borrower should be avoided as far as possible. However, it should first be considered whether investment stimulation could not be achieved with other public incentives such as tax grants or subsidies, which are less distorting and easier to manage than interest rate subsidies.

12. **Interest Rate for Credit Line:** There is a heated debate on whether executing FIs need an interest subsidy for the credit scheme in order to become attractive for them. This debate is in many cases theoretical. In order to calculate the interest subsidy on the level of the executing financial institution, a benchmark against which the interest for the executing FI is assessed is required. In industrialized countries, this benchmark is usually derived from the market for medium- to long-term government bonds. However, in many developing countries, including Bhutan, the bond market is either not existing or illiquid, meaning that no benchmark can be calculated. From a technical point of view it is wise to set the refinancing rate at least as high as the short-term interest rate on the interbank market, which does not exist in Bhutan. Therefore the interest rate on 2-year term deposits, which currently is 6.5% less (internal) administrative costs of about 2% arriving at an on-lending rate of 4.50% is recommended. The interest rate to be charged should be reviewed bi-annually to accommodate to changes in the interest level in Bhutan.

13. **Need for Technical Assistance:** To ensure that loans are disbursed in the most efficient and risk adverse way technical assistance for BDFC is needed to enhance the level of skills in MSE lending techniques at BDFC. As a consequence the PPTA recommends the credit line to be combined with technical assistance.

---

<sup>2</sup> Official classification of enterprises (2001)