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Mongolia: Report on Observance of Standards and Codes—Fiscal Transparency Update

This Update to the Report on the Observance of Standards and Codes on Fiscal Transparency for **Mongolia** was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed in **May, 2005**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of **Mongolia** or the Executive Board of the IMF.

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MONGOLIA

Report on the Observance of Standards and Codes

Fiscal Transparency Update

May 2005

A. Introduction[1]

1. The first Report on the Observance of Standards and Codes (ROSC) on fiscal transparency for Mongolia was issued in November 2001. In the context of the upcoming Article IV consultation, the IMF staff reviewed developments in the areas pertaining to Mongolia's observance of the fiscal transparency practices assessed in 2001, with a view to updating, where relevant, changes in current practices, or describing the implementation of the earlier ROSC's recommendations. *Unless indicated differently below, the recommendations made in the 2001 ROSC remain relevant.*

B. Description of Progress

Since the publication of the ROSC in late 2001, Mongolia has made significant progress in enhancing transparency practices in the fiscal area. Actions have been taken under each of the four areas underlying the fiscal transparency code:

Clarity of roles and responsibilities

The original ROSC expressed concern about the quasi-fiscal activities of the Bank of Mongolia (BOM), public financial institutions, and nonfinancial public enterprises. The ROSC also stated that the responsibilities of government agencies, intergovernmental fiscal relations, and the legal framework for fiscal managemen needed to be clarified.

- A new Public Sector Management and Finance Law (PSMFL) was adopted in June 2002 to set the legal basis for public administration reforms, output budgeting, and accrual accounting, and a separate General Budget Law was adopted in November

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[1] The update is based on discussions held during August-November 2003 by Mr. Janis Platais (FAD Long Term Advisor to the Ministry of Finance and Economy (MOFE) of Mongolia) and Mrs. Dawn Rehm (IMF Resident Representative), and it reflects comments provided by the authorities on earlier drafts, including during a staff visit in October 2004. Contributions were also made by Mr. Selim Çakır (FAD) and other members of the Mongolia staff team led by Mr. Lazaros Molho (APD).

2002 to provide for an orderly transition from the previous budget management arrangements to the PSMFL. A key objective of the PSMFL has been to help increase the accountability of budget managers by clarifying their roles and responsibilities in financial management.

- The PSMFL has redefined intergovernmental financial relations, primarily by centralizing allocations to national programs, particularly health and education spending. The new arrangements have reduced the powers of local authorities, which are now defined in terms of output contracts with the central ministries.

- Nevertheless, further work is required to ensure that the PSMFL's provisions are effectively enforced, and to clearly delineate the roles and responsibilities of the executive branch, the Parliament and the Bank of Mongolia in the conduct of debt management operations. For example, in December 2003, the Mongolian government secured the writing off of 98 percent of its long-standing pre-1991 debt to Russia, and repaid the balance of US$250 million (20 percent of GDP) in cash through a foreign intermediary, while providing limited information about the precise terms of this settlement to Parliament and the public. The government borrowed the equivalent of US$137 million from the BOM to finance the debt settlement.

- The Central Bank Law (CBL) was amended in June 2003, and the safeguards framework for the BOM was tightened, to limit the scope for quasi-fiscal activities (QFAs). However, the BOM's role in financing the recent debt settlement operation with Russia has raised questions as to whether the existing checks and balances are adequate. The recently released audit report on the BOM's 2003 accounts has confirmed that the recent government borrowing breached the statutory limits on BOM credit to government. The audit report also identified at least two other breaches of the CBL, on account of higher-than-mandated transfers of profits to the budget, and the extension of Tog 18 billion (1¼ percent of GDP) of loans to private mining companies (a prohibited activity under the CBL).

- The scope for QFAs through public financial and nonfinancial institutions has been reduced. The Trade and Development Bank, Mongolia's largest state-owned commercial bank, was privatized in 2002, and the Agricultural Bank, which was nearly bankrupt following the banking system crisis of the late 1990s, was effectively restructured and privatized in 2003. In the energy sector, the Energy Authority was decentralized into a number of joint-stock companies with private participation, thereby limiting the potential for its use as a vehicle for the granting of implicit subsidies to energy consumers.

- Most former extra-budgetary funds have been integrated in the budget process, accounting, and reporting. All bank accounts of the special funds are now incorporated in a Treasury Single Account at the BOM. Further work is required to extend the coverage of the TSA to all foreign donor grant-funded activities.

- Improved collection and tax-sharing arrangements have reduced the interference of local authorities into the operations of the tax administration. The information on the tax rules and regulations to the taxpayers has substantially improved. However, there still are occasions of revenue authorities calling on public enterprises and private business entities to pay taxes based on "revenue plans" rather than tax returns and assessments based on the tax laws.

Public availability of information

The original ROSC suggested that the public debt registry be improved and information on public debt be published. The ROSC also recommended that the budget should contain statements on contingent liabilities, tax expenditures and quasi-fiscal activities.

- The secrecy with which a major debt settlement operation between Mongolia and Russia was carried out in December 2003 has raised questions about the transparency and accountability in the overall use of public funds. A detailed report about the main components of this settlement, and about the implications for the budget and Mongolia's public debt, has yet to be provided to Parliament and to the public.

- Beginning in 2003, in accordance with the provisions of the PSMFL, a rolling three-year Budget Framework statement has been produced and submitted to the Parliament each year, and budget documents submitted to the Parliament have been improved in quality. However, as indicated above, information about the far-reaching late-2003 debt settlement operation with Russia was absent from the 2004 Budget and the draft Budget Framework Statement for 2005. The first official acknowledgement of this settlement's impact on the public finances was presented with the 2004 Amended Budget in September 2004. In addition, budget documents still do not include updated projections on current-year estimated outturns, which would be needed to make meaningful comparisons with original budget targets, and with targeted revenues and proposed appropriations for the future years.

- The Treasury's monthly reports and selected pages of the Fiscal Financial Report are sent to the National Statistics Office (NSO), for publication in its Monthly Bulletin of Statistics. However, the tables published in the monthly bulletin exclude any data on the government's overall balance and its financing. A concise introductory brochure for the 2004 Budget was published and disseminated with assistance from UNDP.

- A new debt management information system (DMFAS) has been introduced with the assistance of UNCTAD, improving data reporting on debt and facilitating assessment of debt sustainability. Overall, the authorities are able to produce timely and reliable debt data. The data on the size and composition of public debt, and other financial assets and liabilities of the general government have not been published yet.

- The tax authorities compile data on tax expenditures on VAT and CIT and provide these data to the Ministry of Finance and Economy (MOFE), the Cabinet, and the

Parliament. Although required by the PSMFL, information on contingent liabilities and risks has not yet been produced and provided to the parliament.

Open budget preparation, execution, and reporting

The original ROSC noted Mongolia's weak and poorly defined accounting discipline, pointed to the need for an integrated and automated treasury accounting system, and recommended the introduction of a system for reporting on budget payment arrears.

- There has been substantial improvement in the preparation of fiscal and financial information regarding government operations. Cash statements based on GFSM1986 were prepared for the general government for FY2001 and FY2002. Accounts for the general government, based on the GFSM2001 methodology, have also been produced for FY 2002, with the help of FAD's long-term treasury advisor to the MOFE, and the accounts for FY2003 were finalized with the help of a STA mission in August 2004. However, MOFE still needs to build up further its own capacity to sustain the production of fiscal accounts based on GFSM2001 methodology.

- A TSA has been established and its coverage has been progressively extended. As of end-2003, most of government bank balances had been consolidated in a treasury-controlled account in the BOM. While some foreign donor-sponsored extra-budgetary funds and loan- or grant-financed project management units still maintain accounts outside the TSA, this is due primarily to an unwillingness on the part of the respective donors to allow their funds to be moved into the TSA.

- The capacity of the Treasury has improved through the setting up of local treasury offices to cover all operations of the state and local budgets. This has enabled the Treasury to coordinate cash management, tighten expenditure controls, and improve the quality of fiscal reports through better procedures for reconciling cash balances with above-the-line transactions.

- Implementation of a Government Financial Management Information System (GFMIS) in the period ahead, with assistance under a World Bank-financed project, should allow further improvement of accounting and reporting. The Treasury is also in the process of implementing a system of commitment controls, which would initially focus on large commitments, but is to be extended to allow comprehensive registration of all purchase orders and supply contracts when the new GFMIS is in place.

Assurances of integrity

The original ROSC noted that a lack of reliable data had led to unrealistic budgeting in recent years. Partly as a result, expenditure control mechanisms had not been adequate to ensure that spending is restrained within budget targets, and there had been a growing accumulation of payments arrears.

- The realism of budget estimates has improved, but further improvements in the quality and coverage of revenue and expenditure projections, and in enforcement mechanisms, would be required to establish more effective budget discipline. Own revenues of budget entities are systematically underestimated, with budget entities normally allowed to use excess revenues to finance unbudgeted expenditures, at their discretion. In addition, the government has in recent years initiated a number of new investment projects outside the budget process, and was able to implement and finance them without a need for an amended budget, by making recourse to the use of unbudgeted privatization receipts and other excess revenues. In October 2003, the authorities adopted a new regulation that enables budget entities to spend excess revenue only after receiving authorization from the related line ministry and the MOFE. Another regulation adopted in October 2003 introduced a requirement of treasury authorization for commitments that require competitive tenders and for purchases by budget entities that accumulate arrears. However, it remains to be seen how these regulations can be effectively enforced.

- Reconciliation of accounts and compilation of reliable fiscal reports has improved, in part as a consequence of the implementation of the TSA. The authorities produce monthly fiscal data, and the quality of data on corporate income tax receipts, budget entities' own revenues, and privatization receipts has improved significantly. Nevertheless, year-end budget estimates are still subject to substantial revision following the end of the fiscal year; in FY2003 capital expenditures and expenditures on goods and services were revised up overall by 1.1 percent of GDP. The remaining differences between preliminary and final data still limit the usefulness of the monthly reports.

- Government arrears have been substantially reduced since 2001. Monthly reports are now compiled to consolidate the amounts of payables and receivables of budget entities, which allow close monitoring of the level of payables.

C. IMF Staff Commentary

2. Good progress has been made in implementing recommendations of the 2001 ROSC, particularly in integrating most extra budgetary funds with the budget, improving information on public debt, and improving the realism of budget estimates. However, to consolidate these efforts, further work is required to address the new concerns that have emerged in connection with the recent debt settlement operation with Russia, and improve transparency in other areas identified as weaknesses in the original assessment.

3. The following areas are suggested as priorities for attention in the short to medium term:

- Adopt amendments to the Public Sector Management and Finance Law to: (i) establish effective arrangements to ensure adequate budget discipline and accountability of budget managers, including penalties for violating budget authority; (ii) prohibit capital spending on new investments outside the budgetary process; (iii) establish regular publication of comprehensive government fiscal and financial information according to forward release calendars; and (iv) introduce a regular budget review process in the MOFE and the Cabinet, and a mid-year review process in the Parliament.

- Carry out a diagnostic study of the sources and uses of own revenues of budget entities. The current segregation of budget and "own revenues" of budget entities reduces the accountability and the ability to include all sources of funding when prioritizing the government's expenditure programs. The expenditures of the budget entities financed from "own revenues", and, in particular, the capital expenditures of the customs administration, which has been a major source of such excess expenditures, need to be fully examined and audited.

- Conduct an assessment of the reasons for the remaining differences between preliminary and final fiscal data, and use the results of the assessment to improve the reliability of the data in the monthly reports. Make the necessary changes in the corresponding monthly data by using the semi-annual reports and the annual report.

- Prepare a comprehensive report on all the legal, procedural, economic and financial elements of the recent debt settlement operation with Russia for presentation to Parliament, with appropriate references to relevant sections of the PSMFL, Central Bank Law and other applicable laws and disseminate this report to the public as soon as possible.

- Take any necessary steps to further separate the roles of the government and other public entities to avoid the emergence of new QFAs and prevent misappropriation of public funds, including by amending relevant laws and/or taking steps to ensure their proper enforcement. Effective implementation of the oversight role of the Supervisory Board of the BOM will be especially important in this regard. In particular, the Board should conduct a review of all elements of BOM's involvement in the debt settlement operation with Russia in late 2003 and prepare a written assessment of the legality and propriety of related transactions for submission to Parliament.

- Remove inconsistencies between the State Property Law and the PSMFL so as to allow the use of privatization proceeds for debt reduction

- Improve publication and public dissemination of budget documents. The documents submitted to the Parliament should provide detail on the basis of macroeconomic forecasts, as well as fiscal and government finance data. Comprehensive data on the actual financial performance, including the size and composition of public debt and other financial assets and liabilities of the general government should be included. In addition, annexes should provide detailed data on the financial performance of public enterprises, statements on tax expenditures, and quasi-fiscal operations. The full budget documents should be made freely available to the public—and user-friendly summaries should be regularly published.

- Include the foreign grants given to the government entities (in cash or kind) in the budget estimates as completely as possible, and in the budget reports in full amount. Particular attention should be paid to improving transparency of treatment of commodity grants that foreign donors have provided through the agriculture funds.

- Determine the legal status of the remaining self-financed government agencies according to the requirements of the PSMFL and incorporate their accounts into the budget or treat them as public enterprises as appropriate.

- Complete the transfer of all government bank accounts to the TSA at the BOM, including by identifying and seeking to remove remaining constraints imposed by donors on the transfer of their project accounts to TSA.

- Design and approve a single chart of accounts consistent with the GFSM2001 classifications to support the registration of transactions in the GFMIS.

A number of other measures will require continuing attention over the medium to longer term:

- Develop a comprehensive and clearly prioritized public investment program to establish clear directions for capital investment and take account of the current cost of completed projects and their overall macroeconomic impact in the context of the medium-term budget framework.

- Ensure that the social insurance authorities disclose future social security obligations and that these obligations are assessed in line with international standards and fully considered in medium- and long-term fiscal planning.

- Fully enforce the Public Sector Management and Finance Law to: (i) require budget entities to report all their assets and liabilities, revenues and expenses, and cash flows in their financial statements; (ii) require that all public sector entities and the MOFE attach notes to the consolidated government fiscal statements describing the methods of producing the reports and all departures from the International Public Sector Accounting Standards.

- Conduct an inventory of all government assets and ensure that the assets are properly placed under the custody of responsible government entities, recorded, and reported in periodic financial statements.