

# Regulation and Regulatory Environment: Case Study of Bhutan

Presentation at the  
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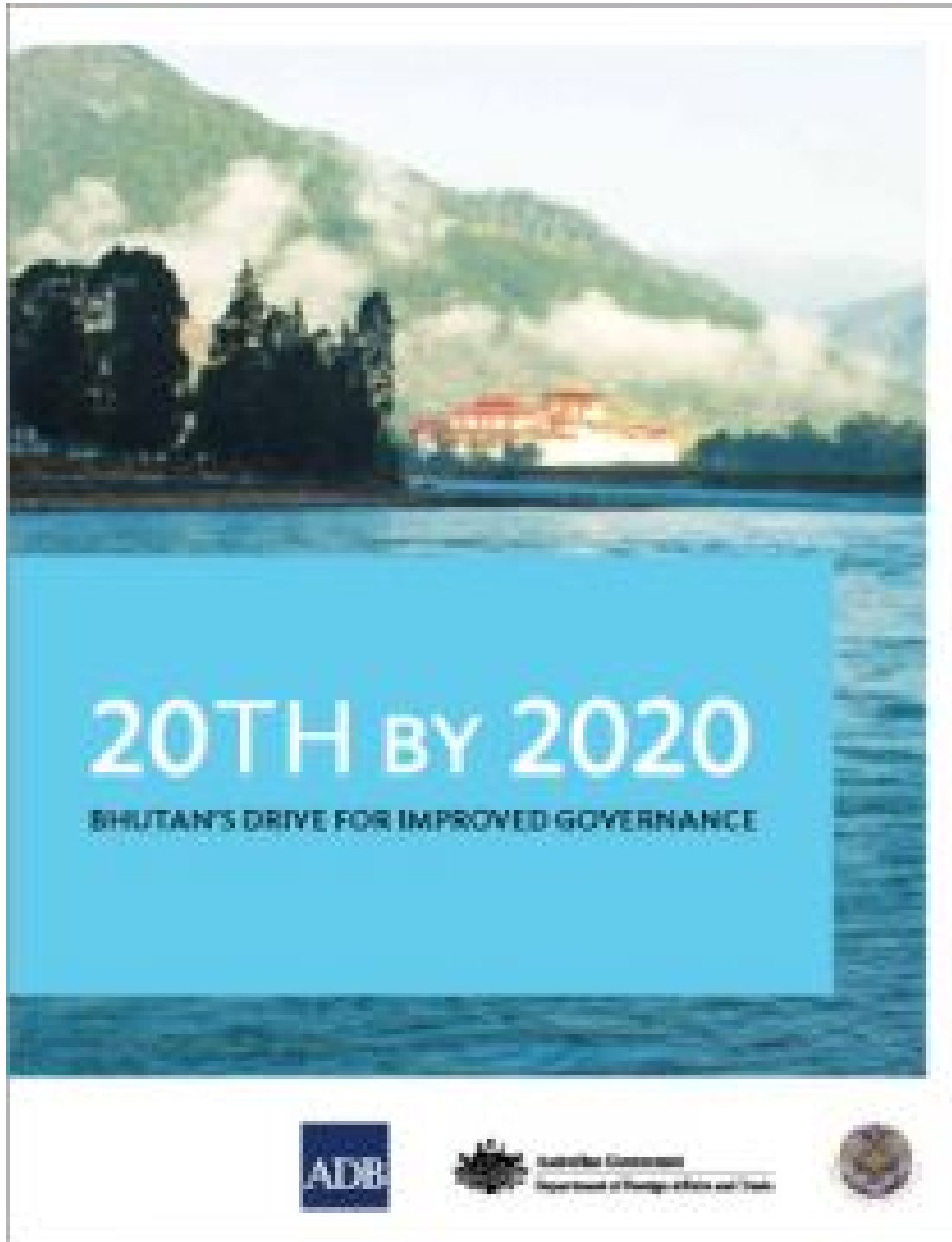
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*Based on presentations at the CMU-Adelaide Executive Program on Regulation (April-May 2015), and the 6<sup>th</sup> Global Conference of the Forum for Economists International, Kuala Lumpur, Malaysia, December 2015*

# Areas to Cover

- Why Bhutan?
- Why NIE and Political Economy?
- Regulatory Environment in Bhutan
- Challenges and Risks
- General Conclusions



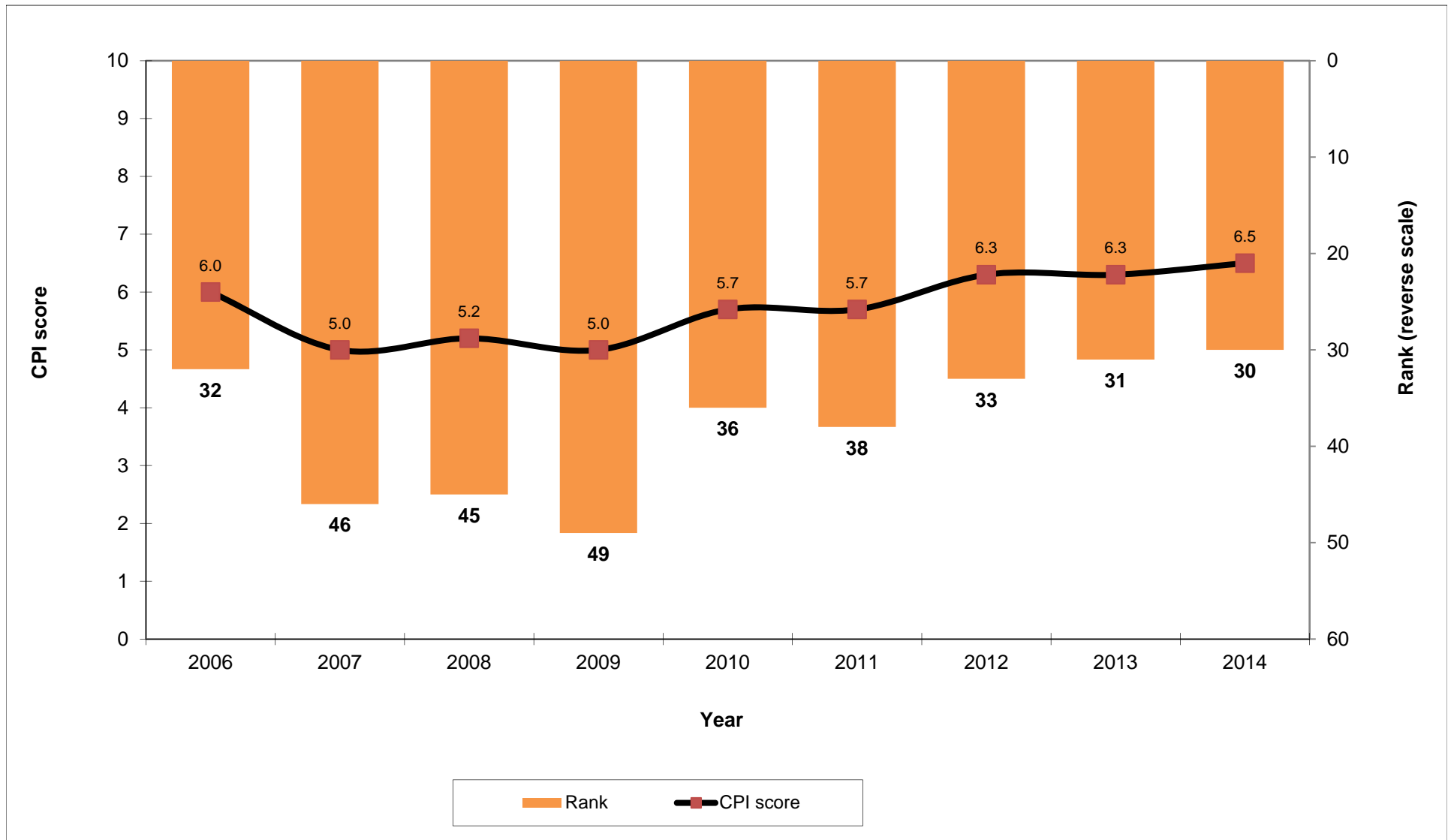
## Bhutan as the “fourth fastest growing economy in the world” (in 2011-2013).(1)

(1) John Berthelsen. 2013. Booming Bhutan: The Happiest Place on Earth? *Foreign Affairs*. Washington, D.C. (Data used was from IMF's 2012 report *World Economic Outlook: Coping with High Debt and Sluggish Growth*. Washington, D.C.

### Significant achievements:

- Number of poor reduced by about half to 12% of total population in 2013 in a span of 5 years
- Per capita GDP one of the lowest in the world at \$51 in 1961 → approximately \$2,611 (2015)
- Average life expectancy increased from 37 years in 1960 to over 68 years in less than half a century

# CPI Trends - Bhutan



## Bhutan's performance on the CPI rating

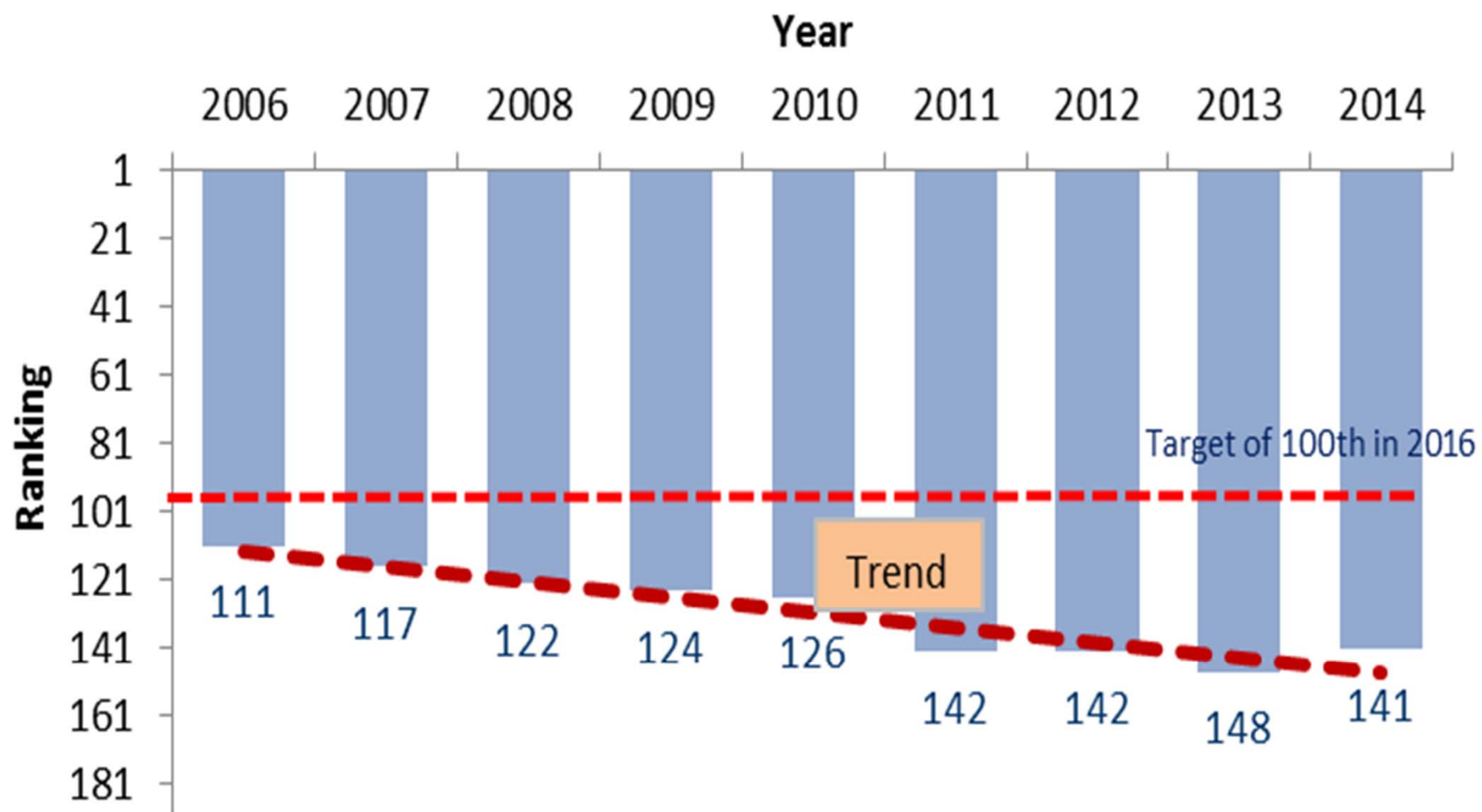
- 1st among countries of South Asia
- 6th in the Asia Pacific region
- 8th in all of Asia

Source: Transparency International,  
CPI, 2014

## *Countries in Asia above Bhutan in CPI ranking in 2014*

- 1 New Zealand
- 5 Singapore
- 9 Australia
- 15 Hong Kong, China
- 18 Japan
- 26 UAE
- 28 Qatar

## Bhutan - Ranking in Ease of Doing Business (2006-2014; reverse scale)



Source: World Bank, Doing Business Survey, various years

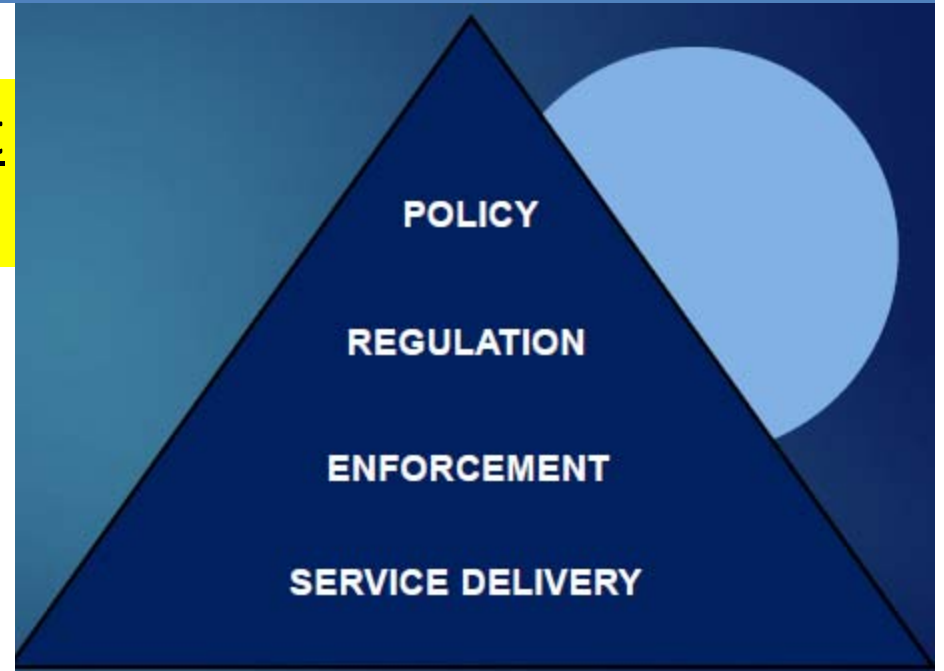
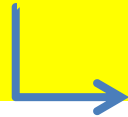
Why regulation is important: *“Opportunities for gainful employment must increasingly come from private sector... there is no other way out” PM Tobgay*

- Limited employment opportunities as growth has been driven mainly by the capital-intensive hydropower sector
- Youth unemployment (*“critical problem”*)
- Pop dynamics: 30% < 15 yrs & 56% < 24 yrs
- Public sector cannot absorb all
- But private sector mainly engaged in low-value, low-productivity investments [*13,000 cottage and small enterprises comprise 97% of all businesses; contribute only 4% to the economy; concentrated in 3 ‘urban’ areas*]
- Thus SMEs, business development, private sector growth, etc. is important – one of five ‘jewels’

Year	Unemployment Rate
2012	7.3%
2013	9.6%
2014	9.4%

# The underlying assumption

Four core functions of government



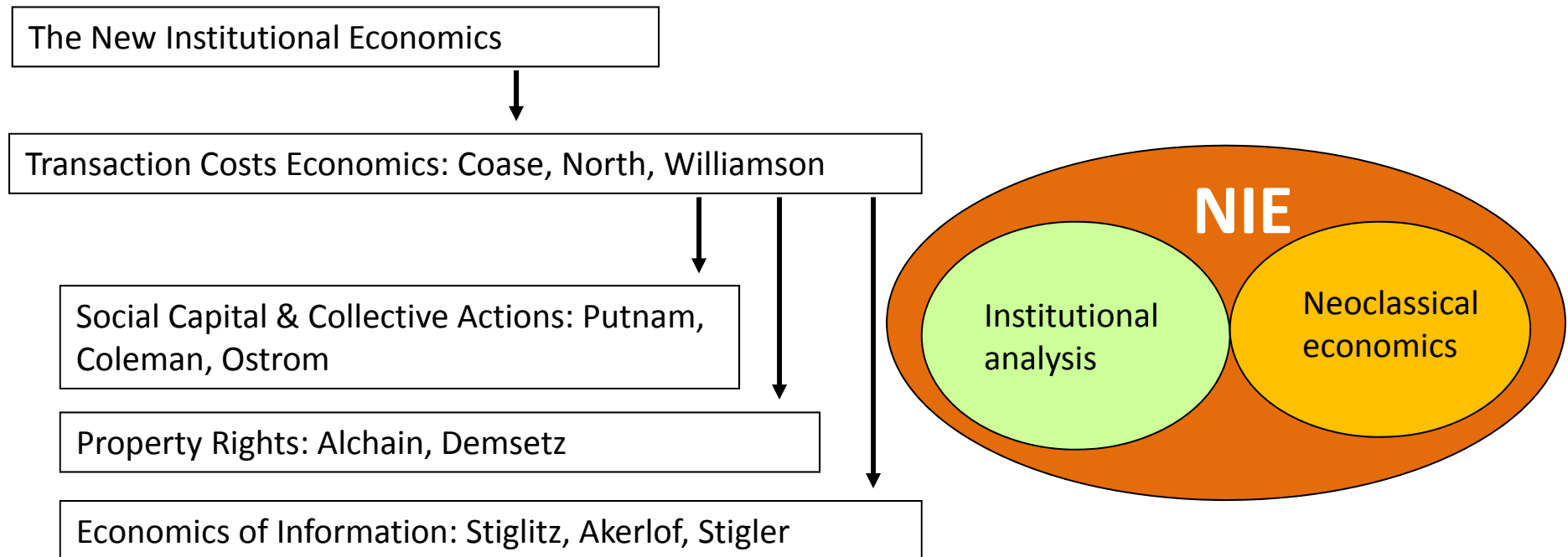
- o Proper markets don't often – and across the board – exist in a developing country
- o This leads to inefficient production, distribution, and sub-optimal consumption
- o Hence, the role of the state: **correct the bias**



# Using NIE to understand the role of the state

- NIE roots in two Ronald Coase articles (*The Nature of the Firm*, 1937; and *The Problems of Social Cost*, 1960) – the latter on transaction costs
- The term NIE coined by Oliver Williamson in 1975
- Some key concepts: transaction costs, credible commitment, information asymmetry (and its product, bounded rationality), property rights, etc.
- Central message: institutions matter (institutions are “rules of the game”)

## Branches in NIE



## Core Concept 1: Information Asymmetry

Imperfect Information Paradigm: incorporates information (or the lack of it) into standard economic analysis to explain the rise of certain institutional settings and lack of efficiency

Inefficient institutions result from imperfect and costly information

1. Lack of information across time  
(*we know more at time  $T-1$  than at  $T+1$* )
2. Asymmetry across space  
(*eg., between core and periphery; organizations, etc.*)
3. Asymmetry when static in perception and interpretation  
(*differential in making sense of available information*)



***Therefore, all players are at best boundedly rational...***

## Core Concept 2: Transaction costs (TCs)

Differential access to, and ability to interpret, information (as well as voting for association) leads to transaction costs

**Variable in impact**  
***(Some businesses/firms more able to meet and internalize)***

### Search and information costs

Businesses need to look for, and gather, relevant information in order to meet the regulations; costs incurred in searching for the information

### Bargaining costs

Costs associated with providing quality assurance; interacting with regulator; interacting with regulated bodies to ensure conditions are met

### Policing and enforcing costs

Monitoring by regulatory body; reviewing reports

***North (1990):  
The inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the third world***

## Core Concept 3: Credible Commitment (CC)

- Assumption of a repetitive game
- Expectation: of *quid pro quo* in commitment to transaction
- Policy reversals—or more aptly, the threat (or perception) of such reversals—lead to a failure to commit credibly
- CC is related to credible threat

$$CC \downarrow = TCs \uparrow$$

## Core Concept 4: Political Economy

*“... all the many activities of cooperation, conflict and negotiation involved in decisions about the use, production, and distribution of resources”\**

**Related to the public interest theory of regulation**

- Developed in 18th century as the study of the economies of states.
- Inter-disciplinary
- These days, it refers to various things: (a) Marxian analysis, (b) applied public choice, (c) advice by economists to government which has political and economic implications, (d) how political forces affect economic policies which, in turn, impact politics and political institutions.

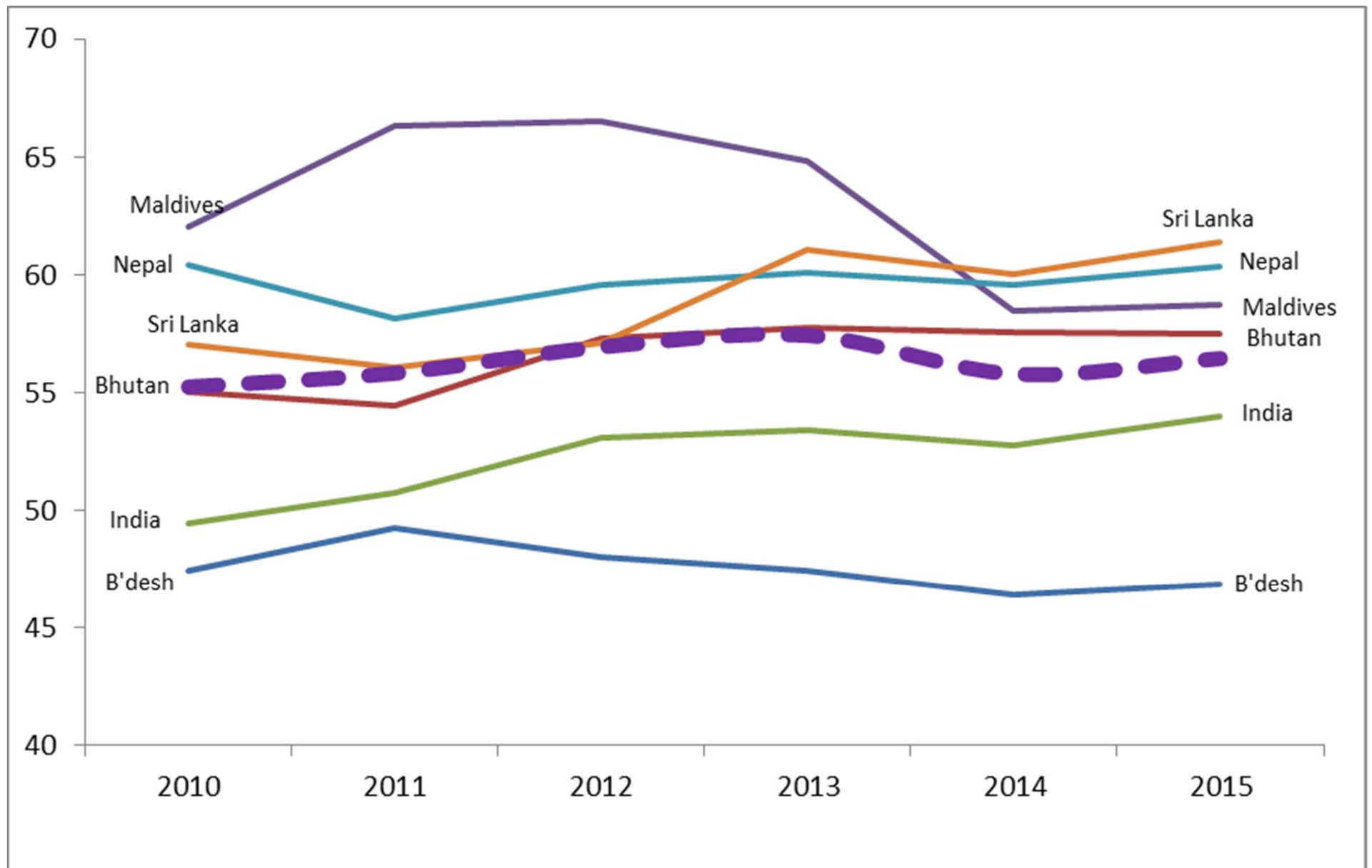
# Further on political economy

[Journal of Economic Literature classification codes](#) associate political economy with three subareas:

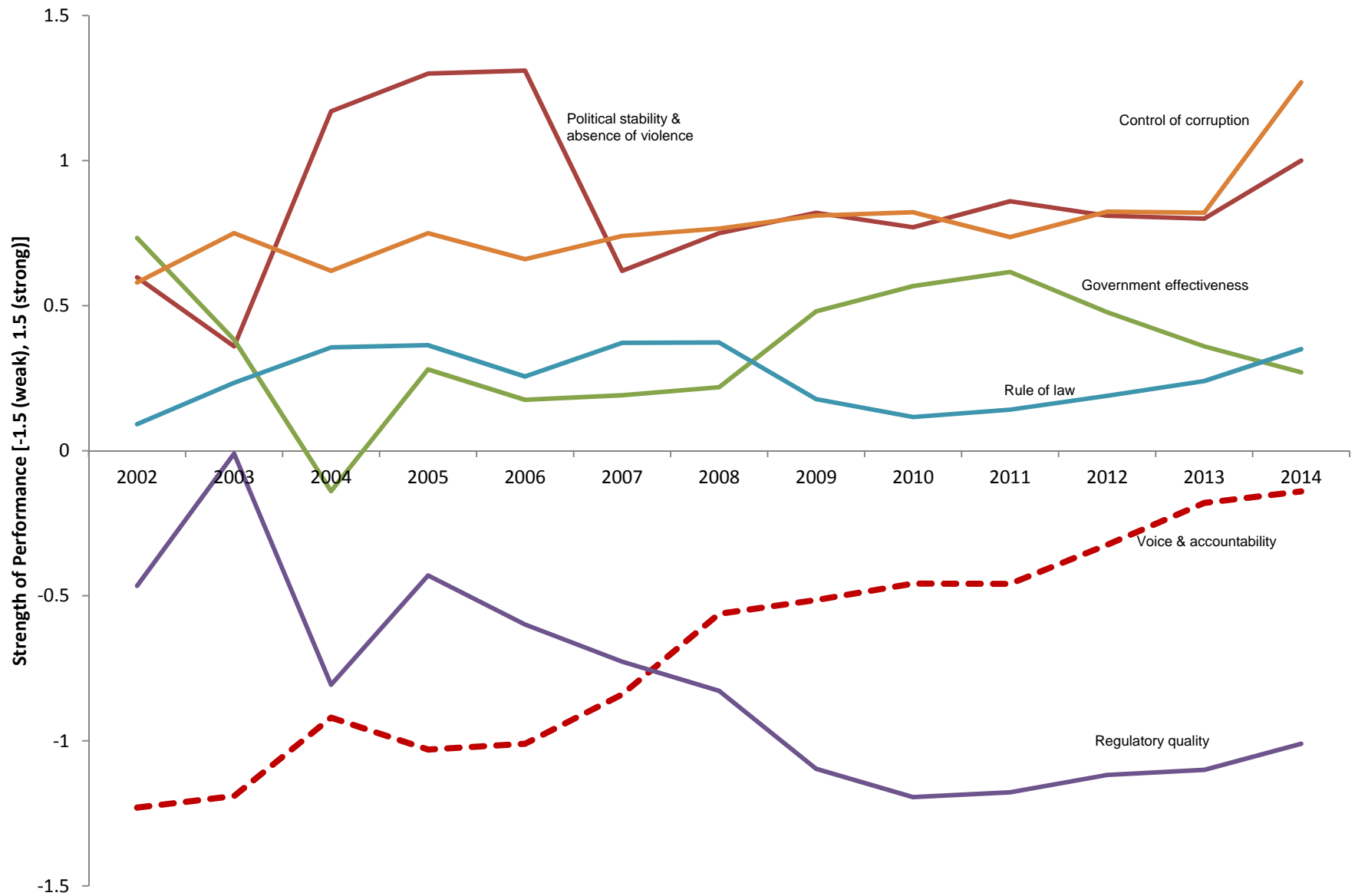
- (a) role of government and/or power relationships in resource allocation and use;
- (b) international political economy; and
- (c) economic models of political processes

“Lack of understanding of the political economy of reform is increasingly seen as a risk to development effectiveness...”

# “Doing Business” Survey Scores (S Asia)



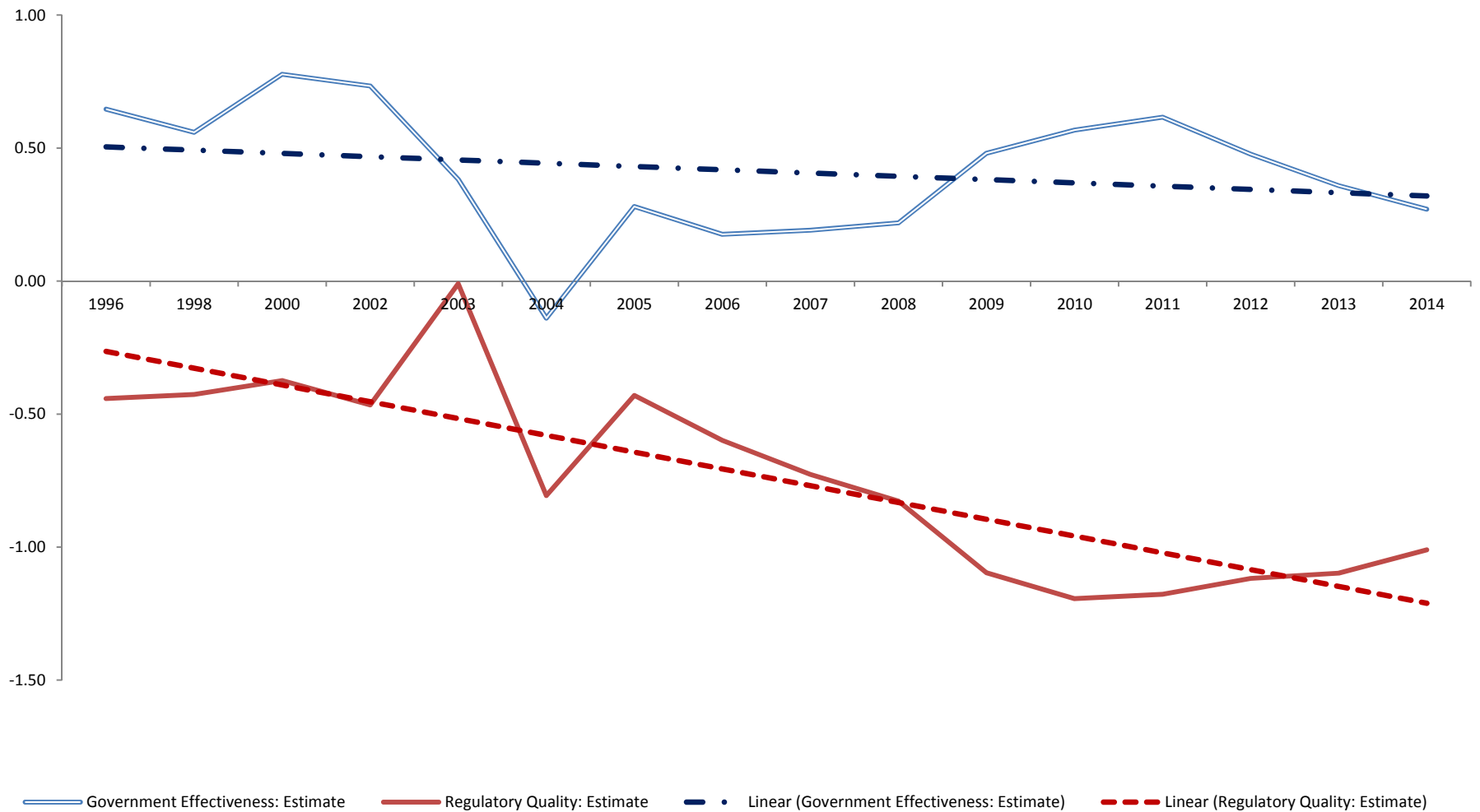
## Bhutan - Trends in Governance Indicators (2002-2014)



Source: Worldwide Governance Indicators, 2015 Update



## Bhutan: Trends in Regulatory Quality & Government Effectiveness



Source: Worldwide Governance Indicators, 2015 updated

**Table 2. Enterprise Perceptions, Bhutan (%)**

Indicator	Bhutan	South Asia	All countries
Percent of firms expected to give gifts to public officials “to get things done”	10.1	24.0	19.2
Bribery depth (percent of public transactions where a gift or informal payment was requested)	3.9	20.5	12.7
Bribery incidence (percent of firms experiencing at least one bribe payment request)	6.3	24.5	16.9
Percent of firms identifying corruption as a major constraint	6.0	35.6	37.1

Note: Business owners and top managers in 250 firms were interviewed from April 2009 through June 2009.

Source: Enterprise Surveys (<http://www.enterprisesurveys.org>), The World Bank. Business owners and top managers in 250 firms were interviewed from April 2009 through June 2009.

**Table 3: CPA Scores for Bhutan**

<b>CPA Indicator</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
Business regulatory environment (a)	4.0	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5
Property rights and rules-based governance (b)	5.0	4.5	4.5	4.5	4.5	4.5	4.0	4.0	4.0	4.0
Quality of public administration (c)	5.0	4.5	5.5	5.0	5.0	5.0	4.0	4.0	4.0	4.0
Composite Country Performance Rating for Bhutan (d)	21.6	20.3	19.5	18.5	17.6	17.6	14.4	16.8	17.3	17.3
Average of all ADF countries for all variables and indicators (e)	13.9	13.3	13.1	13.6	12.4	11.9	11.6	12.6	12.5	12.4
<b>Bhutan rank/total countries</b>	<b>1/29</b>	<b>1/28</b>	<b>1/28</b>	<b>2/28</b>	<b>1/28</b>	<b>1/28</b>	<b>6/28</b>	<b>6/29</b>	<b>3/26</b>	<b>4/25</b>

### **Government steps:**

- A multi-sectoral Doing Business Task Force
- Foreign Direct Investment Policy 2010 revised (in past two years, 16 projects worth \$78 million approved)
- Better Business Council
- Business Opportunities and Information Center

**Target:** SMEs to contribute at least 10% to GDP

# Steps taken to improve business environment

- **Organizational:** e.g., establish Better Business Council (to consider issues of (de)regulation)
- **Legislative:** e.g., Enterprise Registration Bill, which will make doing business easier, including enabling online registration; and legislative reviews ongoing of secured transactions and insolvency
- **Banking and financial:** e.g., greater access to loans for businesses (\$32 million from the Economic Stimulus Plan to commercial banks); a collateral registry for moveable collateral in 2013
- **Administrative:** e.g., simplify business registration process and reduce time required to obtain security clearance certificate; “Doing Business: Meet Your Government” program to provide direct redress system for businesses.

# Bhutan Chamber of Commerce and Industry (BCCI)

Facet	Implications
Set up in 1980, 5 branches now	<i>Cost escalations, both transaction &amp; programmatic</i>
<b>Objective.</b> Supplement government efforts to develop formal private sector	<i>Perception of alignment with extent of government's credible commitment</i>
<b>Resourcing.</b> Relies on voluntary contributions by handful of enterprises	<i>Risk of capture</i>
<b>Functions.</b> Advocacy for greater competitiveness; networking; business information & referral services; skills development; etc.	<i>Dilution of organizational mandate?</i>
<b>Difficulties.</b> (a) weak private sector base; (b) lack of members' voluntarism; (c) "deplorable" levels of resources	<i>"Difficult and challenging" days ahead</i>

# Regulatory Impact Assessment (RIA)

- Needed for: (a) detailed analysis new regulation; (b) assessing likely effects of proposed new regulation; (c) identifying possible side effects or hidden costs of a regulation; (d) quantifying likely costs of compliance → key to businesses
- RIA Unit in 2011; in Cabinet Secretariat, for visibility and credibility
- Steps taken: (a) RIA policy in April 2012; (b) regulatory registry of legal measures; (c) developed RIA methodology, guidelines, and training modules for government agencies
- Task Force to harmonize and to check for any conflict in existing laws

# Measurement against good practice

**Table 5: Distance to Frontier in Doing Business**

<b>Country</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>
Bangladesh	47.4	49.3	48.0	47.5	46.4	46.8
Bhutan	55.1	54.5	57.3	57.8	57.5	57.5
India	49.5	50.8	53.1	53.4	52.8	54.0
Maldives	62.0	66.3	66.5	64.8	58.5	58.7
Nepal	60.4	58.1	59.6	60.1	59.6	60.3
Sri Lanka	57.1	56.0	57.1	61.0	60.0	61.4

Note: a higher score denotes getting closer to the best performers in Doing Business surveys; Source: Doing Business Survey

Table 6: Bhutan's performance vis-à-vis the Frontier in Doing Business, 2016

Selected Topic and Indicator	Who sets the frontier	Best Performer (frontier)	Score for Bhutan
<b>Starting a business</b>			
Procedures (number)	New Zealand	1	8
Time (days)	New Zealand	0.5	15.0
Cost (% of income per capita)	Slovenia	0	4.0
<b>Dealing with construction permits</b>			
Procedures	5 economies	7	21
Time (days)	Singapore	26	151
<b>Getting electricity</b>			
Procedures (number)	15 economies	3	4
Time (days)	Republic of Korea	16	61
<b>Registering property</b>			
Procedures (number)	4 economies	1	3
Time (days)	3 economies	1	77
<b>Getting credit</b>			
Strength of legal rights index (0-12)	3 economies	12	4
Depth of credit information index (0-8)	26 economies	8	6
<b>Protecting minority investors</b>			
Strength of minority investor protection index (0-10)	3 economies	8.7	4.7
Extent of shareholder governance index (0-10)	4 economies	8	4.7
<b>Paying taxes</b>			
Time (hours per year)	Luxembourg	55	85
Total tax rate (% of commercial profit)	Ireland	25.9	35.3
<b>Trading across borders</b>			
Time to export – border compliance (hours)	15 economies	0	2
Cost to export – border compliance (\$)	18 economies	0	59
Time to import – border compliance (hours)	19 economies	0	2
Cost to import – border compliance (\$)	28 economies	0	110
<b>Enforcing contracts</b>			
Time (days)	Singapore	150	225
Cost (% of claim)	Ireland	9	23.1
<b>Resolving insolvency</b>			
Recovery rate (cents on the dollar)	Japan	92.9	0.0
Strength of Insolvency Framework Index (0-16)	4 economies	15.0	0.0

Source: World Bank, 2015. Doing Business, 2016: Measuring Regulatory Quality and Efficiency, Economy Profile, 2016 – Bhutan. [http://www-wds.worldbank.org/external/default/WDSPContentServer/WDSP/IB/2015/11/05/090224b083194ad2/1\\_0/Rendered/PD](http://www-wds.worldbank.org/external/default/WDSPContentServer/WDSP/IB/2015/11/05/090224b083194ad2/1_0/Rendered/PD)



# Application of NIE Concepts

Concept	Evidence in
<b>Information asymmetry</b>	(a) lack of M&E protocols at macro level; (b) incomplete information on private sector (both provided and collected); (c) between those sustaining BCCI and others
<b>Transaction costs</b> (high for regulating and compliance as well)	(a) <u>search</u> – to BCCI, and to businesses; (b) <u>bargaining</u> – to BCCI to deal with businesses not yet opted in, and not committed; to businesses for interacting with regulators without BCCI cover (c) <u>policing &amp; enforcing</u> – to government and BCCI to ensure businesses adhere to regulatory provisions
<b>Credible commitment</b>	<u>Evident in (eg):</u> a) Better Business Council; (b) Business Opportunities and Information Center; (c) RIA work; (d) credit information bureau <u>Missing in (eg):</u> (a) land leasing for commercial purposes; (b) predictable policies on access to credit
<b>Political economy</b>	(a) BCCI's role; (b) organizational capture; (c) incentive structure

# General Conclusions

1. Regulatory environment is key in all policy environments and in all economies
2. Implication is that the relevant issues range from broad macro-economic policy environment to organizational behavior
3. Understanding the nature and extent of information asymmetry in the system can help explain the degree of transaction costs as well as of credible commitment

***Note: theories of imperfect information mean that “even the best designed regulatory systems would work imperfectly” (Stiglitz, 2002)***