

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

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MONGOLIA

**Report on the Observance of Standards and Codes (ROSC)
Fiscal Transparency Module**

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November 6, 2001

EXECUTIVE SUMMARY

This report provides an assessment of fiscal transparency practices in Mongolia in relation to the requirements of the IMF *Code of Good Practices on Fiscal Transparency* based on the authorities' response to the IMF fiscal transparency questionnaire and other documents provided.

Mongolia has made a number of efforts in recent years to introduce modern management techniques to government, but it does not at present meet a number of key practices recommended in the fiscal transparency code. The present government, however, has recognized these weaknesses and is undertaking a program of reform that should result in significant improvements in transparency in the near future.

There have been some noteworthy achievements in improving transparency: Mongolia has established a comprehensive system of reporting on public ownership of, and participation in economic entities. A considerable amount of work has also been done to establish performance measurement in government agencies. Against this, however, deficiencies in reporting and compiling government accounts have become apparent; fiscal data is not comprehensively reported or made widely available to the public, and the budget documents do not encompass all fiscal activities promoted by government. The government has, however, recognized the need to strengthen its compilation and reconciliation procedures for annual reporting and to improve its accounting and internal control mechanisms for managing budget execution.

The staff have suggested a number of measures that could be taken to improve fiscal transparency in Mongolia in the immediate future and over the longer term. For the immediate future, in addition to the measures to improve reporting, a greater emphasis should be given to wide dissemination of fiscal data by providing more detailed budget documents, including a statement on government contingent liabilities and initiation of work on tax expenditures. Sustained efforts are needed to define the role of the state clearly and to separate commercial and noncommercial operations of the public sector. Analytical efforts should be directed at assessing the quasi-fiscal activities undertaken by state-owned enterprises, and the fiscal risks arising from this sector. Continuing efforts are also needed to strengthen internal and external audit. Intergovernmental relationships need to be more clearly defined, and a more transparent system of transfers needs to be put in place.

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ABBREVIATIONS AND ACRONYMS

BOM	Bank of Mongolia
GDDS	General Data Dissemination System (IMF)
GDNT	General Department for National Taxation
GFS	Government Finance Statistics
INTOSAI	International Organization of Supreme Audit Institutions
MIAT	Mongolian International Air Transport
MOFE	Ministry of Finance and Economy
NFPE	Nonfinancial Public Enterprise
NIC	Neft Import Concern
NSO	National Statistics Office
PFI	Public Financial Institution
PSMFL	Public Sector Management and Finance Law (draft)
ROSC	Report on the Observance of Standards and Codes
SAIC	State Audit and Inspection Committee
SFSA	State Financial Supervisory Agency
SPC	State Property Committee

I. INTRODUCTION¹

1. This report provides an assessment of fiscal transparency practices in Mongolia against the requirements of the IMF *Code of Good Practices on Fiscal Transparency*. The assessment has two parts. The first part is a description of practice, prepared by the IMF staff on the basis of the questionnaire response and additional information provided by the authorities. The second part is an IMF staff commentary on fiscal transparency in Mongolia.

II. DESCRIPTION OF PRACTICE

A. Clarity of Roles and Responsibilities

2. **General government is defined in law broadly in line with international practice, but the responsibilities of government agencies need to be clarified.** Constitutionally, Mongolia is a unitary state and the *Budget Law of Mongolia* of 1992 (as amended) defines the government sector to include all units of the central, aimag, and city, soum governments and special budget funds. Implementation of 1996 amendments to the *Law on Government* of 1993 has streamlined government into policy ministries and executive agencies responsible for implementing policy.² These latter operate under corporate rather than civil service law, and further clarity is required regarding the range of activities undertaken and reporting responsibilities to the Ministry of Finance and Economy (MOFE). Among the immediate consequences of this separation have been added difficulties in establishing uniform standards for procurement, civil service practices and employment, and management of public sector financial assets. A draft Public Sector Management and Finance Law (PSMFL), which defines the roles and relationships of the range of entities within the public sector, has passed the first reading stage in the National Great Hural (parliament).

3. **Government's extensive participation in the financial and nonfinancial sectors of the economy is comprehensively reported, and there is an active privatization program.** The State Property Committee (SPC) receives reports from all state-owned enterprises and enterprises with government equity and compiles a consolidated balance sheet and income statement each year. The consolidated report gives details of assets, liabilities, and net worth

¹ This report was prepared during a technical assistance mission in March 2001 by a team consisting of Mr. William Allan (Head) and Mr. Vincent Moissinac of FAD. Contributions were also made by Mr. David Pritchett and members of the Asian and Pacific Department team led by Mr. Lazaros Molho. Earlier draft material was prepared by Ms. Catriona Purfield.

² In 2000, there were 13 ministries and 49 executive agencies, of which 17 were regulatory and 32 implementing agencies (as per *State Information* 2000 No. 34 (171)).

of the economic entities.³ The SPC produces and publishes these data within three months of year-end in an annual document summarizing financial indicators of the state-owned sector *Production, Finance, and Economic Indicators of Economic Entities of State Property or with State Participation*. This document is publicly available, but not widely disseminated. The SPC is responsible for implementing the government's program of privatization under clear public guidelines, which require the government to report on progress to the Economic Standing Committee of parliament. Under the guidelines, the annual privatization program is approved by government decree and published.⁴ Because of the extent of public involvement, regulation of the private sector has not been a major issue. Concerns with private enterprises are being addressed through the development of a legal framework aimed at promoting investment and competition.⁵

4. Quasi-fiscal activities by both Public Financial Institutions (PFIs) and Nonfinancial Public Enterprises (NFPEs) are extensive. State-owned commercial banks undertake policy lending, directed lending to other public enterprises,⁶ and perform services to the government without clear and adequate budget support. The banking system has, in the past, made directed loans to public enterprises under government guarantee. These activities contributed to subsequent difficulties in the banking sector and, in turn, to disputes with the Bank of Mongolia (BOM) regarding claims on government, following the 1999 bank restructuring. Noncommercial operations of policy banks are extensive and the implications are not described in the budget documents. The Agricultural Bank and other banks have also operated the government payments system without adequate or regular reimbursement. Payment contracts between the government and the commercial banks establishing fees and service obligations have been drawn up—although payment of transactions fees has been irregular.

5. NFPE quasi-fiscal activity is particularly significant in the energy sector, but reforms are being initiated. While the government is now committed to reforms, the Energy Authority provides a prominent example of fiscal activities being shifted to the enterprise sector without explicit budget support and the consequent emergence of financial and fiscal pressures. Heating and electricity for urban areas are supplied through a predominantly coal-based central energy system. However, owing to the problems at local coal mines, imported petroleum inputs have become increasingly important. Electricity tariffs

³ Total ownership equity in 1999 is presented as TGR 663 billion (around 72 percent of GDP), and in 2000, TGR 682 billion (around 61 percent of GDP); a detailed listing by company, showing percentage ownership and economic sector is given. It is intended that the report on FY 2000 be available in English. Currently, only some elements of the tables are in English.

⁴ The *Privatization Program for 2001*, available in English, highlights key proposed sales (70 percent of shares in the Trade and Development Bank, 70 percent of Gobi JSC).

⁵ A revised *Law Prohibiting Unfair Competition* of May 2000 represents a step in this direction.

⁶ However, the state-owned banks are increasingly adopting commercial lending practices, and it has become more difficult for loss-making public enterprises to obtain loans.

are determined by the government and had been unchanged for a number of years despite inflation and the recent hikes in oil prices. The Energy Authority also operates the isolated energy system in rural areas that generates power through individual diesel-powered generators. Although the costs of production is some four to five times that in Ulaanbaatar, the Energy Authority charges a lower price to aimags (provinces) not on the central grid—and, in fact, covers the diesel costs of rural aimags—involving an annual loss estimated at around US\$6 million per annum currently. Accumulated losses of the energy sector in the two years prior to November 2000 have been estimated at around US\$25 million. The need for reform is recognized, and the government is undertaking a package of reforms supported by a World Bank loan. The reforms involve tariff increases⁷ aimed at least maintaining financial balance, investment to improve efficiency of generation and distribution, and phasing out of subsidies by the Energy Authority. Problems of quasi-fiscal activities are also important in other sectors.⁸ In most cases, privatization and phasing out of subsidies is seen as the appropriate solution.

6. The central bank has legal independence, but has undertaken quasi-fiscal activity, and further clarification of its role vis-à-vis government is required. The operational independence of the BOM in the areas of monetary and exchange rate policy is enshrined in the *Law of Mongolia on the Central Bank* (1996, as amended up to July 1999). In general, the BOM operates according to the provisions of the law and memoranda of understanding with the government, and it acts independently. However, some disputes have arisen because certain provisions or protocols were ambiguous or not enforced. For example, it used to be unclear whether bank restructuring bonds should be subject to the legal limit over temporary credit for government activities.⁹ The agreed interest payment mechanism for government bonds held by the BOM failed, owing to lack of funds in the government accounts. Most of these problems have been resolved by the current government, but attention will be required to see that these arrangements are sustained. In particular, the ownership by the government of IMF purchases, which has been a continuing source of dispute with the BOM, has been clearly established. The BOM has issued guarantees to

⁷ Administered coal, electricity, and heating tariffs were raised by 15 percent, 15 percent, and 35 percent, respectively, in December 2000.

⁸ Similar problems are associated with the provision of petroleum products at subsidized prices to rural areas by the Neft Import Concern (NIC), the provision of coal for power-generation by state-owned mincs at less than cost, below-cost pricing by Mongolian International Air Transport (MIAT) on domestic flights, and the pricing of urban public transport services.

⁹ Under Article 18 of the central bank law, the amount of temporary credit for government activities is limited to 10 percent of the average revenues over the previous three years. Independently, a 1995 amendment to the Budget Law allows deficits that arise in the quarterly implementation of the budget to be financed by BOM borrowing if it is repaid within the year (Article 13). No reference is made to the ceiling. The current government and central bank have agreed that bank restructuring bonds were not included in the ceiling on government credit because these bonds have long-term maturities.

enterprises under instruction from the government.¹⁰ The fiscal impact of these guarantees is a reduction of profits from the BOM when such guarantees are invoked. In recent years, the provisions made by the BOM for contingent claims arising from guarantees that it had granted on behalf of the government in the early 1990s essentially eliminated its profits. The largest of these contingent claims was recently moved to the government—concurrently with the transfer of the BOM’s reserve provisions for this liability. The relative roles of the BOM and the government could be more clearly defined and explained in the budget documents so that the full fiscal implications of such activities could be assessed.

7. Fiscal roles of the executive, legislative, and judicial branches are clearly defined by the constitution and budget law. General powers of the branches of government are defined in the constitution. Specific fiscal powers are defined in the Budget Law. Parliament has the power to approve the state’s financial, economic, credit, monetary, tax and social programs, and call for reports on budget implementation (Article 25.7 of the constitution). The government is responsible for the management of the state and for the forwarding of proposals, including the budget, to parliament for approval. Under the Budget Law, only the central government or the governors of aimags, soums (municipalities), cities, or districts can submit budgets (Article 5.2.1) or supplementary proposals (Article 5.2.6) during the budget year to parliament or their respective local governor. The judiciary is independent under the constitution (Articles 47 and 49) and plays no significant fiscal role.

8. The allocation of responsibilities between different levels and intergovernmental fiscal relationships need further definition. As noted, Mongolia is constitutionally a unitary state, but elected assemblies (hurals) exercise self-government powers at the aimag and soum level. The constitution gives subnational levels of government power to take independent decisions on social and economic matters affecting the jurisdiction (Article 62 (1)). Under the *Law on the Administrative and Territorial Units of Mongolia* (of 1992, as amended), the local governments have full authority over the local budgets.¹¹ These powers, though exercised in practice, are limited by real fiscal authority at the local level. The 22¹² aimags and soums have significant public responsibilities, but these are not matched by stable sources of revenue. In 1999, about one-third of general government expenditure¹³ and

¹⁰ The BOM has recently facilitated foreign borrowing for export prefinancing by domestic gold mining companies by offering guarantees to the foreign lending institution, and it also conducts off-balance sheet hedging operations, some of which may have quasi-fiscal implications. The latter operations could be more closely examined in the context of monetary and banking ROSC modules in due course.

¹¹ The city of Ulaanbaatar has a special status under the *Law on the Legal Status of the Capital City* of June 1994 whereby, among other things, it can levy certain taxes, is allowed to accumulate resources in a development fund, and the governor can attend cabinet meetings and has direct access to the Prime Minister for policy coordination purposes.

¹² Including Ulaanbaatar city.

¹³ If foreign-financed expenditures are excluded, the lower levels of government account for 40 percent of total state expenditure.

about a quarter of budget revenue were accounted for by revenues assigned to the lower levels of government. The main exclusive responsibilities of the central government are for defense, foreign policy, and justice; all other functions are shared with subnational tiers. In practice, the allocation of budget appropriations among the various levels of government is determined by negotiation through the budget process, with the MOFE allocating directly to central budget entities and aimags (around 250 units in total). On the revenue side, revenues are allocated between central and aimag jurisdictions by negotiation (governed in part by entity size), which in turn has led to disputes.¹⁴

9. Fiscal management is defined in law, but accountability and transparency provisions need further development. The Budget Law provides the legal framework for fiscal management. It is generally founded on sound fiscal management principles, with authority and accountability for revenue collection and expenditure defined, as are broad reporting requirements. However, there are a number of ambiguities and omissions, requirements for disclosure of information in reports are absent. There are compliance problems—arising in part from ambiguity of the law with respect to government authority over bank accounts. The Budget Law defines the revenue and expenditures at the disposal of each level of government and allocates supervisory powers over expenditures to the central government (Article 17.8). Further clarification of the authority over bank accounts is of immediate practical importance, since the present general definition (Article 17.2) provides scope for opening off-budget accounts that reduce the transparency of entity operations. The government is now addressing these problems by limiting the number of bank accounts to two for all government agencies and instituting a treasury single account, which should cover most of the central government and Ulaanbaatar City by the end of June 2002. Another aspect that reduces transparency of budget operations to parliament is the power of budget governors to increase expenditures (with the exception of salaries, administration, and defense) if additional revenue becomes available in the budget implementation process (Article 15.5). While reports are required at specified times under the law, nothing is said regarding the content of the reports. Guarantees may be issued only under the authority of the Minister of Finance (Article 14.2), but there is no requirement to report on contingent liabilities arising from issuance of guarantees.

10. Mechanisms for the coordination and management of extrabudgetary activities are not clear, but a survey is underway. A variety of special fund arrangements are described as extrabudgetary funds, but no complete listing is available. Following a government resolution in 1998, 13 special funds shifted their accounts to the BOM in line with the government's wish to improve coordination and management of these funds. Special funds that operate under separate laws with earmarked revenues, include five social security funds—pension, disability, sickness, unemployment, and work benefit. Management of the social security funds is relatively clear, and they are included in budget formulation and annual reporting. Privatization receipts are paid by the SPC directly into the central treasury

¹⁴ For example, Ulaanbaatar City has withheld revenues collected from entities recently reassigned to the central budget.

account after deducting expenses (which are appropriated in the budget). Other extrabudgetary funds involving donor financing are not reported to the Treasury and are being surveyed by the Treasury Department, with the aim of including them in regular budget reporting. The State Audit and Inspection Committee (SAIC) conducted an audit of a number of funds in 2000. Some irregularities in use of funds have been noted.

11. The constitution and general tax law provide a legal basis for all taxes, but there is substantial scope for discretion. The Mongolian constitution (Article 27.5) gives parliament the power to enact laws with respect to taxation. The *General Tax Law (1993)* defines the scope of parliament's taxation powers, the rights and obligations of taxpayers, and the legal framework for the General Department for National Taxation (GDNT). However, administrative discretion in applying these laws is substantial, and GDNT's ability to enforce the law is weak.¹⁵ Case-by-case negotiation of tax liabilities between officials and taxpayers is commonplace. There are no published procedures governing the settlement of tax cases, the establishment of installment payment schedules, or the writing off of uncollectible amounts. While the tax administration has powers of investigation and seizure (Article 24), it experiences serious enforcement problems owing to lack of resources and support from the judicial system. The Director General of the GDNT has no specific legal protection from political interference, but has the right to appoint the directors of Ulaanbaatar and aimag tax offices.

12. Taxpayers rights are defined in law, but practical implementation is limited. Taxpayer rights are clearly defined under the *General Tax Law (1993)*, but their application is limited by the capacity of the tax administration and the judiciary. Taxpayer audits are not conducted on a systematic basis, and information from these audits is only available to taxpayer with some lag. In addition, VAT refunds are often delayed or denied. The court appeals process is cumbersome and seldom used.

13. Ethical behavior of civil servants is covered in law. The *Law on Government Service* of 1995, as amended, governs ethical standards of behavior of public servants, including staff of executive agencies. The law is broadly compliant with the international code of conduct for public officials, and requires, among other things, a declaration of extent of property and income and any changes. Parliament is considering new laws concerning ethical behavior of civil servants and politicians.

B. Public Availability of Information

14. The budget documents provide a comprehensive but summary coverage of fiscal activity. In line with fiscal transparency code requirements, the government presents an annual central budget to parliament, along with forecasts for the following three years. The

¹⁵ For instance, serious difficulties were experienced in enforcing the derivation rule prevailing for sharing domestic VAT receipts between central and local government, resulting in substantial arrears in payment from local to central government in 2000. Decentralization of the VAT in 2001 has, in effect, transformed the tax into a cascading sales tax in all aimags.

government also presents a summary of the consolidated fiscal position of the general government that arises from the central budget proposal. A comparison of projected fiscal outcome for the preceding year is also given, but actual outcomes from final accounts for the budget two years previously is not shown. Defense spending is included in the budget and annual accounts, but detailed transactions are not available.

15. The budget contains no statements on contingent liabilities, tax expenditures, or quasi-fiscal activities. As indicated above, the Budget Law does not require reporting on contingent liabilities. In turn, internal records on such liabilities are not maintained systematically and policies on government guarantees remain unclear.¹⁶ Tax expenditures, such as those under the foreign investment law and the VAT, are not described in the budget documents and no estimates are made of the revenue cost of these incentives. No statement of the nature, policy justification, or significance of quasi-fiscal activities is included into the budget documents.

16. Information on the level and composition of public debt is not published, and the registry is not fully established. Debt records are being improved and a computerized debt management system is being established, but there are a number of difficulties, particularly for foreign debt reporting. The domestic debt register is well maintained, but recording of domestic liabilities to the BOM with respect to IMF purchases needs to be properly included in government credit.¹⁷ The MOFE and the BOM have recently required that their respective foreign debt registers be reconciled on a quarterly basis. However, the MOFE continues to rely on postal confirmation of disbursements by donors to record transactions and update the register, and the MOFE and BOM registers often produce different data for the same loan tracked. The debt stock is not broken down by maturity. The MOFE does not maintain a register of grants, and less than 10 percent of total grants are recorded in the state budget. No reporting system has been put in place to measure the level and nature of grants received (but in-kind grants are recorded systematically by the customs administration).

17. Debt policy and management roles require further clarification. The functions of mobilizing and coordinating foreign loan and grant assistance, and managing and tracking use of resources are not well coordinated nor well integrated into MOFE budget management. One consequence is that projections of foreign loan disbursements have proved to be unreliable. Lack of coordination has also contributed to the weakness in the debt and aid registry and management. In particular, the process authorizing foreign project loans has not been constrained by debt sustainability considerations, nor has it been based on clearly defined screening principles.

¹⁶ For instance, clarification of implicit liabilities created by a recent protocol agreement between the governments of China and Mongolia allowing for future Chinese loans to a Mongolian-Chinese joint-venture.

¹⁷ Confusion in the treatment of IMF purchases in domestic liabilities may have originally arisen from the fact that the MOFE is the fiscal agent for the IMF.

18. **Information on financial assets is maintained systematically and published.** As noted, the SPC maintains data on balance sheets of all enterprises with state ownership or participation. This information is published annually, but is not integrated with the budget.¹⁸ Furthermore, the MOFE has recently established a unit to monitor repayments for on-lent loans from foreign borrowing.

19. **Commitments to publish fiscal data do not yet meet international standards.** The only formal commitment to reporting is that contained in the Budget Law. As noted in the data dissemination ROSC, fiscal data dissemination standards do not yet fully meet General Data Dissemination System (GDDS) recommendations, principally in terms of coverage and analytical detail. The government prepares half-yearly and annual reports on central budget implementation, and the annual report is discussed in the spring session of parliament. The MOFE does not publish a monthly report, but monthly fiscal data is published in the monthly statistical bulletin of the National Statistics Office (NSO). No advance data release calendars are available.

C. Open Budget Preparation, Execution, and Reporting

20. **The budget documentation meets some requirements of the code, but is insufficiently detailed and the methodology needs clarification.** Summaries of economic prospects and statements of annual fiscal policy objectives are included in the budget documents. More detailed estimates are available to parliament, and these estimates have the force of law (in terms of authority to spend against items identified in the estimates), but they are not widely disseminated to the public. The capacity for macroeconomic planning is limited and dependent on external advice. The annual budget is cast in an aggregate medium-term framework (three-year projection) and the macroeconomic assumptions on which the budget is based are given in broad terms. However, the medium-term budget projections represent an extrapolation of current budget trends and specific fiscal objectives are not set. The budget does not clearly distinguish between the impact of new and existing policies. For example, the 2000 budget contained no statement on the cost of the civil servant wage increase or its implications for future budgets. Capital and recurrent budget planning are not yet clearly articulated in the medium-term budget framework, which also does not provide domestic and foreign debt projections. The budget contains no statement of fiscal risks.

21. **The budget classification is broadly consistent with Government Finance Statistics (GFS) principles, and the general government deficit summarizes the government's financial position on a cash basis.** The chart of government accounts has been revised to remedy areas where the accounts confuse some economic and functional classifications and some discrepancies with regard to consolidation are being amended to conform to GFS 86 standards of analytical presentation. A new chart of accounts, designed to meet revised GFS standards and, eventually, accrual basis accounting, has been agreed and is

¹⁸ The proposed PSMFL will establish a legal requirement for all enterprises to report, with the implication that the MOFE would prepare a consolidated financial statement including such assets.

being tested on a pilot basis. It is envisaged that the 2002 budget will be prepared on this basis and an integrated accounting system will be adopted throughout government. The overall deficit of the central and general government is the only indicator of the government's financial position although operational and primary balances can be easily calculated from the data. However, grants and privatization receipts are placed above the line, which masks the true extent of the deficit. The absence of a published administrative budget makes it difficult to trace administrative accountability for the collection and use of public funds. The broad public sector balance is not estimated.

22. **Accounting discipline has been weak and poorly defined.** The head of the Treasury has, in principle, the sole authority to issue government payment orders. However, in practice, this function has not been under strong central control. The government plans to establish financial discipline through the creation of an accounting cadre that serves all levels of government. First steps toward this goal have been taken by incorporating a provision in the Budget Law to appoint chief accountants in consultation with budget governors and establishing the payment and accounting responsibilities of all chief accountants to the State Secretary of Finance.

23. **The government accounting system is not yet integrated and effective reconciliation processes need to be established.** The Treasury was created within the MOFE relatively recently, in part to separate payment and authorizing functions within the ministry, as well as to establish a coherent disciplined accounting system for all of government. A computerized treasury accounting system is being established, but progress on procurement of software has been slow and further action is needed to expedite this process. As noted, further work is needed to integrate foreign debt and aid transactions with the accounting system.

24. **A system for reporting on budget payment arrears and some tax arrears is being established.** Based on monthly reports by budget entities, which operate a form of accrual basis accounting, the Treasury has established a monthly report on arrears based on accounting data and showing the age profile of arrears. This will provide a vital measure of performance in reducing payment arrears. Tax arrears are estimated only for corporate income tax, VAT, and large taxpayers. A comprehensive system for reporting all tax arrears and GDNT arrears on tax credits, including the age profile of these arrears, is being set up.

25. **Procurement and employment laws are in place, but further capacity strengthening is required.** The *Public Procurement Law* of 2000 brings the procurement and tendering procedures for public goods and services into line with international standards. Partly as a result of separating agencies from civil service law, procurement had not been regulated uniformly in the past. Under the procurement law, all contracts valued above specified ceilings will be open to competitive bidding from domestic and foreign contractors, and the conditions for the selection and award of contracts are specified. A small procurement unit has been established in the MOFE and, with continuing help from the AsDB, is to be further strengthened and established as a division reporting directly to the Secretary of State. Substantial training and monitoring is required to establish disciplined

uniform procurement procedures. The *Law on Government Service* requires vacancies in the civil service to be filled through competition and candidates must have specific selection criteria.

26. **Internal control procedures are in place, but the role of internal audit needs to be clarified and technical capacity is weak.** Currently, the State Financial Supervisory Agency (SFSA) carries out audit/inspection of budget entities and state enterprises over a two-year cycle. The SFSA does not follow a risk-based approach in selecting budgetary entities to be audited. Inspections focus solely on noncompliance with financial regulations, but sanctions against noncompliance with the budget law do not appear to be vigorously applied. The SFSA reports to a council of MOFE and SFSA members. These reports are provided to the external auditor, the SAIC on request only. The SFSA also has the anomalous function of supervision of insurance.

D. Assurances of Integrity

27. **Budget data have not been a reliable guide to actual outturns.** Budgets have not been realistic in recent years and control mechanisms are not adequate to ensure that spending is reduced to available resources.¹⁹ Consequently, unbudgeted demands lead to requirements for supplementary appropriation, and, at the same time, budget entities respond to original budget authority rather than the cash allocation provided by the Treasury. The result has been both that budget expenditure outcome has exceeded original appropriation and there have been significant and growing arrears.²⁰ In 2001, however, the government took steps to improve the realism of the budget estimates by undertaking a mid-year review, with a specific aim of ensuring realistic coverage of obligations.

28. **Statements of accounting policy are not included in the budget and final accounts documents.** However, it is the intention under the PSMFL to make it mandatory for the government and its agencies to incorporate statements of accounting policy in their annual financial statements. A considerable amount of technical work has been done in this regard, so, irrespective of the legal framework, it should be possible for the government to produce such statements in the near future.

29. **The processes of accounts reconciliation and fiscal reporting are now being reformed.** While reconciliation with bank accounts is apparently effective at budget entity level, aggregate level reconciliation had not been carried out effectively prior to reforms

¹⁹ Expenditure in some cases has exceeded legal authority. The *Annual Report* for 1999 of the SAIC cites several instances of expenditure exceeding authority, and also notes instances of procurement of fixed assets from recurrent budget allocations.

²⁰ Total cash expenditure plus net lending has been only marginally above original appropriation for 1998 and 1999, and estimated at 4 percent less in 2000, but this has been achieved by sharp reductions in capital spending and accumulation of arrears. In all years recurrent spending has exceeded original appropriation.

introduced in 2001. Procedures have now been designed to carry out regular reconciliations and provide assurance of accounting data quality, and these are being put in place. An inventory of bank accounts for the whole public sector, including state-owned enterprises, has been completed, and the monitoring of bank account arrangements has been reinforced by creating special registers and instituting annual inventories and stricter standards of reporting.

30. **External audit is carried out by the SAIC, which is legally independent of the executive and is developing its technical capacity.** The SAIC was created in 1995 and its operations and responsibilities are governed by the *State Audit Law* (1995, as amended). The Chairman and eight senior members of the SAIC are appointed by parliament.²¹ The SAIC is required to audit ministries, agencies, the capital city, and aimags and other subnational bodies. An Aimags Auditing Board operates under the SAIC to coordinate the work of the 22 Aimags Audit Committees that conduct external audit of financial operations of the aimags, other subnational bodies, and Ulaanbaatar City. As of March 2001, the SAIC had 33 staff and plans to increase staffing to around 45 in the near future. Around 150 staff work in aimag committees. The present work of the SAIC is wholly focused on financial compliance, but it is broadening its mandate and will be reorganized into five departments, some of which will take on more performance audit and financial statement audit as well as public sector ethics. International auditing standards are not yet observed fully, but national auditing standards are being developed based on International Organization of Supreme Audit Institutions (INTOSAI), US General Accounting Office, and German auditing standards. Development of SAIC standards and training is assisted by the German government. The SAIC reports annually to parliament on the government final accounts report and results of specific audits carried out throughout the year. The report includes a summary of follow-up actions taken by state entities as a result of audit comment.

31. **The basis for macroeconomic forecasts is not subject to external scrutiny.** Assumptions are described briefly in the budget and discussed with the IMF, but independent experts within the country are not involved in scrutiny of the forecasting methodology.

32. **The NSO is given legislative assurance of independence.**²² Legislative assurance for independence of the NSO is provided by the *Law on Statistics* of 1994 (as amended). As described in the data dissemination ROSC, the provisions of the law broadly conform to international standards.

²¹ The present criteria for membership of the SAIC, however, does not avoid potential conflicts of interest and these are being reviewed.

²² The independence of the NSO vis-à-vis the government allows for greater external scrutiny on the making of fiscal policy because it secures the integrity of all national statistics, including national accounts statistics. In the first half of 2001, the MOFE's disapproval of the NSO's preliminary national accounts estimates for 2000 and other expressions of discontent about the quality of NSO surveys led to proposals to make the NSO directly answerable to the Prime Minister. The IMF staff strongly recommends to maintain the legislative independence of the NSO, while the quality of the NSO's data is being improved through further technical assistance projects.

III. IMF STAFF COMMENTARY

33. **Despite recent progress, Mongolia does not yet fulfill a number of key requirements of the fiscal transparency code.** Mongolia has made a number of efforts in recent years to introduce modern fiscal management techniques to government. Early efforts to streamline government through creation of agencies have had mixed results and progress, until very recently, has been slow. The basis of a modern public sector management law is ready for further consideration by parliament, and a considerable amount of work has been done to establish performance measurement in government agencies. But, at the same time, the process of compiling and reconciling the accounts of government has some significant deficiencies, fiscal data is not comprehensively reported or made widely available to the public, and the budget does not encompass all fiscal activities promoted by government.

34. **There have been some notable achievements, and the government's commitment to reform should allow rapid improvements in many aspects of fiscal transparency.** As well as the progress made in fiscal legislation noted above, Mongolia has established a very comprehensive system of reporting on public ownership of, and participation in, economic entities. The annual report produced by the SPA is a concrete step toward establishing a comprehensive government balance sheet as well as an essential database to help guide the state privatization program. There is also a considerable amount of fiscal information within government that could be compiled more effectively for policy analysis, for the benefit of policymakers and managers within government, as well as to provide the legislature and public a clearer picture of the intentions and impact of fiscal policy. The strong commitment of the government to build an effective management system should, therefore, allow rapid progress toward meeting the basic requirements of fiscal transparency.

35. **A number of steps are being taken to address weaknesses and improve the availability and coverage of fiscal data.** The government has recognized the need to strengthen its compilation and reconciliation procedures for annual and quarterly fiscal reporting. It is undertaking a comprehensive survey of bank accounts of budget entities and extrabudgetary funds and proposes to integrate all entity off-budget accounts with the budget.

36. **The legal framework for fiscal control needs to be maintained.** Supporting action is needed to strengthen the Budget Law with respect to the definition of government bank accounts and to make more effective use of the accounting cadre and SFSA to ensure effective control and reporting on budget activity. These measures are necessary to improve internal information and allow reliable and timely reports to be made available to the legislature and the public. As the government gradually undertakes its planned shift to output-based budgeting, moreover, it is critical that amendments to the legal budget framework do not weaken financial discipline. Input controls must be retained until a realistic and disciplined budget framework and reliable output controls are firmly established, and legislative steps should be taken to retain essential elements of the present law and clarify the continuing responsibilities and accountability of officials at all levels of government for budget execution.

37. **A greater emphasis needs to be given to dissemination of fiscal data.** Mongolia does not have a well-established tradition of disseminating data widely. On the other hand, there appear to be few barriers to making data more widely available. There should also be considerable gains, in terms of internal governance and the perception of progress by the international community, from making fiscal data more accessible and easily understood. The following areas are suggested as priorities to improve fiscal transparency in the relatively near term.

- Develop more detailed budget documents giving details of budget estimates by sector, ministry, and budget entities under ministries, as well as by economic classification, and disseminate the budget documents more widely to the public.
- Establish a registry of contingent liabilities and develop a comprehensive statement on all such liabilities (and payments against invoked guarantees and other past contingent liabilities) in the annual budget and accounts reports.
- Prepare quarterly fiscal reports showing general government and the main subsectors of general government. Such reports, when an adequate technical standard has been achieved, should be made available to the public and shown on the MOFE website.
- Provide detailed data on the stock and composition of domestic and external public debt with the annual budget documents and quarterly fiscal reports.
- Strengthen the analytical capacity in the MOFE to make better use of the extensive data on public enterprises that is available. Analysis should be aimed at making better assessment of risks that arise from state-owned enterprise and could involve estimation of a broad public sector balance and detailed assessment of quasi-fiscal activities by the enterprise sector.
- Initiate systematic work by the GDNT to estimate revenue foregone through tax exemptions in the tax laws and make this information available within government, with a view to eventual regular reporting of this data with the annual budget.
- Develop MOFE capacity for macroeconomic analysis and fiscal forecasting, including analysis of sensitivity to change in macroeconomic parameters. The aim should be to publish a detailed statement of macroeconomic assumptions underlying the budget and forward estimates, and to make a clear statement of risks to the fiscal position from macroeconomic or other factors.

38. **Sustained effort is needed to further clarify government's role and to strengthen watchdog institutions.** Mongolia's transition to a market economy will take some time, and continuing effort is needed to define the role of the state clearly, both in relation to commercial activities carried out by public enterprises or the emerging private sector, and in terms of appropriate internal governance and fiscal arrangements. These activities will

achieve results only over the long term, but efforts must be made now to initiate the work and to make a commitment to continuous progress.

39. **Particular emphasis should be given to separating commercial operations clearly from government activity.** The Government of Mongolia has established the practice of using the balance sheet of the public sector as a whole to finance many social subsidies. This practice has been particularly prevalent in the energy sector, but is prevalent in many economic sectors. This practice is nontransparent and has the dual effect of understating the true extent of government fiscal activity and undermining commercial management in the sectors concerned. Privatization will provide a long-term solution, but in the meantime efforts should be made to identify such activities and establish more transparent ways of dealing with them. It is suggested that a survey of quasi-fiscal activity be undertaken by the MOFE and that the budget each year should make a statement on the noneconomic activities undertaken by public enterprises as a matter of public policy.

40. **Intergovernmental relationships need to be defined and streamlined.** As emphasized by a recent IMF mission, there is a need to reassign tax revenue assignments and design a more transparent and stable mechanism of transfer among local governments. It was suggested that an interministerial committee should be assigned this task.

41. **Audit mechanisms need to be strengthened.** Steps have been taken to improve procedures and fiscal discipline within government by creating an accounting cadre responsible for controlling the commitment payment process. These controls need to be supported by strong mechanisms of internal and external audit. A continuing program to develop the SAIC is underway with external support. Establishing a stronger internal audit should be given equal emphasis and sustained long-term support. In this context, it would be appropriate to separate the insurance supervision and internal audit functions of the SFSA and allow the former function to be undertaken by a specialist entity.