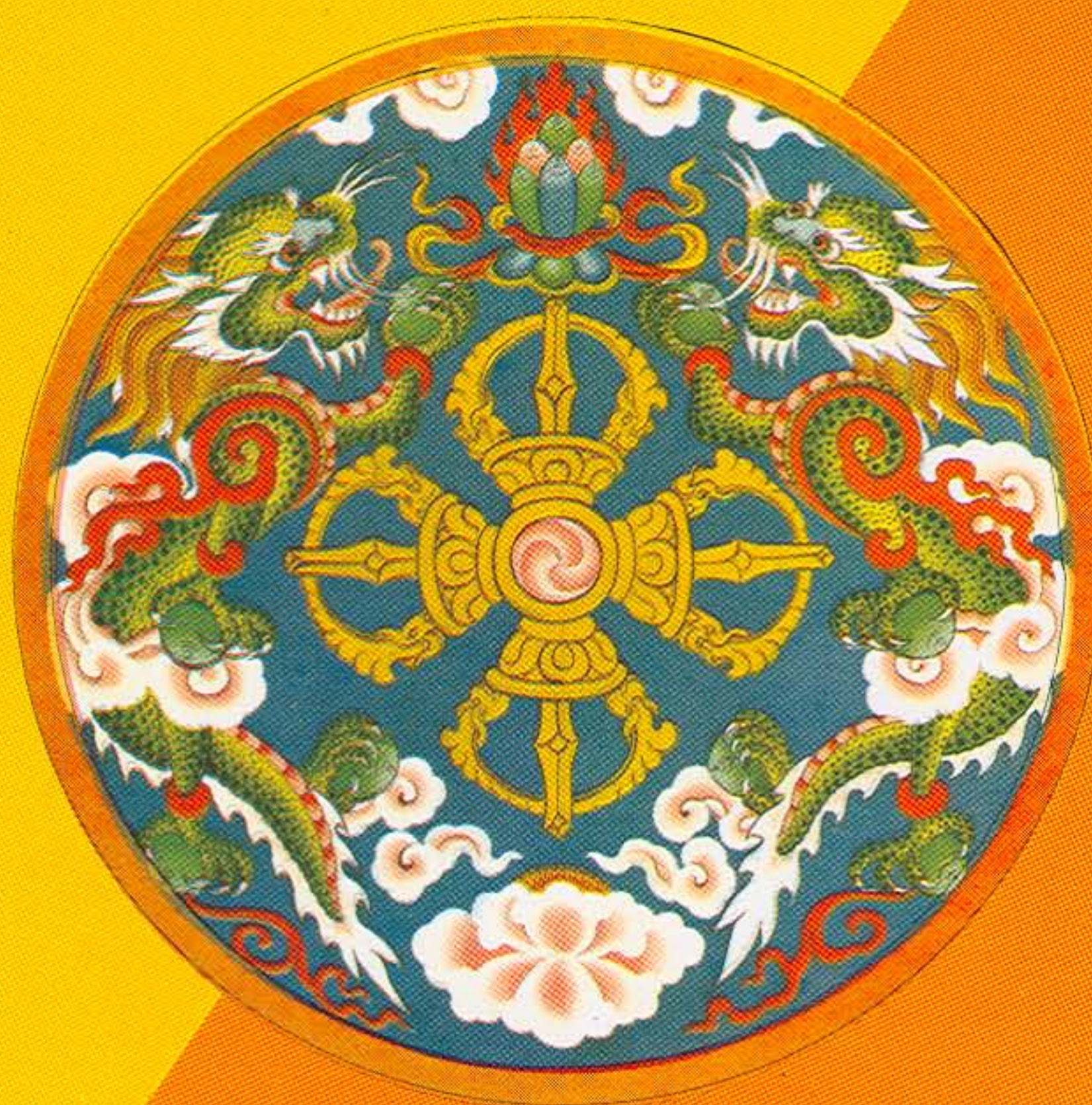


**NATIONAL BUDGET FOR FINANCIAL YEAR
1998 - 1999**

**AND
REPORT ON THE 1997-98 BUDGET**



**MINISTRY OF FINANCE
ROYAL GOVERNMENT OF BHUTAN**

JUNE 1998

Review of the 1997 - 98 Budget

The Ministry of Finance has the honour to report to the honourable members of the National Assembly that the first year of the 8th Five Year Plan has come to a successful end. During the year, the GDP grew by 6% and inflation remained below 10%. There was no budgetary deficit and a revenue surplus as predicted last year was achieved. The balance of payments continued to record surpluses leading to a healthy growth of 26.7% in the external reserves. The additional cost of Nu. 185.0 m on account of the 20% increase in the salary of Government employees was more than covered by the 25% growth in domestic revenue.

In a move to further improve the financial sector, the Royal Government deregulated interest rates, liberalized foreign exchange availability and streamlined import procedures during the current fiscal year. These reform measures are expected to provide greater opportunities for private sector development and market oriented growth.

On the public expenditure front, spill-over activities from the 7th Plan continued to dominate. Summary of the

approved and revised budget estimates for 1997-98 are given below:-

		<u>Nu in millions</u>	
<u>OUTLAY</u>		<u>ORIGINAL</u>	<u>REVISED</u>
I	Current Expenditure	2562.706	2709.305
II	Capital Expenditure	3662.052	3351.139
SUB TOTAL		6224.758	6060.444
III	Net Lending	66.619	44.634
IV	Repayment	382.915	284.209
TOTAL		6674.292	6389.287

SOURCES OF FINANCE

I DOMESTIC REVENUE

i)	Internal Revenue	2931.499	2860.286
ii)	Other Receipts	-	22.683
SUB TOTAL		2931.499	2882.969

II GRANTS

i)	GOI Program Grant	800.000	800.000
ii)	GOI Project Grants	1128.147	770.841
iii)	Grants from Other Int.Agencies	1460.754	1591.634
SUB TOTAL		3388.901	3162.475

III FINANCING

i) Borrowings from External Sources	353.892	344.443
SUB TOTAL	353.892	344.443
TOTAL	6674.292	6389.287

The budgetary allocation of Nu. 6674.29 m approved for the fiscal year 1997-98 has been revised downwards to Nu. 6389.29 m. The reduction in the overall outlay was caused mainly by delays in the implementation of certain projects under donor funding. On the current expenditure side, however, there has been an increase of 5.7% which is the result of inflation and minor unforeseen expenditures.

One of the most important aspects of a government budget is the performance on the revenue front which is a vital indicator for sustainability and self-reliance. On this important front, the Royal Government achieved its objective of fully meeting the current expenditure from domestic revenue. The revised current expenditure for fiscal year 1997-98 is Nu. 2709.30 m, whereas the revenue is Nu. 2860.28 m, thereby generating a current revenue surplus of Nu. 150.98 m. The sustained increase in revenue generation, consistently proven over several years, should ease the concerns of the donors over possible widening in the gap between revenue and

current expenditure as a result of increased expenditure specially in the social sector.

The reduction in the plan outlay for the fiscal year 1997-98 should not be a cause for any concern as the pace of overall development has not been impeded. Most of the projects that could not be started have already been included for implementation during 1998-99. Moreover, the implementation of mega projects like the Kurichhu, Basochhu and the Tala hydro-electric projects are gaining momentum providing ample business and employment opportunities to the Bhutanese people.

The most important event during the fiscal year was the visit of His Majesty the King to all the Dzongkhags for the final reaffirmation of the 8th Plan activities. In keeping with the tradition of dialogue initiated by His Majesty since the 5th Plan period, the people were given the opportunity to hear the policies and programs of the Government and to express their views directly to the King. The process of consultation and dialogue instituted through the forum of Dzongkhag Plan Meeting has strengthened and given true meaning to people's participation in decision making and the development of the Dzongkhags and the nation at large. The Dzongkhag Plans initiated by the Gewog Yargay Tsogchungs and refined by the

Dzongkhag Yargay Tsogchungs were discussed openly with the people and finalized taking into account the resource position and implementation capacity of the Government and the local communities.

In another landmark decision, His Majesty the King issued a Royal Command that Dzongkhag Plans henceforth be prepared on the basis of Gewogs. It was the desire of His Majesty the King to give greater responsibilities to the local communities to strengthen decentralization, enhance people's participation and promote self-reliance at the grassroots level. This decision is expected to enable local communities in Bhutan to assume more responsibilities for their own affairs compared to people in most countries in the developing world.

Fiscal Year 1998 - 99

The Fiscal Year 1998-99, the second year of the 8th Plan, starts on the same note of optimism as during the first year. The economy is expected to continue to grow at 6% with the inflation remaining at about 8%. The balance of payments is projected to remain positive and the currency exchange rate is expected to continue to be stable. Moreover, the expenditures on the mega-projects would provide additional boost to private sector activities.

Most of the plan activities during the first year were spillover works carried on from the 7th Plan. Implementation of new 8th Plan projects will start mainly from this fiscal year onwards. A large number of the major works relate to construction of schools, hospitals, roads and power transmission. As in the past, government expenditure on the social sector will be about 30% of the entire outlay for the fiscal year. The heavy investments in these areas are expected to strengthen economic growth and widen the tax base further.

Summary of the 1998-99 Budget is presented below:

A. <u>EXPENDITURE</u>	<u>Nu in millions</u>	<u>%</u>
I. Current Expenditure	2849.922	39.06
II. Capital Expenditure	4149.355	56.87
Sub Total :	6999.277	95.93
III. Net Lending	44.708	0.61
IV. Repayments	252.206	3.46
Total :	7296.191	100.00

B. RECEIPTS

I. Internal Revenue	3094.081	42.41
II. External Grant		
i) GOI Program Grant	800.000	10.97
ii) GOI Project Grant	1471.148	20.16
iii) Other External Grants	1479.065	20.27
Sub-total :	3750.213	51.40

C. FINANCING

I. External borrowings	451.897	6.19
Sub-total :	451.897	6.19
Total :	7296.191	100.00

The budgetary outlay for the fiscal year 1998-99 projected at Nu.7296.19 m is 14% more than the revised

outlay of Nu. 6389.29 m for the 1997-98 fiscal year. The current expenditure at Nu. 2849.92 m is only 5.2% higher than the revised 1997-98 figure of Nu. 2709.30 m reflecting the government's success over expenditure control. It may, however, be pointed out that the Royal Government has never compromised quality to keep expenditure under control. On the contrary, the policy is to consolidate and improve the quality rather than expansion of facilities.

The capital expenditure for 1998-99 at Nu. 4149.36 m is a substantial increase of 24% over the revised outlay of Nu. 3351.14 m for the previous fiscal year. This is mainly on account of the inclusion of several major projects, the implementation of which could not be started in 1997-98 as projected earlier.

As reported in the past, the most important aspect of our annual budgets is the balance between revenue and current expenditure. The Ministry of Finance is once again proud to report to the honourable members of the National Assembly that the domestic revenue for 1998-99 conservatively projected at Nu. 3094.08 m is more than 8% higher than the current expenditure outlay of Nu. 2849.92 m. Even during 1997-98, revenue exceeded current expenditure by 6%. The

national goal of meeting current expenditure from domestic revenue was also achieved during the 7th Plan.

External borrowings at Nu. 451.90 m show an increase of about 31% over the 1997-98 level reflecting mainly increased disbursements of both bilateral and multilateral loans. These are soft term loans with substantial grant elements and are used for construction of schools and power projects.

The fiscal year 1998-99 is poised to be yet another year with a current revenue surplus enabling the Ministry of Finance to avoid domestic borrowings and to keep the budget deficit at zero level. The Royal Government continues to follow sound fiscal management practices thereby ensuring growth with stability.

Revenue

The revenue target for the 8th Plan approved by the National Assembly is Nu. 15912.0 m. During the 7th Plan period revenue collections increased on the average at 11% per annum even though tax rates had not been increased. The increased collections were the results of an expanded tax base and improved tax administration. The revenue collection in

1997-1998 was Nu. 2860.28 m which was an increase of 25% over the 1996-1997 figure. This was made possible mainly by the doubling of the Chhukha power tariff and increased earnings from public sector industries and other projects. The revenue projected for 1998-99 is Nu. 3094.08 m which is an increase of 8% and exceeds the growth of the GDP.

As reported many times in the past, the Bhutanese still remain amongst the least taxed people in the world and yet enjoy most of the essential services either free or at highly subsidized rates. The rural people, who constitute over 80% of the population contribute only 0.2% of the total revenue and the business income tax constitutes a paltry 5%. It is now time that the Bhutanese people started paying in some measure towards the national revenue. The low rate of taxes and subsidy on service charges or fees threaten the very sustainability of essential services. Nearly all the donors particularly the multi-lateral financial institutions are seriously concerned about sustainability and are against excessive subsidy in direct or indirect form. Hence the donors, almost without exception, insist upon levying of appropriate levels of user charges and the progressive elimination of subsidy as a pre-condition, for their financial support. It is therefore, necessary for Bhutan to take steps to

steadily increase domestic power tariff and other user charges and fees over time to reduce subsidy elements.

The existing tax regulations are inadequate and susceptible to manipulations. We must therefore, streamline our tax policy and ensure that those who earn more also pay more taxes. Tax after all is an important tool to ensure equity in society through its effect upon redistribution of income. The Ministry of Finance, therefore, proposes to introduce Personal Income Tax during the fiscal year 1999-2000. The Ministry of Finance is confident that a simple personal income tax system, with relatively low rates, will be easy to implement and have no adverse effect upon the economy.

With the liberalization of imports and foreign exchange availability, the demand for third country imports including unnecessary luxury items has suddenly surged and threatens rapid depletion of our foreign exchange reserves. Most of the imported items are meant for commercial purposes and must therefore, be treated on the same basis as similar items brought from India. It is now proposed to levy sales tax on all third country goods imported into Bhutan in addition to the existing duties. This will also be more in keeping with the spirit of free trade between Bhutan and India as goods from India are subject only to sales tax.

Balance of Payment and Reserves

In a country like Bhutan where the export potential is presently limited by infrastructure, shortage of skilled manpower and other weaknesses of the private sector, it is necessary to keep a close watch on the developments in the balance of payments and particularly on the current account fluctuations. Any increase in public or private expenditure inevitably leads to greater imports of goods and services as the domestic market is unable to meet the demand. The recent liberalization of imports and foreign exchange availability is adding further pressure upon the balance of payments situation.

The relatively high growth rates sustained over recent years was accompanied by rapid changes in both exports as well as imports. In fiscal year 1996-97, export earnings were valued at Nu. 3553.77 m while imports reached Nu.4546.42 m. The overall balance of payments, however, was favourable with a surplus of Nu. 971.21 m or the equivalent of US\$ 27.0 m.

The Bhutanese economy, inspite of market diversifications as well as significant increases in imports, continues to record surpluses in the balance of payments. As a result of the favourable balance of payments surpluses, total

external reserves of the nation grew by 26.7% and reached a level of US\$ 215.42 m as compared to a level of US\$ 170.0 m in fiscal year 1996-97. The Rupee component of the reserves increased to Rs.1644.7 m as compared to Rs.900.0 m for the same period.

The Ministry of Finance is pleased to report to the honourable members of the National Assembly that our reserves are adequate to meet twenty four months of import requirements, which is far better than the position of most countries in the world and has greatly enhanced the achievement of our national goal of self-reliance.

External Debt

The Royal Government has always pursued a policy of caution regarding public debt particularly external loans. Loans have been resorted to only when grants are not available and that too mainly soft term loans for income generating activities like power projects or industries. The hard currency debt, presently outstanding, is US\$ 85.0 m and the debt servicing cost per annum, about US\$ 7.0 m. The Rupee loan outstanding on account of the Chhukha power project is Rs. 875.5 m and the debt servicing requirement, Rs. 141 m per

year. The total debt service ratio is 13% which is sustainable and will not create undue debt burden upon the Royal Government. Bhutan has reserves in excess of the external debt and is in a position to repay the entire debt in a lumpsum if so required.

The external debt situation is, however, likely to change immensely in the near future as several large loans particularly for the Tala and the Kurichhu power projects will be disbursed. There will also be substantial hard currency loans for the Basochhu power project. These loans are all for income generating activities and hence will considerably increase the national revenue and further strengthen the financial position of the government.

External borrowing for developmental activities such as rural electrification, construction of school buildings and roads will also increase as grant assistance for such investments are not adequately forthcoming. Such investments in social infrastructure are necessary as the Royal Government attaches high priority to improving the well-being and livelihood of the Bhutanese people.

Financial Sector Development

Bhutan was fortunate to have recognized the magnitude and problems of non-performing loans being faced by the financial institutions before the matter assumed crisis proportions. All honourable members of the National Assembly must have heard of the crisis which has devastated the economies of some of the most successful and prosperous nations in South East Asia. While there were various other reasons, one of the main problems which triggered off the recession and currency devaluations were the poor performances of the financial institutions and high external debt. Bhutan has only four financial institutions and as such we must ensure that each institution is managed efficiently and follows sound principles. Resolving the issue of non-performing loans through the normal legal channels as well as the Loan Commission, specially constituted under Royal Command, has already helped to ease the problems for both the financial institutions as well as the borrowers.

Looking at the disastrous impact of the recent economic crisis in South East Asian countries, Bhutan was fortunate to have addressed the issue of non-performing loans with timely interventions under the Command of His Majesty the King. Had the issue not been tackled in time, the consequences on

our economy would have been severe given the limited number and size of our financial institutions.

Most of the non-performing loans were a legacy of the past when proper appraisal mechanisms and sound management practices were not properly instituted. Management boards have now been strengthened and procedures well streamlined. Moreover the Royal Monetary Authority, in addition to issuing policies and guidelines, carries out regular supervision of the financial institutions to ensure sound management practices.

The Royal Government, in order to streamline the financial sector and to encourage competition, have also liberalized interest rates. All lending as well as deposit rates are now determined by the respective boards of each financial institution in keeping with cost of funds and other policy considerations. This is expected to usher in competition and make the financial institutions more dynamic and responsive to ground realities.

In its seriousness to reform and strengthen the financial sector to achieve world standards, the Royal Government in an unprecedented gesture permitted the Asian Development Bank and the City Bank to acquire equity shares in the newly

established Bhutan National Bank to the extent of 20% each. This move is expected to give the BNB an international flavour and benefit from the experience, expertise and global network of the external partners. It was necessary to make the BNB capable of conducting international transactions which is a necessity for the diversification and growth of the economy of Bhutan.

The process of strengthening the financial sector through guidance and supervision of the RMA and technical assistance of donors has helped to improve the management capability of the financial institutions. Bhutanese financial institutions are now set to enter a phase characterized by professional competence, sound policies and greater accountability. Internal capability alone, however, cannot ensure excellence as the financial institutions also need the appropriate legal framework within which loan agreements can be enforced. It is therefore, necessary for Bhutan to enact legislations. Unless the legal framework exists, the financial institutions will be at a disadvantage and be unable to fulfil their mandate of mobilizing savings and promoting investments. Strong financial institutions are indispensable for the strengthening of the private sector and overall growth of the economy.

Private Sector Development

In an effort to boost the development of the private sector, the Royal Government continues to provide support for training and entrepreneurship development programs. While small service oriented businesses are growing we are yet to witness any significant development in the manufacturing sector. With the liberalization of imports and foreign exchange, there was an upsurge in the number of small importers engaging mainly in luxury consumer goods. Export business, particularly for hard currency markets, on the other hand, remains stagnant with the private sector showing very little progress.

The small size of the domestic market and the subsequent lack of investment opportunities is perhaps the biggest obstacle to the emergence of a dynamic business sector. Even the financial institutions continue to face problems of excess liquidity caused by lack of adequate demand for loans for bankable activities. This is evidence of low level of economic activities and a weak private sector. It is, however, expected that the opportunities presented by the mega projects like the Tala, Kurichhu and Basochhu hydro-power projects and the Dungsum cement project would foster the development of a more dynamic private sector that is

capable of becoming the engine of growth for the national economy.

The Royal Government on its part remains committed to the strengthening of the private sector and will continue to pursue policies and programs to uplift the private sector. The private sector must sooner or later assume the main responsibility for economic growth, employment and generally conducting any commercial activity. With this in mind, the Royal Government has decided to offer its remaining shares in the RICB, the PCA and STCB, which are all highly profitable, to the private sector. In keeping with the Commands of His Majesty the King, shares will be sold in an equitable manner through the Royal Stock Exchange giving preference to small buyers, particularly from the Dzongkhags outside Thimphu and Phuentsholing.

The policy of His Majesty the King to promote development of a broad-based private sector will be possible only in a conducive environment where equal opportunities exist for all interested parties. Hence it is necessary for the Royal Government to frame rules and regulations that are liberal and transparent. No efforts will be spared to build up a broad-based and dynamic private sector to shoulder the responsibility of enhancing the productive capacity of the

nation and to provide gainful employment to future generations.

Pension Scheme

All honourable members are fully aware of the great importance that the Royal Government attaches to having a small, competent and honest civil service. In order to make the civil service attractive and to further improve their well-being, the Royal Government approved substantial increase in the pay and allowances of civil servants during the last two fiscal years. His Majesty the King, however, felt that the existing retirement benefits, namely the gratuity and the provident fund, were inadequate and commanded the Ministry of Finance to study the feasibility of instituting a pension scheme. Accordingly, the Ministry of Finance, with technical assistance of the UNDP, carried out a study to see what kind of a pension scheme would be feasible for Bhutan keeping in mind benefits to the civil servants and costs to the government.

His Majesty the King was pleased to Command in a Kasha issued on the 3rd day of the fourth Bhutanese month to the Royal Civil Service Commission that in order to encourage the civil servants to be loyal and dedicated to the government

and the country, it was the desire of the Royal Government to improve the overall welfare of the civil servants including their post-service benefits. As per the present rules, retiring civil servants are entitled to the accumulated amount in their Provident Fund account and a lumpsum gratuity with an upper ceiling of Nu. 100,000.00. In line with the changing times, it was necessary to review the merits of increasing the gratuity limit vis-à-vis introduction of a pension scheme, keeping in mind the costs to the government and resulting benefits to the retiring employees. His Majesty was pleased to Command that the two options be thoroughly reviewed by the members of the RCSC and the Ministry of Finance. His Majesty also desired that the views of the civil servants be taken into account in arriving at the final recommendation.

Economic Prospects

Our country is small and landlocked with no direct access to the sea and face problems related to transport infrastructure, manpower constraints and the small size of the domestic market. Our country is, however, blessed with abundant mineral resources, great physical beauty, vast hydro-power potential and a natural environment that is the envy of the world. Above all else, Bhutan is blessed with an

enlightened leadership and a stable government that is fully committed to improving the well-being of the people. Moreover, the success of planned development particularly in the area of infrastructure, education and power have prepared the ground for enhanced economic activities. We have all the ingredients necessary to enter the new millennium with a successful program for unprecedented growth and prosperity.

Bhutan not only has the potential but there is also an emerging need to promote growth and investment to provide opportunities for employment of the thousands of young people who will enter the labour market every year. The mega-projects by themselves will not be able to absorb all these job seekers. We need a growing number of diverse business activities to come on stream to provide employment and to widen the productive base of the economy.

Given the small size of the domestic market, the potential for growth can be realized only through foreign trade with India and other countries. Bhutan must compete with the rest of the world for capital, technology and export markets even in India. The competitiveness of Bhutan will be determined by the quality of the products and the price at which they are sold. In order to enhance competitiveness, Bhutan must improve the productivity of labour through

development of skills and use of modern technology. In this regard, it is necessary for Bhutan to continue giving high priority to education in general and promoting technical education in particular. The recent decision of His Majesty the King to upgrade the Royal Bhutan Polytechnic at Dewathang to a full-fledged engineering college is most appropriate and timely.

Integration into the world economy whether by choice or not is inevitable and has already happened and we cannot avoid the adverse effects of globalization. We must, therefore, adopt a strategy whereby we are in a position to benefit from the advantages of globalization through appropriate policy measures. The main strategy should be to promote export led growth and free trade. It is of utmost importance for Bhutan to promote hard currency earnings which are required for debt servicing, increased imports and financing of high-tech capital equipment needed for further growth.

Conclusion

As a result of the sound fiscal management practices, the financial year 1998-99 is almost certain to be another year of success with a current revenue surplus. With the success

achieved during the first and second year, we can be confident about achieving the 8th Plan objectives including the financial targets.

The economy is also poised for higher growth as a result of the increased government expenditure as well as the acceleration of the implementation of the various mega-projects. The private sector will enjoy unprecedented opportunities for business in transportation, housing, supplies, contract works and construction.

In addition to the success achieved in mobilising domestic resources, Bhutan continues to receive generous support from our development partners. In spite of the rather dismal aid situation elsewhere in the world, the level of external assistance to Bhutan is on the increase due to Bhutan's outstanding record of success and proper aid utilisation. The Royal Government would like to take this opportunity to express our deep gratitude to all our friendly donor countries and multilateral aid agencies for the generous technical and financial support extended to the people of Bhutan. We are particularly grateful to our traditional friend and close neighbour India for their genuine goodwill and support rendered since the beginning of planned development in Bhutan.

Bhutan is now about to enter an era of unprecedented growth and prosperity as a result of the large investments, improved infrastructure, availability of manpower and the generally favourable socio-economic conditions.

What is important now is to preserve the environment of peace and tranquility that prevails inspite of the continuing Ngolop threat. We are confident that as long as the people are loyal and place their trust in the leadership of His Majesty the King, no threat of any magnitude will ever harm the security of our country.

May the blessing of the guardian deities of the Palden Drukpa and the hard work and enlightened leadership of our beloved King continue to bring peace and prosperity to the people of Bhutan for all time to come.

MONETARY AND FINANCIAL INDICATORS

	1996-97 Actual	1997-98 Estimate	Percent Change
Items			
	<u>Millions of Ngultrum</u>		
I. <u>Total Assets of the Financial Sector</u>	12539.4	14993.3	19.6
a. Royal Monetary Authority	5349.2	6152.4	15.0
b. Four Financial Institutions	7190.2	8840.9	23.0
II. <u>Money Supply</u>	4277.7	5432.7	27.0
a. Time Deposits	2191.7	3519.4	60.6
b. Demand Deposits	1331.9	1175.7	-11.7
c. Ngultrum in Circulation	626.0	737.6	17.8
III. <u>Domestic Credit</u>	1534.7	1925.1	25.4
of which to Private Sector	1097.1	1299.8	18.5
	<u>Millions of US Dollar</u>		
IV. <u>Gross International Reserves</u>	170.0	215.4	26.7
a. Convertible Currencies	145.0	174.0	20.0
b. Indian Rupee	<u>Millions of Rupee</u>		
	900.0	1644.7	82.7
	<u>Ngultrum per US Dollar</u>		
V. <u>Exchange Rate for US \$ (Period Average)</u>	35.8	39.7	10.9

MONETARY AND FINANCIAL INDICATORS

	Items	1996-97	1997-98
		<u>In Percent</u>	
VI.	<u>Structure of Interest Rates</u>		
	Deposit Rates		
	(i) Savings	5.0	5.0-7.0
	(ii) Fixed Deposits		
	3 months to 1 year	8.0	8.0-8.5
	1 year to less than 3 years	10.0	10.0-10.5
	More than 3 years	11.0	11.0-11.5
	Lending Rates		
	(i) Export Finance	13.0	13.0
	(ii) Manufacturing, Service, Transport, Agriculture	13.0	13.0
	(iii) Housing	14.0	14.0
	(iv) Working Capital	15.0	15.0
	(v) Personal and General Trade	16.0	16.0

Interest rates have been deregulated since October 1997. Hence, the financial institutions will, in future, set their own interest rates for deposits as well as lending.