

Mongolia: The State of Nature of Public Finance

<The authors analyse public finance in Mongolia, and the role played by taxation.>

Dari Munhzul is a World Bank scholar attending the Master's programme at Keio University, Japan. **Prof. Yukinobu Kitamura** is from the Graduate School of Business and Commerce at Keio University. *This paper is written in an academic context.*

1. INTRODUCTION

Mongolia is located in the Central Asian steppes, landlocked between Russia and China. In terms of landmass, it is the 5th largest country in Asia and the 17th in the world but with a population of 2.4 million people (2000 estimate). Other features that have and continue to shape development in Mongolia are:

- a low population density of 15 persons per 1,000 hectares with weak infrastructure resulting in large transport and communication costs;
- a high urbanisation level with nearly a third of the population living in the capital city, and another third in 22 towns or

aimag (prefecture) centres which are spread across a vast territory;

- a high literacy level. In 2000, the literacy rate amongst those over the age of 15 year was 96%;
- an average life expectancy of 64 years, which is higher than countries of similar GDP levels;
- rich mineral reserves, including copper, coal, molybdenum, fluorite, gold, iron ore and large deposits of granite;
- exports dominated by copper concentrate and animal products, although there has been a dramatic increase in gold exports;
- the severe annual climate, with temperatures ranging from +30°C to -30°C and a low precipitation; and
- a legacy of 70 years of Soviet-influenced communism.

The agricultural sector is the backbone of the economy and Mongolia remains, largely, a pastoral society with animal husbandry being the main economic activity. There are important links between the agricultural and industrial sectors, with agriculture providing the inputs to many manufacturing activities, including leather and shoe manufacturing, wool processing and cashmere production. The

economic viability of developing much of this natural wealth is, however, yet to be established (UNDP 1996).

The annual average rate of growth of GDP at market prices for the period 1981/90 was 5.6%, which slowed from 1988 onwards to a negative growth in the post reform period. The central feature of the economic dimension of the reform process has been a restructuring package, which has included price liberalisation and privatisation. Mongolia opted for a 'shock therapy' and liberalized its foreign trade regime from 1990 onwards. It also abolished market barriers such as quotas, export bans, minimum export prices and restrictions on the domestic procurement of export goods.

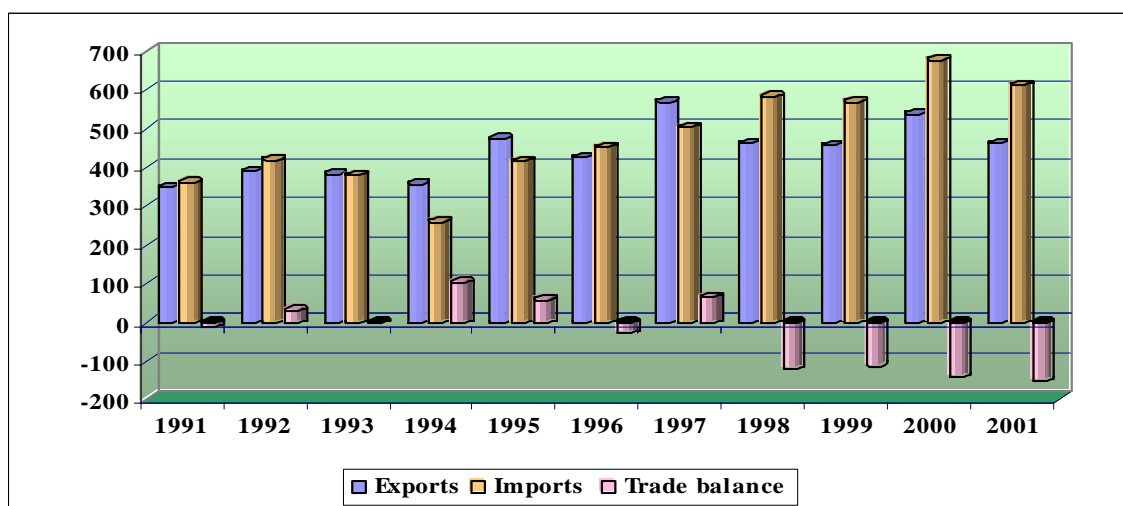
1.1. International Environment

1.1.1. Foreign trade and trade balance

Mongolia achieved tangible results in trade liberalization during its transition to a market oriented economy, and this was highlighted by its accession to the World Trade Organisation in 1997. By 2001, Mongolia was exporting goods to 43 countries and

was receiving imports from 67 countries. Mongolia's main export partners have been China, the United States of America (USA) and Russia, while its imports have come mainly from Russia, China, Japan and Germany (FIFTA 2001). A main feature of exports has been a diversification away from the traditional destination of Russia to China and the industrial countries. In 2001, exports were valued at USD 385.2 million which was a 13% decrease compared to 2000. This was largely due to the fall in prices, in the international market, of the main export products such as copper, gold and cashmere. This situation suggests a need to improve external trade management, by pursuing measures to diversify exports to prevent export revenue falls due to commodity fluctuations. There is also a need to increase processing levels of agriculture raw materials and to raise the competitiveness of export products.

Figure 1: Foreign Trade and Trade Balance (USD millions)



Source: Ministry of Finance and Economy, 2001

Imports increased in 1998 as the *Togrog* (Mongolian currency) remained relatively stable compared with the currencies of its main trading partners, thereby reducing average import prices. The growth in imports led to a widening in the trade account gap. The trade balance, which saw a surplus USD65 million in 1997 has shifted a deficit of USD170 million in 2001, largely as a result of deteriorating external trade terms and decreases in export revenue.

1.1.2. Foreign Direct Investment (FDI)

Mongolia has signed bilateral agreements on investment encouragement and protection with 30 countries and double taxation avoidance agreements with 24 countries. It is a full member of the Multilateral Investment Guarantee Agency (MIGA) of the World Bank

Group, since 1999. As of 1998, Mongolia has signed trade agreements with 78 countries around the world and it has joined the Washington Convention on Settlement of Disputes in 1996 and the Seoul Convention on Investment Insurance" in 1999 respectively.

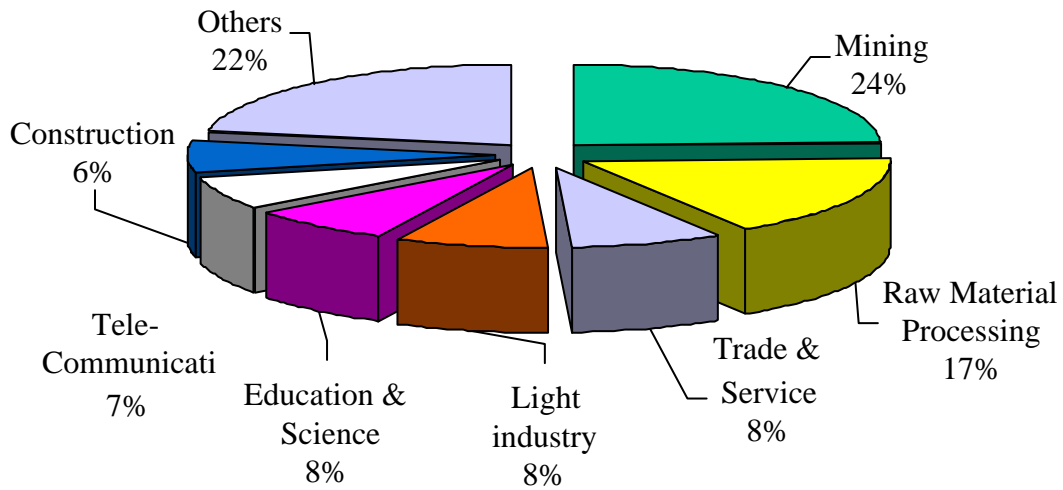
The establishment of a domestic legal environment, including taxation, that provides foreign investors with favorable tax incentives and an export oriented macroeconomic policy will have an important impact in increasing FDI. Other advantages include a stable political situation, educated and cheap labor, low business cost, rich natural resources and access to the large Russian and Chinese markets. FDI has been increasing in Mongolia and the Foreign Investment and Foreign Trade Agency (FIFTA) reported that for the last ten years, 2000 joint ventures and foreign companies from 70 countries were registered in Mongolia.

The sectors that have been prioritized for FDI are as follows:

- Mining: The government recognizes the need to develop the mining industry and has introduced one of the best Mining Laws (1997) in the region. The Mining Law greatly improved the legal

- environment by simplifying the licensing system and reducing royalty and exploration fees. Mining is now a major industry that contributes 30% of total industrial output and 65.5% of export revenues (FIFTA 2001);
- Agro-industry: Mongolia has over 33 million head of livestock and large tracts of land to enable the successful development of agro-industry. The Mongolian cashmere industry has been recognized as the competitive and it produces more than 25% of the world cashmere output. There are also opportunities for foreign investment in other agro-industry ventures including camel wool products, wool processing, leather and meat processing and diary products; and
 - Others: The government has privatized selected infrastructure sectors including telecommunication and there is potential for foreign business development in these areas. The information and communication technology, and, tourism sectors have also been identified as areas in which FDI is to be encouraged.

Figure 2: FDI in Mongolia by Industry



1.1.3. Loans and Official Development Assistance.

From 1991 to 2000, Mongolia benefited from the support of the international donor community, which committed more than USD 2.6 billion in loans and grants. These loans and grants were utilised in various sectors such as transport, communication, banking, etc.

1.2. Domestic Environment

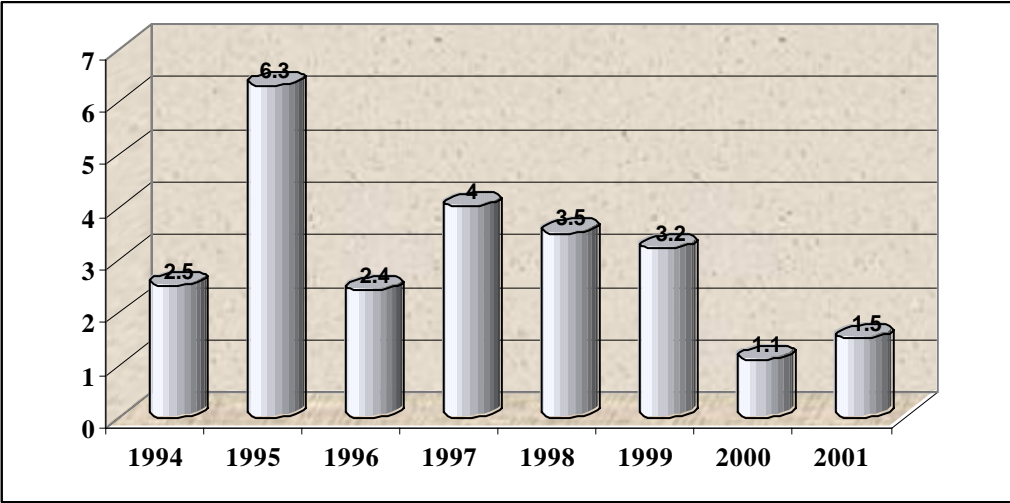
1.2.1. Economic growth

In response to issues caused by economic transition, the government has implemented policies to move towards free exchange system and accelerate restructuring and privatization. Tight monetary and fiscal policies were also put in place to decrease hyperinflation as well as budgetary and current account deficits. Within the framework of legal reform, new legislation on economic relations such as budget, taxes, foreign investment and regulation of unfair competition were passed and implemented.

As a result Mongolia started to recover and achieved macroeconomic stabilization. This in turn played an important role in providing a favourable environment for domestic industry recovery and for sustaining underlying economic growth.

From 1994 onwards, Mongolia experienced unstable but positive real GDP growth rates. This growth has been negatively impacted by harsh weather conditions and continued decline in world prices of Mongolia's key export commodities.

Figure 3: Real GDP Growth



Source: Ministry of Finance and Economy, 2001

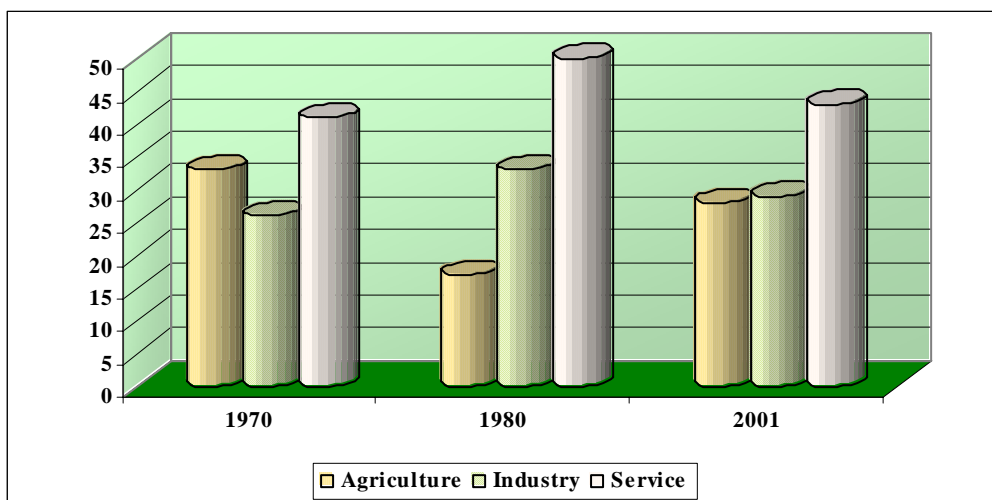
The following sectors are pertinent to Mongolia’s economic growth:

- Agriculture: This sector employs almost half of Mongolia’s work force and accounts for 30% of GDP. It is dominated by herding, which together with cropping play a key role in the country’s economic development. The livestock sub-sector also plays an important role, with animal breeding representing the only source of food, transport, purchasing power (cash/barter) for many people;
- Industrial: This sector has seen a continuing decline throughout 1990s, except for modest gains in 1998. This decline is mainly in reaction to the decline in international prices

for basic metals thereby affecting the mining industry. However, 2001 saw an increase in production especially the agro-industry sector, e.g. cashmere, scoured wool, leather boots, etc. Overall manufacturing industry production increased by 22.7%. Mongolia now needs to concentrate on the development of the manufacturing sub-sectors that utilize minerals and primary agriculture products; and

- Services: The service sector has been more volatile in the past several years than before, due to a shift in the importance of its various components. Since 1997, the banking sector has experienced a decline in its contribution to domestic production while other sectors such as transport, communications, and construction increased or maintained their respective share of GDP. Overall, the service sector accounted for 41% of GDP in 2001.

Figure 4: Sector Share of GDP (%)



Source: Ministry of Finance and Economy, 2001

1.2.1.1. Inflation rate.

Tight monetary and financial policies aimed at facilitating a healthier financial sector and continued strengthening of the *Togrog*, initially resulted in a relatively stable inflation rate which reached single digit levels (i.e. 6%) in 1998. However, this changed with an increase in domestic inflation, a worsening of the current account balance and continued build-up of external debt. The result was a reverse in the declining trend of inflation which saw inflation moving up to 10% in 1999 and 11.2% in 2000.

1.2.1.2. Investment

Mongolia's savings rate, averaging an estimated 16% of GDP in recent years is low, and short of what is required to finance the investments needed for faster growth. Gross capital formation has averaged an estimated 26% of GDP. Foreign resources have contributed to filling the gap but the key to faster growth will be policies to facilitate improvement in the efficient use or productivity of capital.

Table 1: Gross Domestic Investment and Gross Domestic Savings (% of GDP)

	1999	2000	2001	2002
Gross Domestic Investment	27	29	28	29
Gross Domestic Savings	20	18	18	19

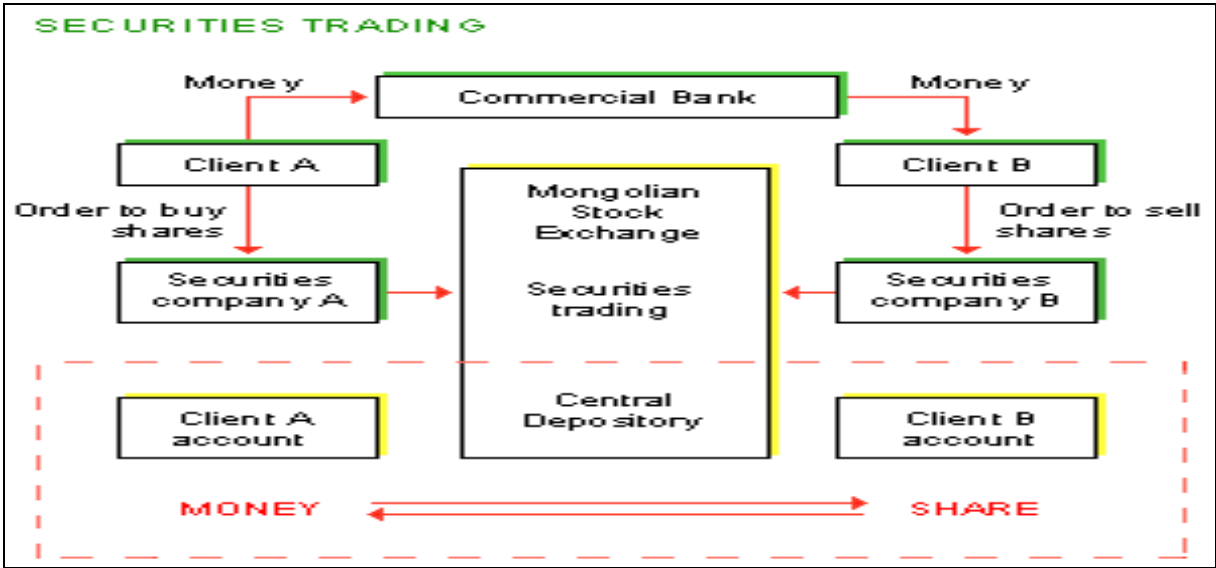
Source: Asian Development Outlook, 2002

1.2.2. Capital stock

The development of the Mongolian capital market began with privatization in 1991. The Mongolian Stock Exchange (MSE) was established in 1991. Initially, the MSE operated as a mechanism

of voucher distribution but later, assumed the role of a regular stock exchange. In 1995, the Law on Securities was passed and dealt with the privatization of brokerage firms, effective enforcement of regulations on dividend distribution, and prices of shares traded in cash. The MSE has grown over the years and its central depository now, has registered more than 4 million shares of 418 joint stock companies and has approximately 270,200 client accounts.

Figure 5: Securities Trading in Mongolia



1.2.3. Money supply and credit

Monetary policy aimed at enhancing the legal and economic environment for the smooth functioning of financial intermediaries, and to improve the efficiency of financial corporations. In order to stabilize money demand and supply, broad money growth was targeted at 30% per annum. By the end of 2001 broad money reached MNT 331.1 billion representing an increase of 27.9% compared to the end of 2000. Measures such as extension of non-cash payment mechanisms and increase in the number of money transfers within and outside Mongolia led to changes in the structure of the money supply.

In 2001, the share of money outside the banks as a component of broad money saw a sharp decrease of 6 percent compared to 2000. Savings have increased and national currency deposit balances are higher than foreign currency balances, which represented a major turnaround, demonstrating exchange stability and confidence in the national currency and moreover continuing overall improvement in banking services. An expansion of industrial output, especially sharp recovery of the manufacturing sector, led to an increase in

demand for money. Despite continuing relatively high lending interest rates, the amount of loans outstanding to the non-financial corporations increased by 152.1%. Performing loans to the private sector rose from a total of 67.2% to 84.3%, while public sector loans declined from 9.3% to 7.8%.

2. FISCAL POSITION

2.1. Government Expenditure

2.1.1. Public expenditure

With respect to the public expenditure and taxation policies, the government implemented policies that aimed to provide fiscal sustainability and transparency for the medium term, eliminate arrears and improve overall fiscal balance. In line with these key objectives, important measures were taken to provide stable budget revenue sources, expanding the tax base, improving budget planning processes, rationalizing public expenditure and limiting

inefficient budget spending. In 1998, the budget current balance was in deficit by 0.7% of GDP, while the overall deficit was 12.5% of GDP. However, by 2001, these aggregates had improved consistently and significantly as a result of major reforms in fiscal management, including reform measures related to tax policy, management and collection activities.

By the end of 2001, the state general budget revenue reached 38.9% of GDP, while budget expenditure was 43.3% of GDP, resulting in an overall deficit of 4.5% of GDP. The last budget surplus was 5.6% of GDP.

Table 2: Government Revenue and Expenditure for 1995–2001 (% of GDP)

	1995	1996	1997	1998	1999	2000	2001
General government expenditure	40	36	38	39	36	37	36
General government revenue	33	27	29	25	27	28	28

Source: IMF News Release, 2001

The government has been shifting expenditure towards education and health care by moving funds away from what it considers to be unproductive current expenditures. This has resulted in a 60% increase in energy prices in 1996 and 2001 with inevitable negative repercussions on household budgets. This illustrates the dilemma faced by the government, as every expenditure shift requires an assessment of trade-offs between parallel social objectives. At the same time, however, there could be scope for better internal financial management within the government as well as greater efficiency in expenditure under different budget categories and sub sectors. This could serve to ensure that existing revenues are used more effectively and systematically.

2.1.1.1. Public debt

The government attached a high priority to establishing the integrity of public debt. Cash flow problems resulted in a build-up of arrears on domestic interest payments over a number of years. The non payment of interest on restructuring bonds, in particular,

had threatened the liquidity and solvency of commercial banks and undermined the financial position of the Bank of Mongolia (BOM). This further weakened the prospects for any significant transfer of central bank profits to the budget, thereby impairing the effective coordination of fiscal and monetary policies. To address these problems, the government has cleared all domestic interest arrears and to reassure market participants that all interest payments will henceforth be made in a timely manner, the government has signed a service contract with the BOM, as its fiscal agent, stipulating that the full amount of interests due each month on restructuring bonds be automatically transferred on the last day of the month from the treasury's central budget account at the BOM to the accounts of payees.

One of the important areas where there is a scope for improved financial management is in the structure of intra governmental fiscal relations. Weakness and lack of clarity in this area is resulting in poor revenue raising strategies at the local level as well as inefficient expenditure practices. Government fiscal

policies will be subsequently reoriented to bring about an enduring reduction in the expenditure ratio, including through reforms that will strengthen the budgetary process and curtail unproductive public expenditures. In order to enhance public management and increase transparency and accountability of budget managers, a series of measures were undertaken by the government including the Treasury Single Account system, amongst others. The general government budget for 2002 was aimed at building on the recent fiscal improvement by containing the general government deficit to 7% of GDP in 2002 and reducing it to around 6% by 2004 (Ministry of Finance of Mongolia 2001)

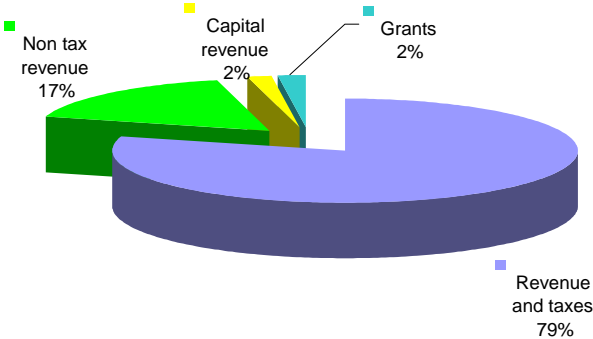
2.1.2. Aggregate revenue

The national budget includes the budget of the central government and the budgets of the *aimag* and the city governments (local government). Central budget revenues are collected and expended by the national government, while local budget revenues are collected and expended by governors of Ulaanbaatar, districts,

aimags and *soums* (smallest local unit). The budget revenue consists of tax revenue and non-tax revenue. Tax revenue covers income taxes on capital and taxes on goods and services etc. Non-tax revenue consists of dividends from government-owned shares in big corporations, government bonds, privatisation income and others.

Budgetary policy is primarily designed to secure macro economic stability and rationalize state administrative management structures. It is vitally important to increase budget revenue, expand the tax base and also to rationalize expenditure in order to reduce the budget deficit.

Figure 6: Government Revenue (FY 2002)



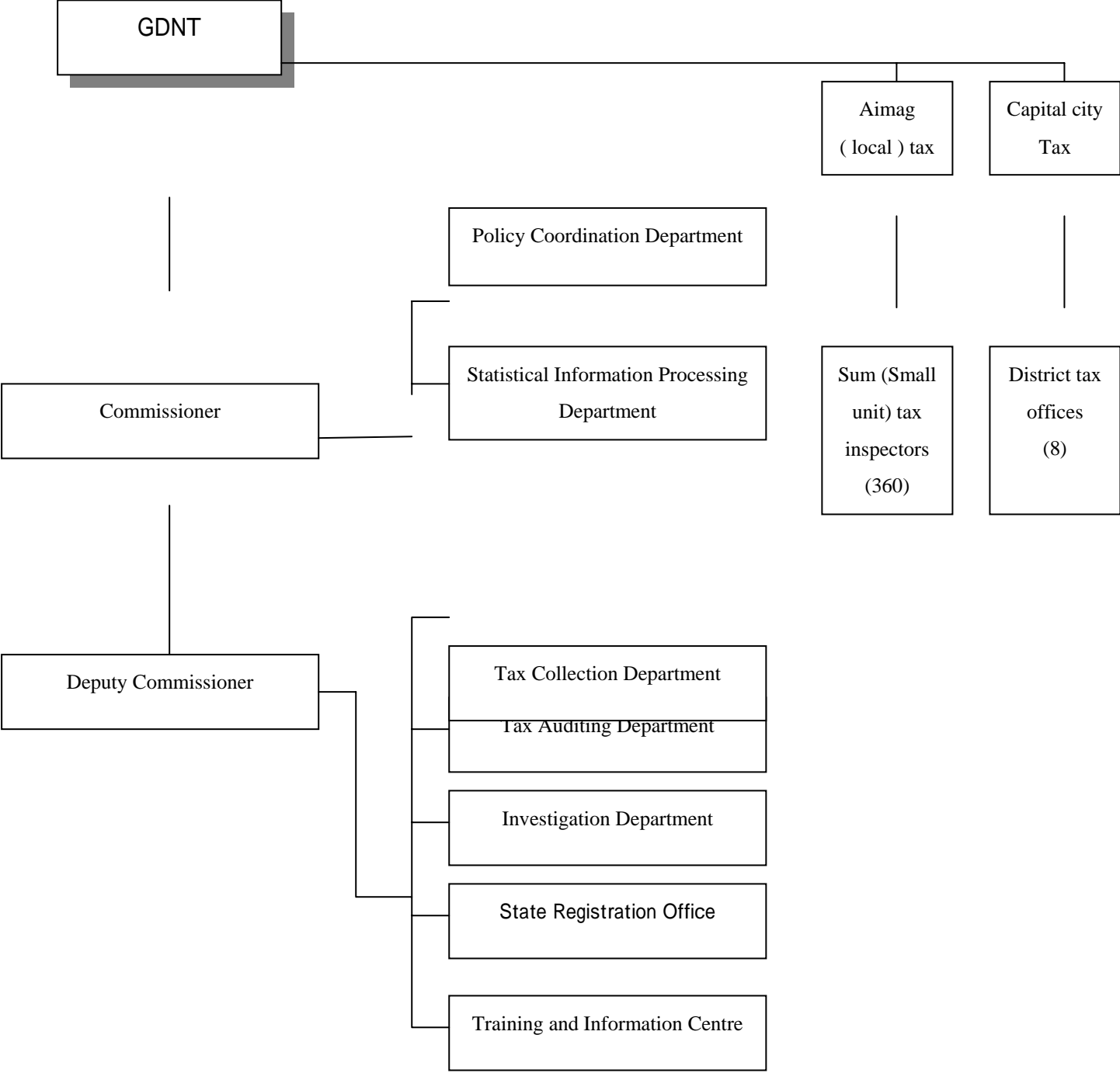
Source: Ministry of Finance Mongolia, 200

2.2. National Taxation System And Tax Structure

2.2.1. National Tax Administration.

The Mongolian Tax Administration (MTA) was established in 1991 when it was separated from the Revenue Department of the Ministry of Finance. The Department was subsequently renamed the General Department of National Taxation (GDNT). In August 1992, the GDNT was established as an independent agency, reporting to the Cabinet through the Minister of Finance and Economy. The Mongolian tax administration has a unified status and consists of GDNT, Ulaanbaatar city tax office and its district tax offices, and, *Aimag* (prefecture) tax offices. The GDNT administers 18 types of taxes covering all direct and indirect taxes, except customs duty, which is governed by the Mongolian Customs Administration.

Figure 7: Organization Chart of the Mongolian Tax Administration



At the headquarters there are four departments, i.e. Audit, Investigation, Tax Collection, and Policy Coordination. The headquarters also has a large taxpayers unit, which is in charge of tax policy formulation for the largest corporations in the country. The Training Centre, Information Technology Department, Taxpayer Service Department, and, Administration and Human Resource Department are also located here.

At the provincial level and in the city district offices, personnel are organized on a functional basis. The main functional divisions are tax collection, assessment and auditing, and, investigations. Tax offices in each of the 22 provinces (which are known as *Aimags*) have 15 to 20 staff each and the eight district offices in Ulaanbaatar have a total of 260 staff. Offices in each of the 360 *soums*, the lowest administrative units in Mongolia, have 3 to 5 tax inspectors.

2.2.1.1. Tax estimation and collection methods

In 1993 Mongolia introduced a self-assessment system. This is a taxation system whereby the taxpayers have to compute their tax liability based on a tax return form and settle such liability within a prescribed period of time. The challenge here is to entrust a taxpayer to carry out this responsibility. It is a prerequisite for a self-assessment system that taxpayers are well informed with regards to tax laws and comply with such laws. In this regard, taxpayer education, services for taxpayer and sanctions against dishonesty have been provided under Mongolian law.

The tax administration provides taxpayers with services such as guidance in interpretation of tax laws, instructions, methods, handbooks and forms regarding enforcement, and access to group or individual tax consulting services.

The tax legislation also provides for the following sanctions and penalties:

- full payment of delinquent taxes, interest and penalties;
- a penalty that is equal to the amount of taxes evaded, if the taxable income has been intentionally understated;
- payment of the amount of understated taxable income plus a 1% interest imposed on annual taxes for each day of delay if the amount of tax base has been unintentionally understated. The amount of interest payable shall not exceed 50% of the total taxes due; and
- interest that is equal to 0.5% of the amount of unpaid tax for each day of delay.

2.2.1.2. Corporate income tax

Corporate income tax, which is regulated by the Economic Entity and Organization Income Tax Law (EEOITL), is a direct tax levied on the profits of foreign and domestic economic entities, organizations, partnerships, permanent establishments, etc. An entity which is a resident of Mongolia will be subject to tax on its worldwide income while a non-resident entity will only be

subject to tax on Mongolian-sourced income. A permanent establishment, which is deemed to be a resident, will only be taxed on its Mongolian-sourced income.

Under the EEOITL, different types of profit are taxed either at progressive rates or via a withholding tax system.

The income tax system for both individuals and companies is a unitary system, i.e. income from all sources is added together and taxed at progressive rates, if not already subject to a final withholding tax.

Table 3: Corporate Income Tax Rates for a Resident

Rate		Filing Requirements	Remarks
Annual Income (MNT)			
0 - 100,000,000	15%	Quarterly tax	Monthly advance
Over 100,000,000	15,000,000	return by the 20 th of the first	payment by the 25 th of each month is

	<p>+ 40% over 100,000,000</p>	<p>month in the next quarter. Annual tax return by the 10 February of the next year.</p>	<p>required per Economic Entity and Organization Income Tax Law Art. 8.2. All kinds of bonuses, pensions, donations, gifts, subscription to publications, housing granted to employees, transport, meals and fuel, interest on past due loans, penalties, and damages caused by the taxpayer are not deductible from taxable income.</p>
--	-----------------------------------	---	---

The following types of income are subject to a final withholding tax based on the gross taxable income:

- income from the disposal of immovable property, at 2% for both residents and non-residents;
- income from royalties, at 10% for residents and 20% for non-residents;
- income from dividends and gains of shareholders at 15% for residents and 20% for non-residents;
- income of a non-resident, from payments for guarantees, at 20%;
- income of a non-resident from lease payments and payments for the use of tangible and intangible property, at 20%;
- income of a non-resident from technical services and other services provided to a Mongolian organization, legal persons or individuals, at 20%; and
- profits transferred by a permanent establishment situated in Mongolia, at 20%.

2.2.1.3. Personal income tax

Personal income tax, which is regulated by the Personal Income Tax Law (PITL), is a direct tax levied on the income, including self-employed income, of individuals. An individual who is a resident of Mongolia will be subject to tax on his worldwide income while a non-resident individual will only be subject to tax on Mongolian-sourced income.

As with the EEOTIL, the PITL taxes individual income at either progressive rates or via a withholding tax, depending on the type of income. The following types of individual income are taxed at progressive rates:

- salary, wages, remuneration, allowances and other identical income;
- fringe benefits;
- pensions, additions to pensions and allowances;
- income from business sources;
- capital gains and income from rights;

- income from property leasing and other similar income; and
- income other than those exempted under the law.

The above income is subject to tax based on progressive rates as follows:

Annual income (MNT)	Tax payable

0-240,000	10%
Over 240.000	20%
Over 720,000	40%

The following types of income are taxed via a final withholding tax based on the gross tax payable:

- income from the disposal of immovable property, at 20% for both residents and non-residents;
- income from remuneration for scientific, literary and artistic works, rights of patent, inventions, innovations, and designs, at 15% for residents and 20% for non-residents;

- income from dividends, gains of shareholders, interest from loans and bank deposits, and other identical income, at 15% for residents and 20% for non-residents;
- income from remuneration for artistic performances and sports competitions, at 10% for residents and 20% for non-residents;
- income from royalties, at 10% for residents and 20% for non-residents; and
- income of a non-resident from the leasing of property, at 20%.

2.2.2. Double Tax Agreements (DTAs)

The tax imposed on non-residents may be reduced or exempted by applicable DTAs entered into by Mongolia with the country of residence of the non-resident taxpayer. The rates of taxation on interest, dividends and capital gains will vary, according to the relevant DTAs. Currently, Mongolia has signed DTAs with 24 countries namely China, South Korea, Germany, India, Russia, Turkey, United Kingdom, Vietnam, Czech Republic, Hungary, Romania, France,

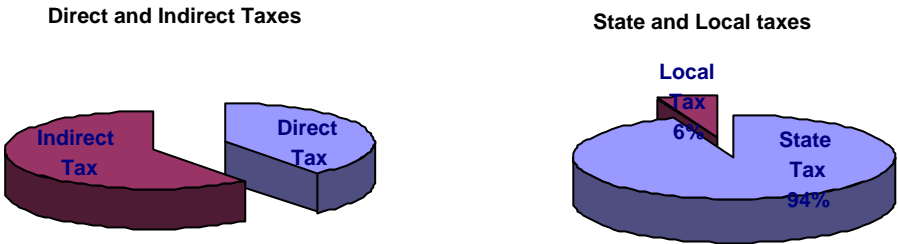
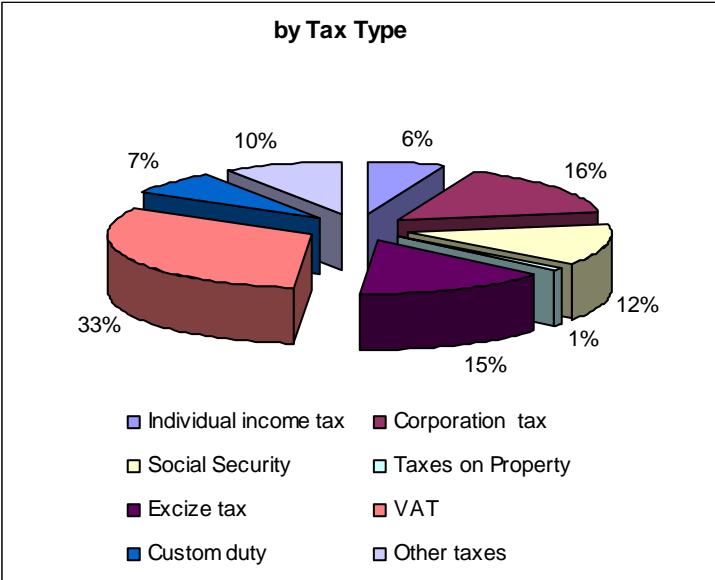
Belgium, Poland, Malaysia, Kazakhstan, Uzbekistan, Indonesia, Bulgaria, Ukraine, Kuwait, Egypt, Luxemburg and Singapore.

2.2.3. Tax revenue by composition.

Under the General Taxation Law of Mongolia, the national taxes of Mongolia comprise nineteen national taxes and four local taxes. The tax rates are determined by the Parliament and applied in the entire territory of Mongolia while the local tax rates are set by the local governments. The national and local taxes are as follows:

- National Taxes: Individual income tax; Corporate income tax; Inheritance and gift tax; Immovable property tax; State stamp duty; Gun tax; Value added tax; Excise tax; Transport and vehicle tax; City and settlement tax; Gasoline and diesel fuel tax; Hunting resource use tax; License fee for hunting and catching animals; Mineral resource tax; Land use tax; Timber tax; Water tax; City tax; Custom duty.
- Local taxes include: License fee for natural resources; Payment for natural plants; Payment for other resources; Payment for mineral springs.

Figure 8: Composition of Taxes Revenues (FY 2002)



Source: General Department of National Taxation 2002

3. COUNTRY SPECIFIC FISCAL ISSUES

Mongolia’s transition to a market economy has proceeded satisfactory (ADB 2002), and the private sector is now the main producer of goods and services. In May 1998, the government

announced a package of tax and revenue expenditure measures which included increasing the value added tax rate from 10% to 15%. Additional revenue raising measures adopted by Parliament in May 1999 included a uniform duty of 5% and an excise tax on beer.

Table 4: Government Revenue 1992-2001 (% of GDP)

Item	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Individual taxes	3.8	1.0	3.3	8.6	2.8	3.8	1.5	1.7	2.7	2.9
Corporate taxes	8.5	8.7	8.8	8.5	8.5	6.3	6.9	5.8	5.8	6.4
<i>Total taxes on income & profits</i>	<i>12.3</i>	<i>9.7</i>	<i>12.1</i>	<i>17.1</i>	<i>11.3</i>	<i>10.1</i>	<i>8.4</i>	<i>7.6</i>	<i>8.5</i>	<i>9.3</i>
VAT	3.8	3.0	3.6	4.3	4.0	3.8	3.6	4.5	4.8	5.6
Excises	1.7	2.5	2.5	4.0	1.7	1.9	1.6	1.9	3.9	4.7
Customs duties & export taxes	2.2	2.1	1.8	2.0	0.6	0.2	0.4	0.8	2.1	2.4
Social security contributions	1.8	1.3	2.3	1.7	2.8	2.8	3.0	3.3	3.8	4.8
Other	1.2	1.3	0.9	0.7	1.7	2.2	1.7	1.7	1.9	2.2

<i>Total tax revenue</i>	23.0	20.0	23.2	29.7	22.1	21.1	18.7	19.8	25.0	29.0
<i>Total revenue</i>	30.01	26.9	27.2	32.8	28.6	28.0	24.0	27.3	33.6	38.9

Source: Ministry of Finance and Economy, 2002

Partly because of these measures, tax revenue increased to 19.8% in 1999, 25% in 2000 and 29% in 2001 compared to 18.7% in 1998. However, tax revenue heavily depends on corporate income tax (CIT). The falls in corporate tax revenue and the revenue from external trade can be attributed to the global economic slow down, which has led to a decrease in world demand for Mongolia's export commodities.

Personal income tax revenue and other minor types of tax revenues slightly increased. At the end of 2000, a number of amendments were introduced to the tax laws including a property tax, and, restricting tax holidays and import duty exemptions for joint entities engaged in priority sectors.

Revenue from VAT is also very much dependent on a few big enterprises, which makes the whole tax system fragile and uncertain. Since 1998, sales tax was expanded as VAT covering all kinds of energy products and now it represents an important source of overall tax revenue. There were also changes from a selective sales tax to an across the board VAT of 15% on all goods and services. Since July 1999, firms with annual income of not exceeding MNT 10 million (previously MNT 15 million) were exempted from the VAT.

In the short term, the revised tax structure may result in a fall in tax revenue. But in longer term, the government anticipates that the incentives to investment provided by the new tax system would result in much higher overall revenues as the business sector begins prosper. However, the concern is the effect that the tax structure will have on individual income levels and consumption, especially those in lower income groups. Table 5 attempts to list the possible positive and negative effects of changes in the main taxation categories. Social insurance contributions are counted as tax revenues and have been included in the table.

Another concern is that due to the slow privatization process, receipts from the sale of government assets were substantially below expectations. By cutting current expenditures, the government reduced total expenditure to 36% of GDP, compared with 39% the previous year. Reducing dependence on external concessional finance can only be achieved through more focused public expenditure and improved revenue performance. The main fiscal target for the government is to bring down the overall budget deficit so it does not require exceptional financing from foreign sources.

Table 5: Effect of Different Types of Taxation

Type of Tax	Nature of Actual Change	Potential Impact on Income Distribution	
		Positive	Negative
Corporate income tax	Two taxable income brackets instead of four. Tax rates	Improved incentives for investment expected to	

	<p>lowered in each bracket</p> <p>but removal of all</p> <p>exemptions for all</p> <p>enterprises above the</p> <p>minimum bracket.</p>	<p>generate more jobs.</p>	
Sales Tax	<p>Change from a selective</p> <p>sales tax to across the</p> <p>board VAT of 15% on all</p> <p>goods and services.</p>		<p>Regressive in</p> <p>effect as will</p> <p>erode people's</p> <p>real income.</p>
Excise Tax	<p>Effective value doubled</p> <p>and expanded to include</p> <p>tax on passenger</p> <p>vehicles.</p>	<p>Higher tax on alcohol</p> <p>could have beneficial</p> <p>health effects if induces</p> <p>reduction in</p> <p>consumption. Revenues</p> <p>for other items coming</p> <p>chiefly from the better</p> <p>off.</p>	<p>If alcohol</p> <p>consumption is</p> <p>inelastic, effect</p> <p>on household</p> <p>incomes could be</p> <p>highly negative.</p>
Personal	<p>Three taxable income</p>	<p>Progressive scales mean</p>	

income tax	brackets instead of five. This has become more progressive with tax rates lowered at bottom end but increased at top end.	that the better off are paying more than the poor. The lower rates across the board favour the poor proportionately more than the better off.	
Import duties	Almost all eliminated in early 1997. In the longer term it is likely to cut production costs, spur investments and improve productivity, all which should help generate more jobs and higher income. However, it has been introduced again since 1999.	Importation of cheaper consumer goods will have positive impact on real purchasing power of consumers. Cheaper imported inputs expected to lower production costs, improve productivity and eventually result in more income and employment opportunities.	Could serve to make more local industries uncompetitive leading to closure and loss of jobs.

Social security	Amount of social security contributions from employers and employees were increased in 1997 by 30%.	Puts the social security system on stronger financial footing.	
-----------------	---	--	--

4. WHERE WE STAND AND WHERE WE GO

Mongolia like a number of other transition economies chose the path of rapid reforms on the assumption that even if this were initially painful, it would set the economy onto an upward path. In retrospect, although some important successes were achieved, especially in macroeconomic stabilization, other changes may have been premature (i.e. liberalizing the environment before some of the necessary institutions were in place). Economic planning in the future will have to pay more attention to the sequence of reforms.

The Government has identified the essential components of their future development strategy to be as follows:

- macroeconomic stabilization;
- private sector development;
- financial sector development; and
- implementation of a social sector development strategy.

The aim is to ensure a higher and sustained economy led by growth in exports, improved living standards, equitable distribution of wealth, developing an effective social welfare system, implement a regional development concept, formulate and effectively implement social and economic development policies, and, install an efficient and accountable governance system.

Medium Term Challenges

The main task facing Mongolia is to bring down the high poverty rates. Besides fiscal consolidation and restoration of macroeconomic stability, the progress in poverty reduction over

the medium term will depend crucially on the Government's success in generating faster economic growth and employment, and in strengthening the overall standards of governance.

Improve the social sector.

Mongolia needs to maintain macroeconomic stability in order to avoid the social consequences of high inflation rates or external bankruptcy. Therefore, Mongolia has to overcome these temporary difficulties while minimizing the effects on the people. In particular, it has to improve social infrastructure particularly health and education both in quality and quantity.

Foster employment.

A strategy of faster growth and hence employment will primarily rely on improving the productivity of investment, both in public and private sectors. At more than 25% of GDP, Mongolia's investment rate compares favorably with that of many developing countries with

similar incomes. However, the productivity of that investment is low and falling. A combination of low energy prices, production inefficiencies, and inadequate application of commercial principles in financial relationships between enterprises has led to a massive build-up of operational deficits that are financed by inter-enterprise arrears and borrowings from the domestic banking system. To improve investment returns, restructuring state enterprises is crucial, and the Government has committed itself to this, including some privatization. The strategy will concentrate on improving technical efficiency and strengthening internal enterprise governance.

Improve good governance.

Efforts to strengthen overall governance standards will primarily focus on reforming civil service, improving public sector management and establishing a legal infrastructure to support the private sector and a market economy. At present, the structure and functioning of the civil service are highly centralized, with pay

and benefits centrally determined and a single annual entrance examination. New management methods and regulations are required, in particular a more performance-based approach. Recognizing this, the Government has embarked on a 10-year program of public administration reform.

Enable private sector investment.

Improved productivity of private investment requires reforming and restructuring the financial system. Despite recent measures to strengthen the banking system, including the liquidation of two large, insolvent banks, the doubling of minimum capital requirements, and the revocation of licenses of banks that do not meet minimum capital requirements, further action is needed. These include curtailing public sector borrowing from the banks, phasing out the Government's role as owner of the banking system, and reinforcing its role as an arm's length banking regulator.

Support to rural economy.

The rural sector should be accorded due attention especially in order to minimize the effects of natural disasters which have been seen in the near past. As migrants from the countryside flock Ulaanbaatar (the city already houses one quarter of the population and the forecast is that the figure will rise to 50%), measures need to be taken urgently to reverse this trend. Living security and employment generation will be important in resolving this problem.

New state of mind

Democratic Mongolia must shed the old tradition of a handful of senior technocrats establishing policies which are to be understood and followed. A change from this requires a new mind set, one where the state embodies a culture of communication with a transparent flow of information and with an openness and responsiveness to the public.

What will actually determine success and failure is whether both government and people believe in their capacity to carve out a different kind of future. The most important shift will not be just to new economic structures or institutions, but to a different state of mind that appreciates the need and potential for government action in support of the well being of its people.

REFERENCE

1. Asian Development Bank, Asian Development Outlook. Oxford and Hong Kong: Oxford University Press, 1994
2. Asian Development Bank, Asian Development Outlook. Oxford and Hong Kong: Oxford University Press, 2001
3. Asian Development Bank, Asian Development Outlook. Oxford and Hong Kong: Oxford University Press, 2002
4. Asian Development Bank. Mongolia: Country Economic Review. Manila: 1997A
5. Asian Development Bank, Country Performance Assessment, 1999
6. Asian Development Publication/29066 ADB PH, Mongolia's Economic Growth Expected to Nudge Upwards in 2002, April 2002

7. Bank of Mongolia. Annual Report of the Bank of Mongolia.
Mongolia: 1997, 1998
8. European Union, Tacis National Indicative Programme 2002-2003,
Mongolia Country Strategy Paper 2002-2006
9. Foreign Investment and Foreign Trade Agency of Mongolia, Annual Report, 2001
10. General Department National Taxation, Annual Report, 1997
11. General Department of National Taxation, Personal Income Tax Law of Mongolia, .
12. General Department of National Taxation of Mongolia, Corporate Income Tax Law.
13. International Monetary Fund Government Finance Statistics Yearbook, 1998
14. Ministry of Finance and Economy of Mongolia, Economic Development Report for 2001, Consultative Group Meeting for Mongolia, Ulaanbaatar, 2002
15. Ministry of Finance and Economy, Mongolia - Letter of Intent, Memorandum of Economic and Financial Policies - Technical Memorandum of Understanding, IMF Publications, 2001

16. Nixson F. and Walters B. 'The Transition to Market Economy: Mongolia 1990-1998', University of Manchester, United Kingdom, 1998a
17. Nixson F. and Walters B. 'Administrative Reform and Economic Development in Mongolia', University of Manchester, United Kingdom, 1998b
18. Tasuku Honjo, 'Strengthening the Function of Tax Collection under the Existing International Tax System in Mongolia', Ulaanbaatar, 1999
19. UNDP, 'Human Development Report Mongolia 1997
20. World Bank, 'Mongolia: Toward a Market Economy', 1992
21. World Bank, 'World Economic Outlook', April 2002
22. IBFD, 'An Overview of Mongolian Income Taxation', Asia-Pacific Tax Bulletin, January 2001