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AND
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BHUTAN

Joint Staff Advisory Note on the Poverty Reduction Strategy Paper

Prepared by Staffs of the International Development Association (IDA) and the International
Monetary Fund (IMF)

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I. INTRODUCTION

1. **Bhutan has made substantial economic and social gains over the last two decades.** Nestled and landlocked in the Himalayas between two large neighbors—India and China—this kingdom, with an estimated population of 735,000, has enjoyed robust growth and low inflation based on sound economic management, good governance, and judicious protection of its natural resources. More recently, economic growth averaged over 6½ percent a year during the Eighth Five-Year Plan (Eighth Plan, 1997/98–2001/02) and the first two years of the Ninth Five-Year Plan (Ninth Plan, 2002/03–2006/07).¹ Social indicators have also registered an appreciable improvement and Bhutan appears to be on track to meet several of the Millennium Development Goals (MDGs).²

2. **Bhutan’s Poverty Reduction Strategy Paper (PRSP) reflects the country’s long tradition of participatory planning.** The PRSP is comprised of a PRSP cover note and the Ninth Plan. The PRSP was developed through extensive consultation with communities and stakeholders down to block (gewog) level.

3. **The PRSP aims to galvanize the poverty reduction efforts of the Royal Government of Bhutan (RGoB), building on past achievements.** The PRSP reflects Bhutan’s distinctive approach to development, enshrined in the concept of Gross National Happiness. This concept is based on four pillars: economic growth and development; promotion and preservation of cultural heritage; sustainable use of the environment; and good governance. The key strategies for achieving these goals are maintaining sound macroeconomic policy, ensuring good governance (emphasizing decentralization), expanding physical infrastructure (access to roads, electricity and telecommunication services) and improving access to social services (principally schools and hospitals). The objective is to sustain the growth momentum while broadening its base and to reduce poverty further, especially by overcoming the challenges of Bhutan’s geography to reach the poor in secluded communities.

4. **As the RGoB moves ahead with PRSP implementation and its efforts to reduce poverty, staffs believe that three key areas merit further attention from the authorities.** Staffs’ recommendations concern the need to: (i) strengthen the macroeconomic framework and policies; (ii) improve public expenditure management; and (iii) bolster poverty monitoring and evaluation. The remainder of this note elaborates on these three areas.

¹ Bhutan has formulated five-year plans since 1961. The fiscal year begins on July 1.

² For example, between 1991 and 2000, the gross primary enrollment rate is estimated to have risen from 55 percent to 72 percent and the under-5 infant mortality rate is estimated to have fallen from 123 to 84 (per 1,000 live births). These estimates are subject to wide margins of error, given data deficiencies described in Section IV.

II. MACROECONOMIC FRAMEWORK AND POLICIES

A. Sources of Growth and Vulnerabilities

5. **The PRSP contains ambitious targets for economic growth compared to historical experience.** The PRSP targets an average growth rate of 8¼ percent during 2004/05–2006/07, which is about 1¼ percentage points above that experienced during the Eight Plan and the first two years of the Ninth Plan. Pushing the economy to this higher growth trajectory will be a challenge. Some increase in the growth rate can be expected over the medium term, as the Tala hydropower project comes on stream (projected in 2006) and construction of new hydropower plants begins. In addition, implementation of the government’s strategies in various sectors, as outlined in the Ninth Plan, will also be important. More importantly, reaching the PRSP’s growth targets would require a take off in private sector growth.

6. **Over the near term, the public sector will continue to play a dominant role in Bhutan’s development.** In particular, the construction and commissioning of hydropower projects and other public investments in housing, schools, hospitals, and roads are expected to remain the main drivers of economic growth. Notably, work on the large Tala project continues where the annual cost is 15 percent of GDP. When completed, Tala will more than triple electricity production and exports. The dominance of the public sector reflects, in part, the RGoB’s development strategy that accords priority to protect the environment and preserve the cultural heritage, which in turn constrains the expansion of certain sectors, such as logging and tourism.

7. **Private sector growth needs to take off in Bhutan to achieve higher growth rates over the medium term, raise income levels for the poor, and generate employment.** This would also help provide employment opportunities for the large number of young job-seekers expected in the coming years since capital-intensive investment projects in the power sector offer limited opportunity for job creation. The PRSP recognizes these issues and envisages measures to improve the business environment, including investments in human and physical capital, regulatory reform, and trade liberalization.³ These reforms are steps in the right direction. At the same time, staffs would encourage the RGoB to consider enhancing labor market flexibility and further liberalizing restrictions on foreign direct investment, consistent with the RGoB’s own priorities on environmental and cultural heritage preservation. These reforms would help Bhutan reap its comparative advantage in the tourism sector and tap the potential for higher productivity in agriculture. Greater private sector participation in the financial sector would also facilitate the development of commercial banking that could nurture entrepreneurship.

8. **The medium-term growth prospects are subject to risks.** The narrow base of economic growth and the concentration of exports to India (destination of more than 90 percent of exports) are likely to persist in the near term. In particular, the dominant role of the power sector ties Bhutan’s fortunes closely to developments in India, where all electricity exports are directed. Delays in the completion of the Tala hydropower project would also have an adverse

³ Negotiations to accede the WTO began in November 2004.

impact on growth. Other risks to the growth outlook include the possibility of shortfalls in external assistance, which finances most of the public investment program. Preparing contingency plans would enhance flexibility of the PRSP and help the RGoB meet these risks if they materialize.

B. Fiscal Sustainability

9. **The key fiscal challenge is to limit the size of fiscal deficits in the face of an ambitious public expenditure program.** To accomplish this, the PRSP envisages a rise in domestic revenue by 1¼ percent of GDP over the medium term, to about 17½ percent of GDP in 2006/07, and a decline in current expenditure by 2 percent of GDP over the same timeframe. Capital expenditure, which broadly corresponds to the overall fiscal deficit (before grants), is heavily frontloaded reaching 21–22 percent of GDP this fiscal year and next before falling to 16 percent of GDP in 2006/07. To finance the resulting deficits, the RGoB is relying on substantial grant inflows (of 10–15 percent of GDP a year), concessional external financing of about 4 percent of GDP a year; and domestic financing of around 3 percent of GDP a year.

10. **Bhutan’s PRS could be strengthened by elaborating on key aspects of this fiscal framework:**

- The PRS should identify the measures underpinning the projected rise in the revenue-to-GDP ratio. In particular, the PRS should detail the expected contribution from Tala to the budget as these large amounts are subject to uncertainties. In this context, staffs note the need to broaden the tax base and reduce dependence on revenue from the power sector (which accounts for almost half of total revenue). While the introduction of a personal income tax (PIT) in 2002 was a positive step, the National Assembly recently passed large cuts in the PIT.
- The allocations for current spending over the medium term are unlikely to be sufficient to maintain and operate ongoing projects and sustain the ambitious planned investments. In particular, capital spending is projected to rise significantly, which presages substantial increases in recurrent costs in the coming years. Indeed, already in 2003/04, the long-standing RGoB objective of meeting recurrent expenditures with domestic revenues was not met, and the 2004/05 budget similarly anticipates recurrent expenditures in excess of revenues.
- An important omission in the PRSP is the implication of the fiscal framework for debt dynamics. Staffs estimate that the projected deficits would push government debt (excluding debt related to power sector projects, which are not financed through the budget) from around 30 percent of GDP at end-2003 to 35–40 percent of GDP over the medium term, despite a favorable average GDP growth-interest rate differential. The rapid growth in the overall debt of the public sector (which includes the power sector) from 41 percent of GDP in 2000 to 74 percent of GDP in 2004 also underscores the importance of incorporating the power sector and public corporations (such as the national airline) into debt sustainability analyses.

- To facilitate implementation, the PRS needs to provide more details on its projections of external financing. Past shortfalls in external financing and the continued heavy reliance on external grants highlights the need for strong donor coordination. Making sure that aid projections are realistic would also help to reduce volatility in government outlays. In addition, it would be useful for the PRS to outline the government's strategy in response to an unexpected shortfall in external financing.

III. PUBLIC EXPENDITURE MANAGEMENT

11. **The RGoB's poverty reduction efforts would be enhanced by strengthening public expenditure management.** Staffs view potential improvements as arising from (i) stronger links between PRSP objectives and annual budgets; and (ii) more realistic assessment of recurrent expenditures in key social sectors. These improvements could be achieved through the adoption of multi-year rolling budgets and a Medium Term Expenditure Framework (MTEF).

12. **The links between the PRSP development objectives and spending allocations in the annual budgets could be strengthened significantly.** While expenditure allocations in the roads sector appear to be consistent with the stated PRSP objectives, weak links are evident in the sectoral spending plans for health, education and rural development.

- The PRSP targets in the education sector include: (i) universal primary enrollment by 2007; and (ii) improvements in the quality of teaching at the secondary level. These targets are set against the background of estimated gross and net enrolment rates in 2002 of 81 percent and 61 percent, respectively, and assessments of a decline in learning outcomes and students' performance in public examinations that has accompanied the rapid expansion of access in recent years. While the sector is receiving about 15 percent of the total budget (one of the highest shares in the world), current expenditures are set to decline substantially in 2005/06 and 2006/07. These proposed declines raise questions about the feasibility of reaching the PRSP goals.
- The PRSP objectives in the health sector include: (i) improved access to health services in remote areas; (ii) higher quality of health services; and (iii) expansion of reproductive health services and family planning. Recurrent expenditures are to rise by 15 percent in the current fiscal year, by 43 percent in 2005/06, and then remain broadly flat in 2006/07. This volatile pattern is likely to adversely affect the effectiveness of sectoral spending.
- Efforts to accelerate rural development through decentralization would benefit from clearly identifying the financing gap, setting out the arrangements for intergovernmental transfers, and addressing capacity issues at the district and local level. This would help the RGoB follow through on the commitment to decentralization and the implementation of spending plans at the gewog level.

13. **Underestimation of recurrent expenditures in key social sectors—education and health—may be substantial.** Budgeting norms indicate that capital expenditures in these sectors, for which large investments are planned to continue over the medium term, require more subsequent recurrent expenditures to make full use of the newly created assets.

- The growing capital expenditures in the education sector, associated largely with efforts to expand access and develop secondary schooling to keep pace with the increasing numbers of children who complete the full cycle of primary education, foreshadows sharply increased recurrent expenditures. The share of capital spending in the education budget is to increase from an average of 27 percent in 2002/03 and 2003/04, to 45 percent in the current fiscal year, to 60 percent in 2005/06 and 2006/07. This suggests an extraordinary expansion in facilities, which will require significant additional spending in order to use them fully, while the last year of the Ninth Plan indicates a fall in recurrent education expenditure in nominal terms.
- The RGoB has also emphasized major investment in the health sector, amounting to about 33 percent of total spending in the sector, except for the current fiscal year (2004/05) where capital expenditures will absorb 55 percent of the health budget. Meeting the costs of staffing, medicines and maintenance will be challenging.

14. **Staffs encourage the RGoB to proceed with plans to implement multi-year rolling budgets and an MTEF to strengthen links between PRSP objectives and spending plans.** Such an effort would enable the authorities to strengthen the link between the annual budgets and longer term goals, and between planned investments and the associated recurrent spending required for operation and maintenance. It would also contribute to better prioritization of spending, taking into account quality considerations in the choice of projects, facilitate adjustments in the event of revenue shortfalls and permit a more flexible execution of the budget. These plans would be helped by an explicit integration of the Tala hydroelectric project into fiscal planning as the project will require relatively low recurrent expenditures while generating substantial revenues. The RGoB has taken some steps in this area, including elaborating a multi-year budget framework in the PRSP, calling for rolling budgets in the revised 2002 Budget Manual, and exploring the adoption of an MTEF.

IV. POVERTY MONITORING AND EVALUATION

A. Targets, Indicators, and Monitoring

15. **The PRSP recognizes that poverty monitoring and evaluation needs to be strengthened.** Available information suggests that the bulk of the poor live in rural communities, where the incidence of poverty exceeds 40 percent. The higher incidence of poverty in the rural areas is related to their remoteness and difficult terrain, which limits access to the outside world. Thus, the lack of infrastructure, especially roads, electricity and communications, emerge as major concerns of the rural poor. The poor also lack access to social services and remunerative employment opportunities. Data on poverty, however, is largely based on surveys conducted in 2000 and need to be updated, and existing information could be more effectively harnessed to underpin policy formulation and planning. Several issues stand out in this regard:

- The RGoB has yet to conduct a modern census, which raises questions about the reliability of demographic estimations, such as the age-sex distribution of the population. In the absence of a census and a sound sampling frame, it is also difficult to scale up

survey results to the national level. Sampling errors may be compounded by the fact that all surveys are conducted on a sample of nationals only.

- For administrative data, especially the existing monitoring and evaluation system for health and education, systems need to be strengthened to provide checks on the quality of information, and produce an appropriate baseline for indicators and other information relevant for tracking progress towards implementing the RGoB's PRSP and meeting the MDGs.
- More recent surveys (including a National Labor Force Survey in 2004, and the Bhutan Living Standards Survey in 2003) could be used for assessing poverty and to underpin policy and planning, especially in the health and education sectors.

16. **To improve poverty monitoring and evaluation, much remains to be done.** Staffs support RGoB efforts to establish a Poverty Monitoring and Assessment System (PMAS), which aims to improve the coordination, consolidation and harmonization of existing data gathering for improved policy. The proposed PMAS also seeks to strengthen the statistical system for monitoring poverty, including establishing a consensus among stakeholders on targets and indicators for monitoring progress towards achieving national development goals. In this context, the staffs would underscore the need to establish clearly defined targets and indicators that can be tracked over time. The PMAS initiative would require a modern census following the recommendations of the United Nations, and steps to provide policymakers with a timely and integrated flow of information. An extended questionnaire should be prepared covering key areas, such as education, health, employment and labor, migration, and disability. Following surveys of 5–10 percent of the population, this extended questionnaire should provide benchmark indicators. Monitoring would also benefit from more consistent use of the data that is already being collected, and better management of data collection efforts, including through donor coordination.

B. Institutional Issues

17. **Institutional arrangements for poverty monitoring also need to be strengthened.** The RGoB has addressed some institutional problems by creating a separate National Statistics Bureau (NSB). However, the agency's authority needs to be bolstered through the passage of a statistics law and the development of a statistical master plan. Such steps would help move away from ad hoc survey efforts (partly driven by the availability of donor funding), and improve the coordination and sequencing of surveys over the medium term. The line ministries (such as Health and Renewable Natural Resources) are in the process of establishing monitoring and evaluation systems, and categories and indicators need to be standardized through a national level system following international norms. Similarly, the reporting frameworks at the district (dzongkhag) level need to be consolidated, which would help address a sense of "reporting fatigue" noted in the PRSP cover note. Capacity is also a major concern that requires attention.

18. **Staffs encourage the RGoB to continue building the mandate of the NSB as a focal agency for developing a statistical master plan, coordinating future survey work, and building consensus around indicators and targets.** This will create a national statistical system in which data gathered in different surveys are comparable and can be meaningfully integrated

into an assessment of the welfare conditions in the country. The NSB will need to work closely with PMAS in the Department of Planning.

V. CONCLUSION AND ISSUES FOR DISCUSSION

19. **Bhutan has enjoyed a strong growth record over the last decade through a combination of sound macroeconomic management, good governance and rapid development of hydro power resources.** A salient aspect of Bhutan's development policy is its pursuit of the twin goals of growth and poverty reduction, mindful of balancing these objectives with environmental sustainability and preservation of cultural heritage. In addition, a highly inclusive approach has traditionally underpinned the planning process. The PRSP continues in this vein, and the outlined spending priorities and investment projects are the result of this broad participatory process. Significant challenges remain however, in achieving their poverty reduction goals, particularly in the remote areas where access to infrastructure and basic services continues to be a major concern.

20. **The PRSP broadly reflects the RGoB's vision to address the aforementioned challenges but would benefit from greater specificity with regard to defining priorities and aligning budgets.** Accordingly, staffs have identified three key areas that need to be strengthened to facilitate the implementation of the poverty reduction strategy. First, the macroeconomic framework could be clarified and expanded by explicitly integrating Tala into the macroeconomic analysis and recognizing risks and policy trade offs that may impinge on medium-term growth prospects. A broader challenge for the RGoB in the context of sustaining rapid growth is to develop policies to promote accelerated private sector development. Second, public expenditure management could be greatly enhanced by the adoption of rolling budgets and an MTEF, which would help bolster the links between PRSP objectives and annual budgets, and generate more realistic assessments of recurrent expenditures. Finally, clarifying institutional arrangements is essential for improving the coordination of RGoB efforts to monitor progress in poverty and key social indicators. A key step will be to conduct a modern census, which can underpin future surveys and would help sharpen pro-poor policy formulation.

21. Do the Executive Directors concur with the broad directions of Bhutan's PRSP (as described in paragraph 3) and the staffs' identification of priority areas and the related recommendations for strengthening the PRSP over the coming years?