2020

Institutional and Structural Reforms for a Stronger and More Inclusive Recovery

WORLD BANK GROUP

Institutional and Structural Reforms for a Stronger and More Inclusive Recovery

Policy Note for Mongolia

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CONTENTS

ACRONYMS AND ABBREVIATIONS

AML-CFT - Anti-Money Laundering and Combating the Financing of Terrorism

AQR – asset quality review

BOM – Bank of Mongolia

CAR - Capital Adequacy Ratio

CSC – civil service council

CSO - civil society organization

DB – Doing Business

DTI – Debt-to-Income

EITI - Extractive Industries Transparency Initiative

FDI – foreign direct investment

FSL - Fiscal Stability Law

FTA – free trade agreement

GDP – gross domestic product

IAAC - Independent Authority Against Corruption

IMF – International Monetary Fund

IPS - Investment Policy Statement

LCR – local content requirement

LDF - Local Development Fund

LTV - Loan to Valuation

MCC - Mongolian Chamber of Commerce

MIAT – Mongolian Airlines

MNAO - Mongolian National Audit Office

MOF – Ministry of Finance

MTFP - Medium-Term Fiscal Plan

NDA – National Development Agency

NPL – non-performing loan

NSFR - Net stable funding ratio

OGP - Open Government Partnership

OT – Oyu Tolgoi

PIM - public investment management

PIP - Public Investment Plan

PPD - Public Private Dialogue

PPP – public-private partnership

RoE - Return to Equity

SCF - supply chain finance

SIRM - Systemic Investor Response Mechanism

SME – small and medium enterprise

SOE – state-owned enterprise

SWF - Sovereign Wealth Fund

TA – technical assistance

WEF – World Economic Forum

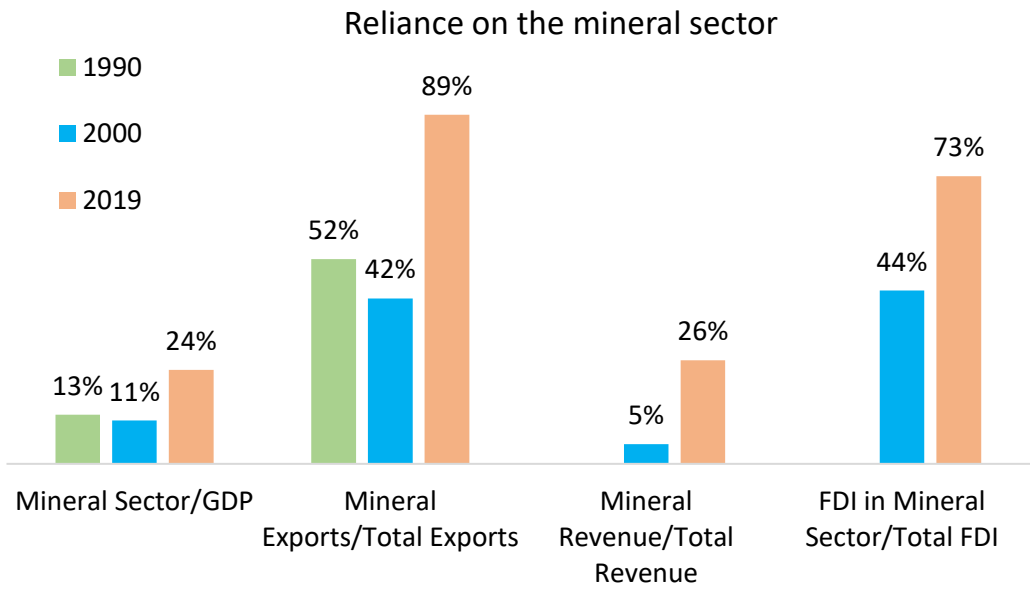
WOG - whole-of-government

1. BACKGROUND AND INTRODUCTION

The government is taking office at the time when Mongolia and the world is faced with an unprecedented public health and economic crisis. The global COVID-19 pandemic has embroiled the world economy in a sharp and sudden downturn. Major advanced and emerging economies are expected to move into a recession this year. Commodity prices have collapsed. Global trade is plummeting, and widespread travel restrictions have derailed tourism. While global financial markets have largely stabilized thanks to decisive action by major central banks, emerging markets have experienced substantial capital outflows and financing conditions remain tight amid heightened investor risk aversion, as evidenced in elevated yields for sovereign and corporate bonds in emerging markets. While there are signs of the pandemic abating in several countries, risks of second wave outbreaks and ensuing disruption to economic activity remain high. The global environment is expected to remain challenging, marked by slower growth and high uncertainty.

COVID-19 has exerted a significant shock on Mongolia's economy. Economic growth is expected to contract by 0.5-2.6 percent in 2020, 6-8 percentage points lower than the pre-COVID 19 projection and the first contraction since the global financial crisis in 2009. This will reflect a combination of low commodity prices, weak external demand, especially from China as well as the impact of containment measures to stem risks of a domestic outbreak. A recent survey by the Mongolian Chamber of Commerce (MCC) indicated that about 8,000 jobs have been lost since the COVID-19 outbreak — a trend that is likely to continue with detrimental social and poverty impacts. Inflation accelerated in the first quarter of 2020 and is likely to exceed the central bank target. External pressures are intensifying due to weaker export earnings, lower foreign investments, and tighter access to external liquidity, creating risks of an external balance of payment crisis. Fiscal gains of the past three years are being rapidly eroded by unprecedented revenue losses and buoyant public spending, reversing the recent downward trajectory in the government debt to GDP ratio. With weakening domestic demand, however, inflation decelerated in the first half of 2020 and is likely to remain under the central bank target. These challenges are compounded by the fact that Mongolia's policy buffers to absorb shocks are relatively limited with already sizable public and external debt, relatively thin capital buffers in the banking sector, and a precarious external position.

Mongolia has become more dependent on commodities



Source: NSO, MoF, BoM; World Bank staff estimates.

Beyond the current crisis, Mongolia's medium-term challenge is to move towards a more diversified and resilient economy. Over the past few years, Mongolia's economy has become increasingly dependent on export of commodities, especially coal and copper, which represent a quarter of Mongolia's GDP and close to 90 percent of Mongolia's export revenue. While growth of the mining sector has fueled very rapid GDP growth, it has exposed the economy to the volatility of global commodity demand and prices – with procyclical macroeconomic policies intensifying rather dampening boom and bust cycles. Moreover, capital intensive mining activity offers limited opportunities for substantial jobs growth. While its strategic location, well-educated workforce, and vast natural resources present enormous economic potential, private sector activity outside mining is stifled by persistent and high levels of macroeconomic volatility, weak governance and an unpredictable investment climate.

2. KEY POLICY RECOMMENDATIONS

Against this backdrop, the new government is confronted with the difficult task of stabilizing the economy while laying the foundation for a sustainable recovery. In the short run, carefully calibrated macroeconomic policies are needed to ensure stability and mitigate acute risks of an external balance of payment crisis while reducing downside risks to growth and addressing the social impacts of the crisis. In the medium run, reinforcing macroeconomic policies would need to be accompanied by a credible structural and institutional reform program that addresses the central challenge of moving towards a more resilient and diversified economy that is less dependent on extractive industries and that creates more and better jobs as the basis for broadly shared prosperity for all Mongolians. This policy note identifies five key institutional and structural reform priorities to achieve these objectives and specific policy options to address them.

a) Securing macroeconomic stability and avoiding a balance of payment crisis

Mitigating risks of a balance of payments crisis will be an immediate priority for the incoming administration. External liquidity pressures are mounting amid low commodity prices, declining export revenue and tighter financing conditions. The BOM has intervened to support the tugrik and more recently accommodated pressures by allowing the exchange rate to depreciate. Faced with dwindling reserves, further exchange rate adjustments may become necessary. Large external debt repayment needs—totaling US$12.7 billion for 2021-24 (of which US$2.9 billion represents foreign currency sovereign bond)—exacerbate external liquidity needs[1]. In line with the general pull back from emerging marketed, yields on Mongolia's sovereign bonds have doubled since the beginning of the year. It is estimated that Mongolia may face an external financing gap of over US$1 billion in 2020. Given high exposure of government debt portfolio to foreign currency risk, it's critical to improve debt policy formulation through amendment of the debt management strategy and mitigate debt rollover and currency risks.

Policy Options:

Short Term	Medium Term
• **Allow more exchange rate flexibility to absorb external shocks.** The central bank should limit its forex intervention and allow more flexibility of the nominal exchange rate. • **Mobilize external financing to close financing gap:** Consider the benefits of the G20 decision on debt service suspension on official bilateral debt, while exploring alternative external financing options or debt restructuring.	• **Use stabilization and sovereign wealth funds to mitigate external volatility and build stronger buffers:** Ensure a well-functioning Stabilization Fund and Sovereign Wealth Fund (SWF) as effective countercyclical tool and way to harness mining revenue to accelerate Mongolia's diversified development. • **Adopt a new medium-term debt management strategy**, with a greater focus on portfolio risk management and domestic bond market development; transparency and frequency of publication of government debt statistics; and the quality of legal framework for government debt management.

[1] Total external debt data maintained by the BoM covers all sectors including the government, the central bank, and the private sector.

b) Implementing countercyclical and sustainable fiscal policies and strengthening fiscal governance

The immediate challenge in the remaining months of 2020 is to manage the fiscal impact of the COVID-19 appropriately. The key fiscal impact of the COVID-19 includes the fall in revenues and increase in health expenditure as well as additional spending-related fiscal relief package. Considering potential revenue losses this year, the country's fiscal deficit could widen to about 5 percent of GDP in 2020, which may not be financed without additional financial assistance from its development partners. Post-COVID-19, the key fiscal policy challenge will be to contain the high budget deficit, reduce the debt, and strengthen the role of fiscal policy. This requires fiscal planning to strictly adhere to the deficit and debt ceilings of the Fiscal Stability Law (FSL), based on realistic revenue projections. Fiscal governance challenges ranging from uneven enforcement of tax rules to weak public investment management should also be duly addressed to prevent from insufficient fiscal buffers and high public debt. A credible and transparent fiscal consolidation plan including the tapering off the COVID-19 relief measures would be critical to restore fiscal sustainability and governance.

Policy Options:

Short Term	Medium Term
• **Implement a credible Medium-Term Fiscal Plan (MTFP).** The fiscal authorities should use the crisis to steer Mongolia towards implementing a credible MTFP. This would be the first step to regain the market and investors' confidence in the credibility and transparency of fiscal management. • **Temporary and targeted rescheduling of lower-priority public investment.** The authorities should re-program low priority recurrent spending and infrastructure development projects worth about $264 million (or 1.8 percent of GDP) to open space for more urgent spending. If crisis-response measures exceed the currently programmed levels, further cuts in non-priority investment would be required unless additional donor support could be mobilized. At the same time, planned capital expenditure (Capex) should be accelerated to stimulate growth in the short term and expand the border's capacity for trade and revenue collection.	• **A focused and smarter tax incentives regime.** Prior to COVID-19 related measures, Mongolia already had too many tax exemptions which have reduced the country's tax base. In fact, around 50 percent of VAT liabilities are exempted from taxation. It is therefore urgent to undertake a systematic review of ongoing tax exemptions and tax expenditures. Moreover, the adoption of a new tax incentives strategy articulated around the findings of the systematic review would be important. • **Reform the public investment management framework.** There should be a unified, quality based single-entry point for all forms of public investment, regardless of funding source or means of implementation (PPPs, externally funded projects, budget financed projects etc.) Funding Commitments to existing projects should be prioritized to ensure completion of existing projects efficiently and effectively. Regular portfolio reviews should identify and rationalize non-performing projects. The existing PPP portfolio should be rationalized without delay, following a legal review on the associated fiscal risks and contingent liabilities.

	• **Re-assess whether Mongolia's State Equity Policy in the mining sector is an optimal use of scarce fiscal resources.** In principle the State Equity Policy is intended to capture mineral resource rents for the benefit of the nation. In practice state equity is financed on a working interest basis which requires the state to finance a corresponding share of the cost of developing and operating mining assets. Given liquidity constraints, state equity has been financed by borrowing, either directly from banks or by having the State's share carried by the non-State equity holders, as in the case of OT. This is straining the budget and eroding fiscal space that could be used for financing needed investments in infrastructure and social services. Mandatory state equity participation is also exposing the state to commercial risks, including cost overruns while at the same time discouraging private investment in developing mining assets. Instead, a transparent and predictable fiscal framework with a competitive tax regime for the mining sector (royalties and profit taxes) could be used to capture a portion of the resource rents. This would not only free up fiscal space but be more conducive to mobilizing private sector investment in the mining sector. • **Reinforce independence of Fiscal Council to safeguard prudent and countercyclical fiscal policy.** The Fiscal Council should be detached from the Parliamentary structure. The most successful fiscal councils foster transparency, promote a culture of macroeconomic stability, and provide non-partisan advice regarding the budget process. A larger proportion of new fiscal councils around the world have guaranteed legal access to information and benefit from safeguards on their budget.

c) Building a sound, efficient and inclusive banking system

Mongolia's banking system faced significant structural challenges even before the current crisis put additional strain on bank balance sheets. Representing 90 percent of Mongolia's financial system, the health of the banking system remains key concern for both financial stability and efficient resource allocation in the economy.

In the context of a sharply slowing economy, a more wide-spread deterioration in asset quality could lead to significant capital impairment in the banking system. Non-performing loans will likely increase due to reduced corporate profitability and repayment difficulties facing both firms and households hit by the outbreak. On corporate side, Mongolia's insolvency framework is relatively weak. According to the 2019 WBG Doing Business Report, Mongolia was ranked on the 152nd place under the Insolvency related indicators, the recovery rate is a mere 16.9 cents on the dollar, much lower than the EAP average 35.5. This reflects the current system's limited capacity to deal with debt resolution cases – which is crucial for financial stability and efficiency especially during an economic downturn (see also next priority on business environment reforms). On the banking sector side, the ability to absorb losses is hampered by thin capital buffers at least in some banks. While average reported capital adequacy indicators are above the minimum requirements, an asset quality review performed in 2017 as well as a forensic audit in 2019 revealed significant needs for additional regulatory capital.

Despite improvements in recent years, reforms of the supervisory and prudential framework also remain incomplete. Certain aspects of the legal framework undermine the independence of the BOM, thus weakening supervision. For example, the Infringement Law requires some supervisory measures to be executed by the Prosecutor, instead of allowing the BOM to require these measures directly from banks. Corporate governance of Mongolian banks is also relatively weak. At the same time, weak corporate governance has exacerbated the effect of concentrated ownership, as dominant shareholders may overrule risk management considerations – a concern that is amplified by limited transparency around connected and related party lending.

Finally, despite a fairly high banked population in terms of account ownership, SMEs in Mongolia continue to have limited access to finance. Several studies suggest that, among others, access to finance is a major constraint for business development, and most of the demands are for financing current assets. Mongolia has already successfully developed a basic infrastructure (Pledge Law and collateral registry) to enable lending based on movable properties (e.g., receivables, inventory, equipment), which is much needed by SMEs including herder families (e.g., livestock is a type of inventory). However, the current size of the movable asset finance market is still small. Mongolia should continue efforts to expand the market, particularly by focusing on the development of supply chain finance (SCF, a way to organize receivables and inventory finance). The usefulness SCF has been demonstrated in a number of markets for increasing access to finance by SMEs and for improving value chain competitiveness. For example, SME suppliers/distributors can leverage the higher credit standing of their larger buyers or sellers to borrow from financial institutions. Finally, the availability of credit reporting services in Mongolia is minimum as no private credit bureau is really existing and the public credit registry run by BOM remains tiny in size and limited in functions. Mongolia is among the 3-4 economies in the Asia-Pacific Region without a modern credit reporting system. Regulators and financial market participants in the country increasingly recognize that good credit reporting is a necessary basis for scaling up SME finance, improving risk management and maintaining financial stability.

Policy Options:

Short Term	Medium Term
• **Regulatory capital should be effectively increased and banks´ corporate governance strengthened**. Efforts to effectively recapitalize banks should be continued, including potential additional needs derived from the previous	• **The general legal framework should be reviewed to ensure there is no interference while exercising regulatory and supervisory functions.** BOM should be allowed to impose supervisory requirements and all enforcement measures directly. In addition,

recommendations. In conjunction with capital injections, corporate governance of Mongolian banks should be significantly strengthened. Introducing ownership diversification before corporate governance is improved would entail additional significant problems. • **Supervisory and regulatory forbearance should be reduced.** New loan classification standards should be applied consistently. Asset quality reviews and special audits should be undertaken to identify remaining asset quality and capital impairment risks. • **The BOM should adopt countercyclical measures to mitigate volatility in credit flows and asset quality.** The evolution of commodities exports has an important direct impact on the financing of the mining sector, but also indirectly affects in a significant way the rest of the loan portfolio, including retail. Countercyclical measures, including, but not limited to specific countercyclical capital buffers, should be adopted by the BoM to mitigate macroeconomic volatility.	registration of the BOM´s regulations by the Ministry of Justice should be strictly limited to ensuring conformity with higher laws. Finally, legal protection for supervisors should be strengthened. • **Enhance credit reporting system.** Government should allocate sufficient financial resources for BOM to invest in the software and hardware required for the development of a real credit reporting system. The system should cover all the adult population in Mongolia and include all types of creditors. It is one of the fundamental soft infrastructures for the economy to function efficiently. • **Continue efforts to expand SME access to finance** by focusing on the development of supply chain finance and expanded use of movable collateral and secure transactions. • **Central bank governance weaknesses need to be addressed to prevent the BOM supervisory function from being ineffective in practice as is mostly the case now.** The different policy functions (micro-prudential supervision, macro prudential supervision, resolution,) and decision-making bodies should have clear mandates. • **Banks´ business models' sustainability should be assessed and banks with non-sustainable business models should be closed or consolidated.** In this regard, special attention should be paid to the small banks, where profitability is sometimes low, to see to what extent consolidation may be required. In addition to their number and size, several of the small banks are performing weakly and require a high level of supervisory attention in an already resource constrained environment. Consideration should be given to the potential need for consolidation of the banking system.

d) Enabling environment for a more vibrant and productive private sector and job creation

Creating a conducive business environment for Mongolian SMEs and restoring foreign investors' confidence in Mongolia are stated development priorities of the government. In 2020 Mongolia's business environment ranked 81 among 190 countries (down from 62 in 2018) in the World Bank Doing Business Index. While Mongolia is doing fairly well on some DB indicators as Dealing with Constructions Permits, Getting Credit, Minority Investor Protection; others require urgent attention—

e.g., Trading across Borders, Starting a Business, Resolving Insolvency, Getting Electricity. Apart from DB indicators, Mongolia's implementation of business laws and regulations is weak, access to regulatory information, licenses, and finance is uneven. Regulations are changed frequently and playing field is uneven and biased toward SOEs. While Mongolia is open to FDI in terms of policy, it attracts limited FDI relative to comparators, especially outside the mineral sector. Moreover, resource-seeking FDI represented 81 percent of total FDI project value during the period of 2012-2016 studied in the Investment Reform Map report[2], while market-seeking represented only 16 percent. Almost no strategy-seeking and efficiency-seeking investment (the most transformative form) were recorded. Investor confidence has been eroded by sudden policy reversals, the use of "exit bans" preventing foreign executives to leave the country, the revocation of licenses and permits without notice or justification, and other investor-hostile practices. Large-scale projects, even some with donor funding, which the country could have used to its benefit and used as "flagship" investments to promote the location globally, have been stalled or affected by attempts to renegotiate their conditions after the investment was started.[3]

Policy Options:

Short Term	Medium Term
• **Reform business registration process to ease business entry**. Putting in place an online system to verify uniqueness of company names; introducing standardized application forms and articles of association; abolishing the company seal. Abolish the minimum investment requirement of USD100,000 for foreigners to establish a venture. • **Adopt the Insolvency Law.** This needs to be done urgently so that other related reforms can proceed, e.g., the creation and regulation of an insolvency professionals' industry, training of judges, development of out-of-court resolution practices, etc. • **Facilitate trade across borders by reducing cost and time for border clearance.** Improve automation of customs clearance process that will allow electronic submission of transport documents, payments for all border agencies plus railway and the national air freight forwarder MIAT; develop pre-arrival processing system by Customs; develop Authorized Operators program IT system to support self-declaration and payment processes; more robust risk assessment and management system is required to substantially reduce physical inspections; implement Standardized Operational Procedures to streamline	• **Streamline regulatory requirements and practices by government ministries and agencies in their dealings with investors**. For example, standardize land lease contracts, review visas regime to ensure foreign investors, managers and personnel are protected in their rights to stay, exit and re-enter the country as per the visa stipulations. • **Systematically review laws and regulations to identify and eliminate inconsistencies and discrepancies among them.** Consolidate in one legal instrument the current restrictions to foreign participation and consider reducing some of these restrictions. Review local content requirements (LCR) on an economy-wide basis and specifically those applied in the mining sector. • **Develop, through a consultative mechanism, a new Investment Policy.** The policy should state the priority objectives for FDI in Mongolia (e.g., economic diversification, job creation, and/or linkages between domestic and foreign investors); develop a positive list for FDI Investments; and reaffirm the commitment to a fair and non-discriminatory treatment of foreign and domestic investment, restating the core guarantees that it wants to extend to investors.

[2] WBG's *Investment Reform Map* (IRM) (2018).

[3] The Oyu Tolgoi (OT) mining investment agreement with Rio Tinto is perhaps the most emblematic example.

procedures and eliminate uneven performance. • **Establish an effective Public Private Dialogue** (PPD) to identify critical constraints and bottlenecks, in general and in certain sectors, to formulate reform recommendations, and ensure an open channel of communication between the government and the private sector.	• **Develop an FDI Attraction and Diversification Strategy for high priority sectors such as Agribusiness), E-commerce, Eco-Tourism and others**. • **Implement fully the Systemic Investor Response Mechanism (SIRM) to strengthen investor protection** [4] **.** Fully implement SIRM to address investor grievances while preventing some of these from escalating into full-fledged disputes by systematically handling and tracking cases, including a method to filter, analyze, and prioritize grievances. • **Develop a proactive Investor Aftercare Program** to retain existing investments including in the extractives sector, by serving their needs. • **Support a Linkages Program to foster connections between FDI and domestic firms to increase overall in-country value addition.** The extractive sector may be the most likely sector for some linkages in the short term, but the new strategy should also consider linkages in other sectors such as tourism or agribusiness.

e) Building more accountable and effective public sector institutions

Mongolia has been characterized by its relatively advanced regulatory framework yet ineffective implementation due to weak governance institutions, fragmented distribution of power and shortsighted clientelistic behavior. The public administration and the broader civil service in the country have been confronting a variety of challenges largely driven by the lack of meritocratic principles in recruitment and promotion. Adequate institutional set-up and capacity to oversee and manage the civil service is also lacking. The 2017 Civil Service Law provides stronger and clearer arrangements to address these issues, so efforts should be made to ensure mechanisms and enforcement measures are put in place to ensure effective implementation. Proper management of the human resources in the public sector is not only instrumental for improving effectiveness of the government service delivery at various levels in general but also is key for the government for appropriately responding to the emerging COVID-19 situation. National and international surveys indicate a lack of trust and perception of corruption in the government remain widespread, preventing the country from achieving the envisioned social and economic development. Efforts to enhance independence and functioning of the formal accountability institutions, improve compliance with the relevant international standards, and to foster transparency and public participation would be key to strengthening accountability of the state towards better delivery of key services to the people. In terms of fiscal institutions, a lack of cohesion and fragmented institutional and regulatory

[4] The initial location of the SIRM within the Cabinet Secretariat and its subsequent transfer to the NDA may reflect some lower priority for the GoM at a time where investor issues would need greater, not reduced, attention and support at the highest level of Government.

arrangements for public investment management (PIM) has led to many concerns regarding public investment in recent years.

Policy Options:

Short Term	Medium Term
• **Adopt arrangements for monitoring and evaluation on the implementation progress of the amended Civil Service Law**, including adoption of a set of indicators and publication of an annual/six monthly report of progress against those indicators. • **Establish a centralized payroll management system** to enable consistent and reliable data for further quantitative and qualitative analysis needed for future policy decisions. • **Reform performance management for public administration and service delivery at the decentralized level.** Performance of local public administrations i.e. at the aimag and soum level, should closely examine "implementation gaps" to identify areas of improvement for better service delivery – e.g., accountability mechanisms for state financing, including for COVID-19-related public services. • **Reinforce the institutional capacity and technical infrastructure of the MNAO and the IAAC and continue efforts to leverage the capacity of citizens and civil society organizations (CSOs)** through multi-stakeholder and collaborative (joint) actions e.g. monitoring of public expenditures to strengthen public oversight. This collaboration becomes even more relevant in the current context of COVID-19 response measures to ensure trust of the citizens in the government's ability to respond effectively. • **Expand citizen engagement channels and invest in building capacity of those outside the government** to scrutinize and provide feedback of government's fiscal and financial data. For this, leverage results of ongoing initiatives including the Glass Account Portal, the Public Investment Management System, e-Barimt system for VAT and other open source and mobile applications as platforms for receiving feedback from citizens and conduct third-party monitoring.	• **Undertake a reform in the pay and grading structure** and give the Ministry of Finance and explicit remit to study and make recommendations on pay comparability between civil service and other employment sectors in order to provide the appropriate incentives for non-biased recruiting, retain, and motivate skilled staff, in particular through the principle of equal pay for equal work. • **Review the experience of other countries in terms of automatic inclusion in the civil service reserve of individuals who previously held high ranking political positions** and introducing political advisers to ministers to reduce pressures for politicization of the civil service. • **Build a nationwide transparency and accountability coalition** including government reform champions, accountability agencies, civil society organizations (CSOs), the private sector and international development agencies working across sectors. • **Digitize the most relevant public services on a step-by-step basis.** Digitalization and automation of procedures will provide clarity on service requirements, mitigate discretionary processes in service provision, reduce face-to-face interactions between government service staff and constituents, which will contribute to enhancing transparency and accountability. • **Operationalize a single-entry point at the MOF for new proposals of all forms of public investment projects.** No project proposal should be considered for ranking and selection until it is fully prepared with all issues (including risks and uncertainties) addressed or mitigated, meets the qualifying criteria of the new project proposal templates, and passes a quality management process starting with the pre-screening. • **For state and municipally owned enterprises introduce comprehensive**

• **Leverage international standards to reinforce integrity of key public institutions** including High Level Principles on Fiscal Transparency, Participation, and Accountability, INTOSAI-ISSAI 12, the EITI, Open Contracting, Anti-Money Laundering and Combating the Financing of Terrorism (AML-CFT) and the use of the Global Legal Entity Identifier. • **Establish and publish a registry of ultimate beneficial ownership** of all corporate entities and similar legal vehicles including trusts, adopting effective sanctions for untruthful registration. • **Enhance the PIM capacity for the MOF as well as line ministries and local government authorities** in operationalizing the new set of PIM regulations (for pre-screening, appraisal, selection and rationalization) and the associated IT system through an awareness and training program to support future budget cycles. • **Improve public procurement practices.** Ensure adequate staffing of the newly re-established Government Procurement Agency and build capacity of the staff in providing oversight and guidance in the area of procurement. Promote competitive principles in bidding through limiting application of the direct contracting method and of domestic preference [5] as well as strengthening transparency of the procurement processes with consistent improvements in the functionality and use of the e-procurement platform.	**measures to strengthen corporate governance** including incentives for ethics in business, transparency, internal control and corruption prevention systems. Establish a system to monitor and assess the efficiency in the implementation of the anti-corruption programs and measures.

[5] While the 2019 amendments to the Public Procurement Law lifted a number of restrictions to the applicability of the law, it did not address the preference granted to local manufacturers, to whom the government issues a list of goods proposed by the relevant ministries that are to be supplied solely by domestic manufacturers. For the tender for these goods, international bidders are prohibited to be invited. This provision grants a high discretionary power to line ministries and could be conducive to anti-competition and possibly corruption risks in the procurement processes.

3. ANNEXES: SECTOR-SPECIFIC NOTES

1) STRENGTHENING ECONOMIC RESILIENCE IN TIMES OF COVID-19

Executive Summary

Exacerbated by pre-existing macroeconomic vulnerabilities, the economy is likely to contract by 0.5-2.6 percent in 2020, 6-8 percentage points lower than the pre-COVID 19 projection and the first contraction since the global financial crisis in 2009. With limited policy space, it will be challenging for the new government to mitigate its impact, engineer a robust recovery, and restore macroeconomic stability.

A key priority should be avoiding a potential balance of payment crisis in the short run, while focusing on strengthening external buffers in the medium run. Balance of payments pressures are likely to build due to external debt payments and shortfall in export revenue. Under such circumstances defending the exchange rate could erode the international reserves and expose Mongolia to a risk of currency crisis. Instead, the authorities should use the nominal exchange rate as a shock absorber and limit its interventions, while building external buffers and seeking avenues to reduce the external debt pressure in the medium run.

Managing the fiscal impact of COVID-19 and restoring fiscal sustainability in the aftermath are likely to be most challenging for the new government. As fiscal revenues decline and expenditures build up due to the COVID-19 crisis, the government would immediately need to improve spending efficiency by re-programming its low-priority projects to create space for more urgent spending. In addition, assistance from development partners may help create fiscal space by substituting high-cost, short-term domestic borrowing with relatively more concessional and long-term external assistance. Moreover, the adoption of a credible Medium-Term Fiscal Plan is also warranted. On the revenue side, a new strategy for tax exemptions will help reduce unwarranted revenue loss. Finally, efforts to contain high budget deficit and reduce the debt as well as resuming several institutional changes (e.g., a more effective Fiscal Council or sovereign wealth funds) would be crucial for fiscal sustainability in the medium run.

Context: A changing Landscape Dominated by the COVID-19 Pandemic

The new government will assume power amidst one of the greatest economic crises of our time. The COVID-19 pandemic has pushed the world economy to one of the worst recessions in the last fifty years, with global output likely to contract by 3 percent in 2020 (WEO, 2020). Mongolia's economy is likely to contract by 0.5-2.6 percent in 2020, 6-8 percentage points lower than the pre-COVID 19 projection and the first contraction since the global financial crisis in 2009. The first few years of the new administration are likely to be marked by slower growth, rise in poverty, episodes of macro, financial instability, and deterioration in fiscal situation.

Despite the recent progress, Mongolia's economy was ill-prepared to face an unprecedented shock like COVID-19. Aided by favorable global commodity prices, fiscal discipline and strong recovery in private investment, Mongolia's economy had begun to grow out of its last fiscal and financial problems that started in 2014. Yet, in recent years, banking sector reforms have stalled, some of the social security reforms have bene rolled back, and external buffers have not been adequately built. In fact, when hit by the COVID-19 shock, Mongolia's economy had already started to slowdown and the macro vulnerabilities were starting to emerge even before the pandemic hit**.**

With limited policy space, decisive (and at times unpopular) actions in the early part of administration will be critical to a robust recovery and a resilient economy. The pre-election period was marked by the easy part of the crisis management, namely announcement of the large relief program. The post-election period will entail the difficult task of financing the deficit, servicing debt payments, addressing banking sector problem, restoring growth as well as protecting the poor and vulnerable from the adverse impacts of the crisis. Unless tough actions are taken early in the tenure of the new administration, Mongolia will once again fail to break out of the boom-bust cycle that has done so damaging to the country's economy and society.

Impact and outlook

The COVID-19 shock has transmitted to Mongolia's economy mainly through production, trade, and finance channels. The containment measures taken by the government has affected the production of many sectors. A combination of factors including declining demand from China, drop in commodity prices, and border closure with China have severely affected Mongolia's trade performance. Finally, as global financial conditions deteriorate, Mongolia's access to financial market has become more challenging. In addition, critical financial resources such as foreign direct and portfolio investments are likely to slow down.

The COVID-19 could undo much of the development gains of the past five years. Mongolia's economy will likely experience a significant contraction ranging from 0.5-2.6 percent in 2020. In addition, mostly driven by food prices, inflation which accelerated in the first quarter of 2020, would probably exceed the central bank target. External sector pressures will increase as balance of payments is likely to reach its highest deficit of the past 5 years, due to weaker export earnings, lower foreign investments and healthy imports supported by the fiscal stimulus. The fiscal gains of the past three years are being rapidly eroded by unprecedented revenue losses (estimated to be around 3.5 percent of GDP in 2020) and spending increase (e.g., health care costs). The government debt as a share of GDP is likely to rise again, reversing the downward trend of recent years. A recent survey by the Mongolian Chamber of Commerce (MCC) indicated that about that about 8,000 jobs have been lost since the COVID-19 outbreak. This trend is likely to continue, contributing to further increase in unemployment rate and reversing recent progress on poverty reduction.

Key Challenges and Recommendations

Key Challenge 1: Macroeconomic Stability and Resilience

Avoiding a potential balance of payments or a financial crisis should be immediate priority of the incoming administration, followed by the medium-term goal of building up the stabilization funds and strengthening its external buffers.

Key issues

a) **Reserves management and exchange rate policy.** The level of reserves is likely to fall to precarious level if the central bank continues to intervene to support the local currency. While the level of gross international reserves (US$4.4 billion or equivalent of 7 months' imports) appears high at end-2019, the level of net reserves is modest and inadequate to mitigate a large external shock. Defending the exchange rate amidst the growing pressure of balance of payments could erode the international reserves to a level where Mongolia will be exposed to a risk of

currency crisis. The central bank's intervention has already reached US$1.6 billion[6] in the first half of 2020 (US$ 740 million in first quarter), which compares to US$1.2 billion in the first half of 2019 or US$ 700 million in first half of 2016 before the exchange rate depreciated by 12 percent.

b) **External debt burden.** Mongolia will soon face the daunting challenge of repaying part of its large external debt. A total external debt of US$12.7 billion (of which US$2.9 billion of foreign-currency sovereign bonds) is expected to mature in 2021-24. Given the heightened volatility in the global financial market, it would be expensive to rollover the maturing debt at a reasonable cost. For instance, current yields on Mongolia's sovereign bonds are on average almost double the rate before the outbreak (in late March 2020 it reached as high as triple the rate before the outbreak). The external financing gap in 2020 is estimated to be over US$ 1 billion. Furthermore, debt levels and the capacity to debt service could also deteriorate if risks materialized from rapid exchange rate depreciation, fiscal and monetary policy slippages, and contingent liabilities.

Recommendations

a) **Allow more flexibility in exchange rate movement.** The central bank should limit its forex intervention and allow more flexibility of the nominal exchange rate.

b) **Explore ways to reduce debt burden:** Take advantage of the G20 decision on debt service suspension on bilateral debt to negotiate similar debt standstill with private debt holders, while exploring alternative external financing options or debt restructuring (see also fiscal recommendation).

c) **Stabilization and sovereign wealth funds:** Ensure a well-functioning stabilization Fund and the Sovereign Wealth Fund (SWF) as an effective countercyclical tool and to harness mining revenue to accelerate Mongolia's diversified development.

Key Challenge 2: Fiscal Sustainability

Key issues

a) **The immediate challenge in the remaining months of 2020 is to manage the fiscal impact of the COVID-19 pandemic appropriately.** The key fiscal impact of the COVID-19 includes the fall in revenues and increase in health expenditure, and additional spending related fiscal relief package. Considering potential revenue losses this year, the country's fiscal deficit could widen to up to about 5 percent of GDP in 2020, which may not be financed without additional financial assistance from its development partners.

b) **Post-COVID-19, the key fiscal policy challenge will be to contain the high budget deficit and reduce the debt.** This requires fiscal planning to strictly adhere to the deficit and debt ceilings of the Fiscal Stability Law (FSL), based on realistic revenue projections. A credible and transparent fiscal consolidation plan including the tapering off the COVID-19 relief measures would be critical to restore fiscal sustainability.

[6] Data on BoM's direct purchase of FX from big mining companies (e.g., OT and Erdenet) is not publicly available and therefore excluded from the above net intervention estimation.

Recommendations

a) **Implement a credible Medium-Term Fiscal Plan (MTFP).** The fiscal authorities should use the crisis to steer Mongolia to implement a credible MTFP. This would be the first step to regain the market and investors' confidence in the credibility and transparency of fiscal management.

b) **Temporary and targeted rescheduling of lower-priority public investment.** The authorities should re-program low priority recurrent spending and infrastructure development projects worth about $264 million (or 1.8 percent of GDP) to open space for more urgent spending. If crisis-response measures exceed the currently programmed levels, further cuts in non-priority investment would be required unless additional donor support could be mobilized. At the same time, planned capital expenditure (Capex) should be accelerated to stimulate growth in the short term and expand the border's capacity for trade and revenue collection.

c) **A focused and smarter tax incentives regime.** Prior to COVID-19 related measures, Mongolia already had too many tax exemptions which have reduced the country's tax base. In fact, around 50 percent of VAT liabilities are exempted from taxation. It is therefore urgent to undertake a systematic review of ongoing tax exemptions and tax expenditures. Moreover, the adoption of a new tax incentives strategy articulated around the findings of the systematic review would be important.

d) **Independent and effective Fiscal Council.** Despite the efforts in advancing the fiscal transparency agenda, the country has run short in implementing the relevant laws and in fulfilling the Open Government Partnership (OGP) commitments. In 2018, a parliamentary resolution was passed to establish a Fiscal Council under the Budgetary Standing Committee of the Parliament. However, this arrangement does not guarantee political independence of the Council as advised and evidenced from international good practices. The independence of the established Fiscal Council and its proper functioning should therefore be revisited.

e) **Re-assess whether Mongolia's State Equity Policy in the mining sector is an optimal use of scarce fiscal resources**. In principle the State Equity Policy is intended to capture mineral resource rents for the benefit of the nation. In practice state equity is financed on a working interest basis which requires the state to finance a corresponding share of the cost of developing and operating mining assets. Given liquidity constraints, state equity has been financed by borrowing, either directly from banks or by having the State's share carried by the non-State equity holders, as in the case of OT. This is straining the budget and eroding fiscal space that could be used for financing needed investments in infrastructure and social services. Mandatory state equity participation is also exposing the state to commercial risks, including cost overruns while at the same time discouraging private investment in developing mining assets. Instead, a transparent and predictable fiscal framework with a competitive tax regime for the mining sector (royalties and profit taxes) could be used to capture a portion of the resource rents. This would not only free up fiscal space but be more conducive to mobilizing private sector investment in the mining sector.

2) ACCELERATING BANKING SECTOR REFORMS

Executive Summary

Supervisory forbearance must be eliminated, and the legal framework must be strengthened. The BOM's governance weaknesses undermine the effectiveness of the prudential supervision function. Central bank governance must be strengthened, by ensuring policy functions and decision-making bodies have clear and separate mandates and tools. In addition, the legal framework must be reviewed to address significant government and industry interference which undermines supervision effectiveness even further, including, but not limited to, supervisors' legal protection.

Banks´ business models' sustainability should be assessed and banks with non-sustainable business models should be closed or consolidated. The Mongolian economy largely depends on the exports of commodities, so the BoM should adopt countercyclical measures to mitigate the derived volatility of the quality of the banks´ loan portfolio. Furthermore, given the number and types of banks, there is a need for consolidation in the banking system. Finally, banks' sustainability of business models should be considered on a case by case basis using a more forward-looking perspective.

Regulatory capital should be effectively increased and banks´ corporate governance strengthened before ownership concentration is reduced. Recapitalization following the AQR and forensic audit results has not yet been completed, there remain serious doubts about the integrity and legitimacy of the capital raisings. Efforts to effectively recapitalize banks should be continued, including potential additional needs derived from the previous recommendation. Corporate governance of Mongolian banks should be significantly strengthened. Introducing ownership diversification before corporate governance is improved would entail additional significant problems.

Context

Banking is by far the prevailing financial activity in Mongolia. Banking represents more than 90 percent of the financial activity in Mongolia. There are six large banks that represent 92 percent of the banking system and seven small banks. The table below contains the most relevant indicators:

Table 1 – Main Financial Indicators[7]

Indicator	Large banks (D-SIBs)	Small banks
Number of banks	6	7
Market Share	92%	8%
Capital Adequacy Ratio (CAR)	17,2%	25,6%
NPLs to Gross Loans	8,5%	7,0%
Return to Equity – (RoE)	11,4%	7,8%
Net stable funding ratio (NSFR)	133,0%	124,2%

These data must be considered with caution, as there is significant uncertainty regarding their reliability. Capital adequacy indicators are well above the minimum requirements, but these figures

[7] Weighted averages - end of Q2 2019 (deviations are usually quite significant, especially regarding extreme values).

must be considered with caution, as levels can be considerably lower given the results of the forensic audit commented on below and a culture of supervisory forbearance. The same applies to asset quality, as there can be significant losses hidden in the loan portfolio given the results of the AQR. Finally, profitability is positive and Mongolian banks are very liquid.

An AQR was performed in 2017, revealing specific significant needs for additional regulatory capital. As a result of an AQR, capital injections were required for six banks. Following these capital increases, the IMF expressed doubts if the capital raised was clean and genuine and it required a forensic audit. When assessed against international standards, capital increases were considered illegitimate by the forensic auditor in practically all cases.

The BOM issued a new asset classification and provisioning regulation which broadly aligns the definition of NPLs and forbearance with the Basel international standard. However, no firm date for implementation has been decided yet, but prompt implementation of this regulation is vital to ensure more consistent identification, recognition and valuation of NPLs across Mongolian banks. Initial estimates of the effect of the new asset classification by the banking industry point to a material impact. Banks informed of an average increase of 10 percent in the NPL ratio (from an industry average of 10 to 20 percent), an increase by 21 percent in provisioning expense and a decrease of 3 percent in Tier 1 ratios. These are industry estimates, the BOM should perform its own bank by bank impact assessments.

Other regulations in line with international standards have been developed, but implementation has been delayed. A recent decree ("The instructive regulation on management, framework and reporting of reducing nonperforming exposures") requires banks to develop an NPL strategy, an operational plan, a separate NPL workout unit, governance arrangements and reporting systems. From discussions with banks and the BOM supervision department, it appears implementation progress was still limited at the end of last year. Other regulations on collateral valuation and loan origination are under preparation have yet to be issued.

Key Challenges and Recommendations

Key Challenge 1: Legal, Regulatory and Supervisory Framework (Supervisory Forbearance)

Regardless of potential additional staff needs, the BOM's governance and decision-making processes and procedures give rise to several significant conflicts of interest that undermine the standing and authority of the supervision function. For example, the supervision function is outnumbered in the Supervisory Committee where supervisory and regulatory decisions are made. Furthermore, the internal organizational structure of the supervision department groups incompatible policy functions like regulations issuance and banking resolution. Also, only the monetary policy department decides on macro prudential supervision measures despite there being cross functional policy objectives and instruments, such as Loan to Valuation (LTV) and Debt to Income (DTI) ratios, with micro prudential supervision.

The legal framework has significant weaknesses which undermine the independence of the BOM, thus weakening supervision even further. The Infringement Law requires supervisory measures to be executed by the Prosecutor, instead of allowing the BOM to require these measures directly from banks. Also, every regulation needs to be registered by the Minister of Justice to ensure conformity with the basic principles of the legal framework. In practice, this has opened the door to interference in regulatory drafting and indirect lobbying by banks. Finally, legal protection for individual supervisors

in the Central Bank Law is weak and this leaves the BOM supervision staff open to intimidation by bank owners and managers.

The BOM has been receiving extensive TA from the IMF to bring laws and regulations in line with international standards, but implementation still presents important weaknesses, significantly limiting real progress and international alignment in practice. Provided TA has been especially focused on convergence with the EU framework and transition to risk-based supervision**.** Nevertheless, real progress in implementation remains weak.

Recommendation: Restrain Supervisory Forbearance

Central bank governance weaknesses need to be addressed to make the BOM supervisory function effective. The different policy functions (micro-prudential supervision, macro prudential supervision, resolution) and decision-making bodies should have clear mandates and tools in normal times and in crisis times. They should also not undermine each other. The governance of the BOM should be assessed and strengthened in accordance with international standards and good practice.

The general legal framework should be reviewed to ensure there is no interference while exercising regulatory and supervisory functions. Notwithstanding the right of banks to appeal to administrative courts, the BOM should be allowed to impose supervisory requirements enforcement measures directly. In addition, registration of the BOM´s regulations by the Ministry of Justice should be strictly limited to ensuring conformity with higher laws, without allowing banks to lobby for changes. Finally, legal protection for supervisors should be significantly strengthened to prevent any potential intimidation of supervisory staff by banks.

Key Challenge 2: Banks´ Business Viability

The Mongolian economy largely depends on the exports of commodities, especially coal and copper, with China being the main importer. Around 90 percent of Mongolian exports represent commodities, with coal about 40 percent and copper around 30 percent of the total. While commodities prices are relevant, the principal factor is demand, especially from China, the main importer. Thus, the evolution of the Chinese economy in general terms and more particularly its demand for coal and other commodities is critical for Mongolia and for Mongolian banks in particular.

Given the number and types of banks, there can be a need for consolidation in the banking system. There are six large banks (D-SIBs) in Mongolia which represent most of the banking system in terms of size (92 percent). The remaining seven are small banks, whose aggregated size is smaller than any of the D-SIBs but the smallest one. In addition to size, there are significant differences between the D-SIBs and the small banks in terms of the main business and risk factors.

The BOM supervision department has been finalizing a comprehensive assessment of the banks' business plans with the assistance of the IMF, but banks' sustainability of business models has not been considered. Current challenges include the results of the forensic audit, some banks with low profitability, high competition, uncertain levels of NPLs, and upcoming tougher asset classification regulation. The BOM's exercise is useful and necessary, but remains focused on quantitative factors, such as assessing future capital needs, and does not sufficiently address the sustainability of business models and the viability of banks. In fact, the BOM supervision department does not produce comprehensive assessments of banks' business models and their viability.

Recommendation: Identify and address banks´ business viability weaknesses

The BoM should adopt countercyclical measures to mitigate the volatility of the quality of the banks´ loan portfolio derived from the evolution of these external factors. The evolution of commodities exports has an important direct impact on the financing of the mining sector, but also indirectly affects in a significant way the rest of the loan portfolio, including retail. Countercyclical measures, including, but not limited to specific countercyclical capital buffers, should be adopted by the BoM to mitigate the related volatility introduced by these external macroeconomic factors.

A forward looking and more qualitative assessment of the viability of individual banks' business models should be performed. Any newly capital raised by banks will be quickly eroded if these raisings are not accompanied by sound lending policies in the context of sustainable business models and intrusive prudential supervision. A bank by bank business model sustainability assessment needs to be performed considering both quantitative and qualitative factors.

In this regard, special attention should be paid to the small banks, where profitability is sometimes low, to see to what extent consolidation may be required. In addition to their number and size, several of the small banks have weak performance and require a high level of supervisory attention in an already resource constrained environment. Consideration should be given to the potential need for consolidation of the banking system.

The BOM needs to direct more attention to preventive supervision and be more focused on addressing the causes of problems rather than the symptoms when they arise. The BOM lacks a forward-looking approach in its supervision of the banking system and is continuously addressing symptoms instead of root causes. This approach implies than in most of the cases problems can be solved just on a temporary and/or superficial basis.

Key Challenge 3: Regulatory Capital and Corporate Governance

Banks´ business and balance sheets have grown at a slower pace than the Mongolian economy due to challenges in raising capital because of ownership concentration. Banks ownership is concentrated in Mongolia, with an average of 4.5 shareholders per bank and the biggest shareholder owning 58 percent of the capital (79 percent if the second shareholder is also considered). Given the lack of developed capital markets, this has made it difficult for banks to raise enough regulatory capital to support business growth at the same pace as the Mongolian economy.

With serious doubts about the legitimacy and integrity of the capital raisings remaining, required recapitalizations following the AQRs have yet to be completed. Following capital injections in six banks, the IMF expressed doubts if the capital raised to cover the shortfalls revealed by the AQR was genuine and legitimate (not being sourced from loans or other artificial constructions). It required a forensic audit to investigate the capital raisings. The main result was that most of the capital increases were considered illegitimate and not in line with international standards in practically all cases.

Corporate governance of Mongolian banks is weak. Ownership concentration weakens corporate governance in Mongolian banks, as the interest of the main shareholders can overrule risk management considerations in management decisions, for example when lending to related parties. Business policies are also not clearly defined and credit granting processes are weak. There is little transparency around connected and related party lending because the information on the beneficial ownership of many companies and the financial statements are not always reliable. Credit risk management should be improved, especially regarding project finance and requirements for personal guarantees. Even though collateral execution is not easy in Mongolia, banks can better differentiate between good, enforceable collateral and ineffective collateral, especially for those assets that are

closely linked to business. These issues exacerbate the significant need for regulatory capital, as banks performance is usually poor under these circumstances.

Recommendation: Increase regulatory capital effectively and strengthen corporate governance.

Efforts to recapitalize banks should be continued, including those arising due to potential additional needs derived from the assessment of business models. Banks' regulatory capital should be increased as needed, including not only those amounts considered necessary to cover the current provisioning shortfalls, but also those arising from the banks´ business viability evaluations and the potential need for the consolidation of the banking system.

Banks´ corporate governance and management should be significantly improved. Decision-making processes, business policies, and risk management systems should be significantly strengthened, including, but not limited to, the loan portfolio and the related lending policies and credit risk management. Clear lines of responsibility, decision making bodies and reporting should be defined and implemented.

While it would be certainly convenient to reduce ownership concentration of banks, it is not recommended to do it until certain prerequisites are effectively in place, as a premature diversification would entail additional significant problems without solving much. Banks´s ownership concentration cannot be effectively reduced until corporate governance has improved significantly, and local capital markets have been developed. Efforts to reduce concentration by introducing a significant number of minority and retail shareholders before these two prerequisites are met, have the potential to make things worse, not better, in the short term. Poor decision-making processes would be more prominent, there would be stronger incentives for conflicts of interest, and a lack of protection for minority shareholders.

3) MORE AND BETTER JOBS THROUGH INVESTMENT CLIMATE REFORMS

Executive Summary

Mongolia's Vision 2050 highlights the need to implement people-centered development policy, ensure equal participation of every citizen, and increase jobs through encouraging businesses with state policy. This policy note makes four cross cutting recommendations as significant steps in that strategic direction:

- Accelerate efforts to improve the Doing Business indicators to improve investor sentiment
- Undertake critical investment climate reforms to signal to the investor community that the government is committed to a business-friendly policy environment
- Develop and promote a proactive foreign investment policy for economic diversification
- Adopt a better, stronger, and targeted investment promotion strategy

Context

LOOKING BACK: A DIFFICULT BUSINESS ENVIRONMENT AFFECTING BOTH DOMESTIC AND FOREIGN INVESTORS

Creating a conducive business environment for Mongolian SMEs and restoring foreign investors' confidence in Mongolia are stated development priorities of the government. The COVID-19 crisis will have a devastating impact on Mongolia's economy and will further constrain private sector development. The sharp decline in global commodity prices, global trade and FDI decline, and the economic slowdown in the countries most affected by COVID-19 (e.g., China, EU, US)—some of which are important sources of FDI for Mongolia—do not lead to optimism.

Notwithstanding the pandemic, decades of observation has shown that macroeconomic volatility, weak governance and unpredictable investment climate make Mongolia's development path challenging and unsustainable. A few key challenges are as follows*:*

Government interference in the economy (fiscal crowding out, government directed funding) and in SOEs (energy, mining, transport) distorts the market and does not encourage the private sector.

The environment for doing business in Mongolia has worsened – it ranked 81 among 190 countries (was 62 in 2018). While some DB indicators fare well (e.g., Dealing with Constructions Permits, Getting Credit, Minority Investor Protection), others require urgent attention (e.g., Starting a business, resolving insolvency, Getting Electricity[8].

The Mongolia Investment Reform Map (IRM) highlighted the importance of "Trading across borders" reforms if Mongolia is to attract more FDI, especially the efficiency-seeking type that is sorely missing from its "basket".

[8] WBG, "*Doing Business in…*", 2020

Apart from DB indicators, Mongolia's implementation of business laws and regulations is weak, access to regulatory information, licenses, and finance is uneven; regulations are frequently changing; playing field is uneven and biased toward SOEs.

Mongolia is open to FDI in terms of policy (*de jure)*, but still registers low volumes of FDI relative to comparators. Sudden policy reversals, at times encouraging FDI and at other times openly hostile to it, the use of "exit bans" preventing foreign executives to leave the country; the revocation of licenses and permits without notice or justification, and other practices have eroded investor confidence.

Mongolia's performance in terms of FDI attraction and retention have not been optimal[9]. Mongolia receives over 50 percent of its FDI from two countries (Canada and China) making it vulnerable to the economic outlook of these economies. Moreover, resource-seeking FDI represented 81 percent of total FDI project value during the period studied (2012-2016) conducted for the Investment Reform Map report, while market-seeking represented only 16 percent, and almost no strategy-seeking and efficiency-seeking investment (the most transformative form) were recorded.

Investor retention is weak. Large-scale projects, even some with donor funding, which the country could have used to its benefit and used as "flagship" investments to promote the country globally, have been stalled or affected by attempts to renegotiate their conditions after the investment was started.[10]

Mongolia has extremely limited investment promotion capabilities. Invest Mongolia had around eight people engaged in investment promotion activities; NDA now has only four people active in its investment promotion team, focused more on public relations and marketing for the NDA rather than investor-targeted and proactive strategic investment promotion.

[9] WBG's *Investment Reform Map* (IRM) (2018)
[10] The Oyu Tolgoi mining investment agreement with Rio Tinto is perhaps the most emblematic example of this.

LOOKING AHEAD: CRITICAL REFORM TO CREATE A MORE INVESTOR FRIENDLY BUSINESS ENVIRONMENT – BOTH DOMESTIC AND FOREIGN INVESTORS

Mongolia needs to undertake significant investment climate reforms in order to stimulate private sector investment to achieve more sustainable growth, increase country's competitiveness, and create more and better jobs, while starting to diversify its economy.

Key Challenges and Recommendations

Based on international good practice as well as the WBG's policy engagement in Mongolia, this note summarizes four sets of recommendations for the Government of Mongolia to consider:

Recommendation:

a) Accelerate efforts to improve the Doing Business indicators

i) Focus on the **Doing Business indicators** where Mongolia ranks poorly and that are most important for investors, e.g. Starting a Business, Trade Across Borders, Insolvency, Getting Electricity.

ii) **Starting a Business**: Putting in place an online system for checking the uniqueness of the company name; introducing standardized application forms and articles of association; abolishing the company seal. Abolish the minimum investment requirement of USD100,000 for foreigners to establish a venture.

iii) **Trade Across Borders.** Improve automation of customs clearance process that will allow electronic submission of transport documents, payments for all border agencies plus railway and the national air freight forwarder MIAT; develop pre-arrival processing system by Customs; develop Authorized Operators program IT system to support self-declaration and payment processes; more robust risk assessment and management system is required to substantially reduce physical inspections by Customs and General Agency for Specialized Inspections medium and low risk consignments; implement Standardized Operational Procedures across all Border Crossing Points and internal terminals to eliminate uneven performance and reduce unnecessary steps and procedures developed by units.

b) Signal to the investor community that the government is committed to sustained investment climate reforms

i) **Streamline certain business practices** by government ministries and agencies in their dealings with investors (e.g., reneging on commitments made to investors; revoking licenses and permits without due process and legitimate reason; excessive use of exit bans, etc.). For example, standardize land lease contracts as to establish clear conditions on primary contracts and requirements for extension. Review visa regime for investors to ensure that foreign investors, managers and personnel are protected in their rights to stay, exit and re-enter the country as per the visa stipulations.

ii) Systematically **review laws and regulations to identify and eliminate inconsistencies** and discrepancies among them but also to clarify rules and provisions that contribute to the prevailing feeling of uncertainty in the business community. For example, consolidate in one legal instrument (such as a negative list) the current restrictions to foreign participation and

consider reducing some of these restrictions. Review local content requirements (LCR) on an economy-wide basis and specifically those applied in the mining sector.

iii) **Establish an effective Public Private Dialogue (PPD) to identify critical constraints and bottlenecks, in general and in certain sectors, to formulate reform recommendations, and ensure an open channel of communication between the government and the private sector.**

c) Develop and promote a proactive foreign investment policy for economic diversification

i) Announce a comprehensive **Investment Policy Statement** (IPS) – in consultation with relevant stakeholders - that could be adopted as Prime Minister's Order or other high-level document issued by the government. This could send a very positive signal to the investor community while providing a road map to the line ministries and government agencies at national and subnational level.

ii) Develop, through a consultative mechanism, a **new Investment Policy** that assures foreign investors certainty of rules, and provides an enabling business environment; states the priority objectives for FDI in Mongolia (e.g., economic diversification, job creation, and/or linkages between domestic and foreign investors); develops a positive list for FDI Investments; reaffirms Mongolia's commitments to the fair and non-discriminatory treatment of foreign and domestic investment, restating the core guarantees that it wants to extend to investors.

iii) Build awareness within the government on the obligations undertaken by Mongolia through its domestic laws and international treaties (such as BIT's and FTA's) in the treatment of investors.

iv) Implement fully the **Systemic Investor Response Mechanism** (SIRM) to strengthen investor protection[11]. The new Investment Policy could announce the government's intention to strengthen the legal framework for investment but also to fully implement SIRM to address investor grievances while preventing some of these from escalating into full-fledged disputes. It is essential to define the systematic way of handling and tracking cases, including a method to filter, analyze, and prioritize grievances.

d) Adopt a better, stronger and targeted investment promotion strategy

i) Develop an **FDI Attraction and Diversification Strategy** with a strategic focus on sectors that would promote high growth and job creations such as agribusiness (already developed with IFC support), e-commerce, eco-tourism and others. This needs to be aligned with the new Investment Policy Statement.

ii) Develop a proactive **Investor Aftercare Program** – to retain existing investments including in the extractives sector, by serving their needs. Investor aftercare is often regarded as a "low-hanging fruit" approach by Investment Promotion Agencies (IPAs) as existing investors already know the country, its advantages and constraints, and the IPA knows the investors as well. International experience suggest it is much easier (and cheaper) to convince an already established investor to stay invested and grow than to attract a potential foreign investor who is not yet in Mongolia.

[11] The initial location of the SIRM within the Cabinet Secretariat and its subsequent transfer to the NDA may reflect some lower priority for the GoM at a time where investor issues would need greater, not reduced, attention and support at the highest level of Government.

iii) Build **NDA's capacity and effectiveness** by allocating staff with appropriate promotion experience and skills to the unit in charge of investment promotion within the agency; and establishing more effective coordination and collaboration mechanisms with other relevant stakeholders in the country. Public agencies need to work together in developing and implementing investor promotion campaigns in targeted sectors.

iv) Support a **Linkages Program** or initiative to foster connections between FDI and domestic firms to increase overall in-country value addition, develop or attract new technologies and capabilities and better integrate local firms into supply chains of foreign investors where possible. The extractive sector may be the most likely sector for some linkages in the short term, but the new strategy should also consider linkages in other sectors such as tourism or agribusiness.

4) STRENGTHENING FISCAL GOVERNANCE AND PUBLIC SECTOR INSTITUTIONS FOR RESILIENCE AND ACCOUNTABILITY IN MONGOLIA

Executive Summary

Mongolia has been characterized by its relatively advanced regulatory framework yet ineffective implementation due to weak governance institutions, fragmented distribution of power, and shortsighted clientelistic behavior. The public administration and the broader civil service in the country have been confronting a variety of challenges largely driven by the lack of meritocratic principles in recruitment and promotion, and by adequate institutional set-up and capacity to oversee and manage the civil service. The 2017 Civil Service Law provides stronger and clearer arrangements to address these issues, so efforts should be made to ensure mechanisms and enforcement measures are put in place to ensure effective implementation. Proper management of the human resources in the public sector is not only instrumental for improving effectiveness of the government service delivery at various levels in general, but also is key for the government for appropriately responding to the emerging COVID-19 situation.

A lack of cohesion and fragmented institutional and regulatory arrangements for public investment management (PIM) has led to many concerns regarding public investment in recent years in Mongolia. Given its implications beyond the technical aspects onto medium term fiscal planning and economic growth, fiscal risks, debt management, anti-corruption, and public procurement matters, PIM is a key area to tackle for the government towards strengthening fiscal governance in Mongolia. During the recovery period of the COVID-19, a strong PIM system will also help the government ensure effective resource allocation.

National and international surveys indicate a lack of trust while perception of corruption in the government remain widespread preventing the country from achieving the envisioned social and economic development. Efforts to enhance independence and functioning of the formal accountability institutions, improve compliance with the relevant international standards, and to foster transparency and public participation would be key to strengthening accountability of the state towards better delivery of key services to the people.

Context

Mongolia needs to continue strengthening its governing institutions, accountability systems, and efficiency and transparency of its public sector to better serve the people. Weak governance institutions associated with a lack of transparency and short-term rent-seeking behavior have compromised resource allocation decisions and significantly undermined the population's faith in the ability of the political class and government to deliver public goods and services to its citizens [12]. Despite advancements in the regulatory framework, effective implementation of often well-designed

[12] The 2018 Study of Private Sector Perceptions of Corruption of the Asia Foundation indicated skepticism in the respondents' assessment of the government's ability to effectively implement economic policy as 24.8% and 43.6% of the respondents reported the implementation of economic policy was "not at all effective" and "hardly effective", respectively. Further, since 2006 political institutions such as "political parties," "Parliament," and "national government" have received a worsening assessment from the general public and today are considered among the most corrupt institutions in the Asia Foundation's Survey of Perceptions and Knowledge of Corruption.

policies remains an issue[13].Transparency efforts in accessing information and monitoring the use of public resources coupled with participatory mechanisms in budgeting at the decentralized level have been advanced but have produced uneven results[14]. They do not yet provide a sound foundation for stronger accountability in the country. At a more operational level, these issues translate into problems with credibility of the budget, quality and predictability of public investments, and capabilities and stability of civil service (SCD 2018).

A resource rich country, Mongolia built formal institutions to utilize revenues from extractive industries for long-term growth, following the example of a well-managed resource rich country like Chile. However, the institutional capacity and regulations are being influenced by power asymmetries, so that technical decisions are overshadowed by short term political interests eroding the credibility of the commitment to prudential management of resources (WDR 2017). The role of the public sector in the economy and its involvement in the mining sector are significant; yet, government effectiveness in Mongolia has a score of -0.26 (on a scale of -2.5 to 2.5), lower than its peers in East Asia and Pacific. Fiscal governance issues, ranging from uneven enforcement of tax rules to weak public investment management, resulted in insufficient fiscal buffers and high public debt (73 percent of GDP), making the country even more vulnerable to shocks like the COVID-19 (IMF 2018).

Fragmented distribution of power has challenged accountability and policy credibility more broadly in the country. Political power is fragmented and unevenly distributed among key institutions of state governance. Parliament plays a particularly important role in the political status quo in Mongolia and uses its constitutional power to influence both the overall budget envelope and its sectoral composition. Political interference from the Parliament has prevented state agencies from implementing policies and regulations as intended and has raised concerns about the government's long-term commitment to existing policies. Parliamentary interference can also be associated with what is known in Mongolia as the "implementation gap" — the lack of a motivated, professional civil service free from clientelism and from the so-called "provisioning pact", in which access to centrally controlled rents, patronage and clientelism dominate. As the country strives towards sustainable economic development, instability, a lack of meritocracy, and politicization of the civil service are seen as major factors contributing to the weak implementation of the regulatory framework to address the country's challenges in terms of fiscal-financial, physical and logistic infrastructure.

A lack of cohesion in the institutional and regulatory arrangements has led to concerns regarding public investment in Mongolia, which constitutes almost one third of the total budget expenditure. Mongolia's public investment in recent years have been among the highest in the world. At an average of about 7.5 percent of GDP in 2010-18, public investment in Mongolia far exceed the 4.4 percent of emerging markets and development economies. In 2019, Mongolia ranks 102th globally regarding public spending efficiency as indicated by the World Economic Forum's Global Competitiveness Index (WEF 2019). Several types of rents in this regard appear to be utilized in the country including: i) The selection of public investment projects remaining largely non-transparent, and a number being assessed as poor performing and requiring rationalization; ii) Contracts related to PPP/BT/BOT schemes being made without proper considerations to the strategic need, the associated debt and

[13] For instance, while Mongolia has a well-designed fiscal rule-based system, embedded in the Fiscal Stability Law of 2010 (FSL) and the Integrated Budget Law, adherence to the key requirements of the FSL, including on fiscal deficits and debt, has been uneven. Although systems are in place to for rules-based allocation of mineral licenses, in practice, there is scope for rent seeking activities by well-connected insiders (IMF 2018).

[14] On the 2017 Open Budget Index (OBI), for instance, Mongolia was among the countries whose score decreased from 51 (out of 100 points) in 2015 to 46 in 2017 (though back up to 56 in the 2019 survey). Anti-corruption efforts have not been as effective as expected given the country ranked 103 (in the bottom half) on the 2017 Transparency International Corruption Perception Index.

fiscal risks which may span decades; and iii) Conflict of interest in the ownership of construction companies being engaged in large-scale construction with decision-making powers over permits, access to credit, and public procurement.

Despite its democratic roots and an increasingly active civil society, the power of the public to make the government accountable has been limited. The roles and responsibilities of the formal accountability institutions in public matters and the relationship and coordination between them are well defined in the legal framework but their performance and effectiveness have varied due to their weak independence. An evolving civil society and an improved legal framework for citizen engagement strive to complement the formal institutions in holding the government accountable but the efforts require further strengthening and institutionalizing the mechanisms for engaging citizens e.g. through leveraging ICT solutions that may help improve transparency and public service delivery.

The COVID-19 pandemic is having a devastating economic and social impact in Mongolia greatly challenging economic activity and public services. Exports, fiscal revenue and investments are sharply down in the first quarter of 2020 and the government has been taking a set of measures to minimize the economic and social costs of the crisis. The role of the government institutions at all levels, including key line ministries as well as *aimag/soum* authorities, and coordination across line ministries, levels of governments, as well as private and social sectors is crucial not only in fighting against the crisis but also in its aftermath. Agility, competence, and digitization in delivering government services to the public and transparency of information in this regard would be essential for ensuring accountability and effectiveness of the government response actions and building trust in state. Further, the government should prepare for large scale rationalization/re-prioritization of public investment projects to help finance the emerging recurrent cost needs related to increasing health spending and social protection programs.

Key Challenges and Recommendations

Key Challenge 1: Civil Service and Public Administration

The role of a professional civil service would be critical for the government in undertaking the public administration and governance reforms needed for Mongolia. The lack of meritocratic principles and patronage driven decisions in recruitment, promotion in practice, and gender bias[15] have resulted in the government's inability to recruit and retain skilled civil servants. Ineffective controls and absence of proper functional reviews over the creation of and appointments to civil service positions have led to an increase in the size of the civil service and the associated growth of the wage bill. While the amended Civil Service Law (2017) introduces considerably stronger and clearer arrangements than before and aims to reinforce the political neutrality of the civil service, detailed implementation mechanisms and procedures would need to be put in place to facilitate effective enforcement of the law. Moreover, improvements in the institutional set-up for the civil service, particularly with regards

[15] A qualitative study undertaken by the Bank in 2018 found that working in the civil services sector is regarded an attractive option in the labor market, but it is "*only possible to those who have private connections and are willing to lose their job after every election, since many civil servants are generally all fired and replaced by new people whenever a new political party wins the elections. Basically, almost every civil service job is like an appointment, where high officials hire only their relatives and friends. Many young professionals also perceive that they have no chance to build their own businesses because loans are only given out to those who have a permanent working contract or properties. Many women stress that they are treated differently within the job selection process. They are asked when they want to start a family and often have to sign contracts promising that they are not pregnant yet. Examples were offered in the discussions—by both male and female participants—of women being fired because they were pregnant*" (WB, 2018, p.39).

to more clarity in roles and responsibilities of the Cabinet Secretariat and the Civil Service Council in managing the human resource and providing the oversight, would be essential for improving the effectiveness and efficiency of the civil service in the country. In the short term, to effectively respond to the COVID-19 pandemic, the civil service will need to operate in an agile and coordinated manner while ensuring availability of the required competence and capacity e.g. in the health sector. Also, in the new working environment with social distancing and remote work arrangements, information and communication technology solutions need to be put in place to enable a smooth running of the most basic and essential government operations such as payroll and treasury transactions.

Recommendations to be addressed in the short term:

a) **Adopt arrangements for monitoring and evaluation on the implementation progress of the amended Civil Service Law**, including adoption of a set of indicators and publication of an annual/six monthly report of progress against those indicators.
b) **A review of the mechanisms and capacities of managing and developing a more capable and resilient civil service should be carried out** urgently focusing on clarifying responsibilities among various government bodies involved, strengthening their capacities, and improving coordination among them. It should also make recommendations on making the core service delivery systems resilient to shocks/disasters such as COVID-19 as well as on making a possible further change to the Civil Service Law to rationalize the allocation of responsibilities for the longer term.
c) **A centralized system of payroll management should be established**, linked to a central human resource management information system, so that a consistent and quality set of data from the systems allow further quantitative and qualitative analysis needed for future policy decisions. In light of COVID-19 , prioritize integration of payroll and the associated human resource/compensation data into the system, to review and analyze the information and ensure availability and proper incentives of staff to carry out essential functions, especially in the health sector.
d) **At the decentralized level, the system of branch CSCs and the mechanism of performance management for public administration and service delivery should be reviewed**. For the former, an assessment of their current coverage and effectiveness of the branch CSCs would be useful in order to determine how effectively they operate at the local level and to identify potential recommendations for improvement. As for performance management for local public administration i.e. at the *aimag* and *soum level,* "implementation gaps" should be closely examined to identify areas of improvement for better service delivery –e.g., accountability mechanisms for state financing at *aimag* level and for effective implementation of the COVID-19 -related public service delivery e.g. in the health sector and other response measures at the different levels of government.

Recommendations to be addressed in the medium term:

a) **Undertake a reform in the pay and grading structure and give the Ministry of Finance and explicit remit to study and make recommendations on pay comparability between civil service and other employment sectors** in order to provide the appropriate incentives for non-biased recruiting, retaining, and motivating skilled staff, in particular through the principle of equal pay for equal work.
b) **Review the experience in other countries in terms of automatic inclusion in the civil service reserve of individuals who previously held high ranking political positions** and introduce political advisers to ministers and with a view to reducing pressures for politicization of the civil service.

Key Challenge 2: Public Investment Management

Fragmented institutional arrangements and use of multiple financing sources make it difficult to ensure a cohesive management of public investment activities in Mongolia. There is no single institution in charge of public investment management (PIM). On one hand, the Ministry of Finance (MOF) has oversight for projects that are with a value of up to MNT 30 billion (approx. USD 11 million) that are prepared and submitted by line ministries and local governments and financed from the state budget. On the other hand, the National Development Agency (NDA) is in charge of large investment projects with the value above MNT 30 billion that are reflected in the Public Investment Plan (PIP), including a large PPP and concession portfolio[16]. Hence, the MOF has no say in the preparation of sector development plans and projects in the PIP, so currently more than 80 percent of all public investment by value are outside the remit of MOF and there is no systematic process in place for their appraisal and selection. This causes considerable challenges in managing the fiscal risks associated with the extra-budgetary project financing mechanisms.[17] Another source of fragmentation affecting PIM in Mongolia is the policy of consolidating public interests in mineral resources through a SOE holding company, and through it financing public investments in (a) strategic mineral deposits and (b) strategic infrastructure, such as rail links to export markets, and prospectively the major water diversion scheme to supply the South Gobi. At the decentralized level, the Local Development Fund (LDF) is a budgetary instrument that enables local governments to plan and implement smaller scale capital projects that respond to the priority needs of the citizens. LDF has been an important vehicle for enhancing governance and citizen engagement and therefore improving the responsiveness and effectiveness of rural service delivery. While the investment projects with the LDF financing are managed under a regulation approved by the MOF and the performance of local governments in managing the LDF has generally been improving[18], implementation capacity and efficiency of the investments have varied. As the economy expanded, there was meant to be more competition with an increasing number or private contractor firms in consulting and construction. However, a large majority of the public investments have been done outside the Public Procurement Law (e.g. those by the Development Bank of Mongolia until the recent amendments to the law in March 2019 and PPPs and concessions) and with limited transparency and oversight despite the comprehensive e-procurement system rolled out. For example, the maintenance of national roads contracts executed by state-owned legal entities are excluded from the national procurement law. The recommendations offered below for improving PIM in Mongolia would not only help strengthen the public financial management and governance but also be critical for resource allocation decisions during recovery from the COVID-19 crisis.

Recommendations to be addressed in the short term:

a) **The PIM framework should be revised to enable a quality based single-entry point for all forms of public investment, regardless of funding source or means of implementation.** PPPs and all forms of external financing should be harmonized and regulated within the PIM framework as soon as possible, with only specific issues that are unique to PPPs to be regulated individually.

[16] State budget financing only contribute to 8 projects in the PIP (i. e. 2.75 percent of all projects in the PIP, by value) while the Build Transfer (BT) contracts, that created significant explicit liabilities, are still being paid off and the aggregated capital value of the BOT contracts currently amounts to around 58% of GDP. The BOT portfolio is currently being reviewed by the MOF with support from international project lawyers.

[17] This is more of a PFM issue than a purely PIM issue. While the MOF is, for instance, responsible for playing an oversight role in assessing fiscal risks for PPP contracts, in practice the capacity to do so has been negligible.

[18] The average *soum* score on the Annual Performance Assessment (APA) of the LDF conducted under the Third Sustainable Livelihoods Project increased from 32 percent in 2016 to 59.5 percent in 2019. The measures the LDF performance of the *soums* across six groups of criteria including pubic participation, planning & budgeting, transparency/disclosure, budget execution, M&E, and asset ownership.

b) **Prioritize all existing commitments to projects ahead of creating new ones** when planning the State Budget resources in order to ensure completion of existing projects efficiently and effectively.

c) **Ongoing projects in distress should be reviewed.** Projects that are no longer relevant, have insurmountable implementation issues or are unable to demonstrate their future utility or value, should be rationalized.

d) **Enhance the PIM capacity for the MOF as well as line ministries and local government authorities** in operationalizing the new set of PIM regulations (for pre-screening, appraisal, selection and rationalization) and the associated IT system through an awareness and training program to support future budget cycles.

e) **The existing PPP portfolio should be rationalized** without delay, following a legal review on the associated fiscal risks and contingent liabilities.

f) **Conduct an analysis on the efficiency and effectiveness of local investments including considerations to environmental and social risk management issues.** The review should include local investments financed from all sources including the state budget, LDF, local budget revenues as well as private funding in the case of *aimags/soums* with extractives, and aim to identify a suitable arrangement that ensures local priorities and needs are adequately met, coordination and complementarity between the investment projects exist, and social and environmental risks are sufficiently addressed.

g) **On a temporary basis, increase transfer amounts and introduce an incentive for labor-intensive investments through the Local Development Fund (LDF)** to provide a channel for increased wage-earning opportunities to help counter the employment impacts of the economic downturn, and women's access to paid work.

h) **Improve public procurement practices in a number of respects.** Ensure adequate staffing of the newly re-established Government Procurement Agency and build capacity for the staff in providing oversight and guidance in the area of procurement. Promote competitive principles in bidding through limiting application of the direct contracting method and of domestic preference[19] as well as strengthening transparency of the procurement processes with consistent improvements in the functionality and use of the e-procurement platform. Also, maintain adequate independence, professionalism, follow-up/resolution mechanism with a feedback loop, as well as staff time allocation at the MOF for handling procurement complaints and appeals.

Recommendations to be addressed in the medium term:

a) **Operationalize a 'single entry point' at the MOF for new proposals of all forms of public investment projects.** All BOO contracts in the utility sector should be included in the PIM framework thus subjecting them to a quality assurance regime, prior to being contracted. No

[19] While the 2019 amendments to the Public Procurement Law lifted a number of restrictions to the applicability of the law, it did not address the preference granted to local manufacturers, to whom the government issues a list of goods proposed by the relevant ministries that are to be supplied solely by domestic manufacturers. For the tender for these goods, international bidders are prohibited to be invited. This provision grants a high discretionary power to line ministries and could be conducive to anti-competition and possibly corruption risks in the procurement processes.

project proposal should be considered for ranking and selection until it is fully prepared with all issues (including risks and uncertainties) addressed or mitigated, meets the qualifying criteria of the new project proposal templates, and passes a quality management process starting with the pre-screening.

b) **An integrated, whole-of-government (WOG) approach should be used for digital investments and transformation of the public sector.** A WOG approach for digital government provides the commonly used IT tools and services for shared use across all agencies on a 'built once, reuse always basis'. This reduces the need for each agency to invest in their own IT resources, cuts IT operational and overhead costs, improves interoperability and coordination, and enables agencies to focus on core digital services delivery to citizens and businesses instead of technologies. It also enhances data and information sharing and collaborative decision-making at the political and operational levels, and provides agencies integrated cybersecurity protection of their mission-critical systems.

c) **Adopt sector-based investment planning starting with the utility sector**. 5, 10, and 15-year investment plans for each utility should be drawn up based on projected need for increased supply and transmission or the replacement of existing supply and transmission. These investment plans should be subjected to independent audit.

d) **Develop a policy which defines the quantum of guarantees to be used in PPPs** for critical infrastructure development and a set of strict criteria by which they can be deployed.

Key Challenge 3: Accountability and Transparency

Efforts were made by the state to strengthen accountability institutions and mechanisms to increase transparency and integrity over the use of public funds and the delivery of public services. The legal framework governing the different actors in the accountability ecosystem including the Fiscal Council, the Mongolian National Audit Office (MNAO), the Independent Authority Against Corruption (IAAC) have been revised and comprehensive strategies and action plans have been adopted towards achieving the objectives. Also, given the high level of dependence on mineral resources, Mongolia became an early adopter of the Extractive Industries Transparency Initiative (EITI). It became compliant with the then applicable EITI standard and in subsequent years the compliant status was re-validated as the standard became more rigorous and wide-ranging[20]. However, as is the case for many other reform processes, these efforts have shown uneven results and run short of demonstrating real results of improved transparency and accountability and reduced corruption in the use of public funds. An area of increasing concern in this regard is the limited transparency of SOEs in terms of their funding, use of profits as well corporate governance as none of the ten largest listed SOEs disclose regularly information on their board of director evaluations and board composition. Available information with regard to SOEs points to all manner of conflicts of interest with board membership, and private business or political connections. The latter has been reflected in the people's perception of national and international surveys indicating corruption not only remains widespread but also prevents the country to achieve the envisioned social and economic development.

[20] The Secretariat of the EITI (http://www.eitimongolia.mn/en) was supported financially by the World Bank until 2018 but it currently does not have external financing support available. A test of the impact of the EITI will be whether two current initiatives, which will be conditions for continued complaint status, are implemented well: (a) disclosure of beneficial ownership of interests in mineral rights, so that the ultimate rather than paper beneficiaries of interests in minerals are available to the public; (b) mainstreaming of public disclosures required by EITI into country systems, so that they are no longer "supply-driven" exercises outside government reporting systems.

Past reforms have often focused more on identifying and designing sound technical solutions and enabling the legal framework, but often lacked commitment and collaboration from the various institutions and stakeholders. As a result, neither the reforms met the citizens' expectations from the state, nor the citizens were able to get organized collectively to amplify their bargaining power to effectively bring changes. The limitations of these past governance reform efforts point to the need for an integrated, holistic strategy, beyond supply-side interventions in isolation, to address the multiple drivers of governance changes (De Gramont, 2014), and call for 'working with the grain' (Levy, 2014)[21]. Concerted efforts are needed to harness the power of new information and communication technologies (ICT) to bridge the interaction and collaboration among the different state and non-state actors at the national and local levels.

Recommendations to be addressed in the short term:

a) **Strengthen the intuitional capacity of the MNAO and the IAAC and support their current efforts to leverage the capacity of citizens and civil society organizations (CSOs)** through multi-stakeholder and collaborative (joint) actions e.g. monitoring of public expenditures to strengthen public oversight. This collaboration becomes even more relevant in the current context of COVID-19 response measures to ensure trust of the citizens in the government's ability to respond effectively. As the crisis unfolds ex-ante, controls are likely to loosen to allow the government to timely address citizens' needs. This will in turn require strengthening ex-post controls to ensure the allocated resources reach the intended beneficiaries.

b) **Reinforce the independence of the Fiscal Council of Mongolia** by detaching it from the Parliamentary structure. The most successful fiscal councils foster transparency, promote a culture of macroeconomic stability and provide non-partisan advice regarding the budget process. A larger proportion of new fiscal councils around the world have guaranteed legal access to information and benefit from safeguards on their budget.

c) **Sustain efforts of information dissemination and communication campaigns to raise awareness and invest in building capacity to garner meaningful participation among citizens in public matters** including in the planning and monitoring of the LDF to enable it to function effectively as a redistributive "benefit sharing" mechanism that channels resources to all parts of the country to finance decentralized local investments and service delivery in an equitable, predictable, transparent and responsive manner.

d) **Aggressively seek public input and invest in creating structured spaces for state-citizen interfaces and joint problem-solving**. For this, leverage results of ongoing initiatives including the Glass Account Portal, the Public Investment Management System, e-Barimt system for VAT and other open source and mobile applications as platforms for receiving feedback from citizens and conduct third-party monitoring to inform policy design and implementation, service delivery as well as revenue management.

e) **Comply with international standards**, among others, the United Nations Convention against Corruption, High Level Principles on Fiscal Transparency, Participation, and Accountability,

[21] A focus on working to solve very specific development problems – moving away from a pre-occupation with longer-term reforms of broader systems and processes, where results are long in coming and hard to discern; recognizing that no blueprint can adequately capture the complex reality of a specific setting, and thus that implementation must inevitably involve a process of iterative adaptation. Feasible reform process should consider a three-pronged approach: i) Public Management (result-driven reform in a few priority sectors, build small high-capacity units in central policy & budget agencies and build internal financial controls); ii) Multi-stakeholder (Utilize participatory mechanisms for monitoring service provision, utilize external anchors as commitment mechanisms; and iii) initiate capacity development for judiciary and other non-executive institutions of accountability.

INTOSAI-ISSAI 12, the EITI, Open Contracting, Anti-Money Laundering and Combating the Financing of Terrorism (AML-CFT) and the use of the Global Legal Entity Identifier.

f) **Establish and publish a registry of ultimate beneficial ownership** of all corporate entities and similar legal vehicles including trusts, adopting effective sanctions for untruthful registration.

g) **For state and municipally owned enterprises introduce comprehensive measures to strengthen corporate governance** including incentives for ethics in business, transparency, internal control and corruption prevention systems. Establish a system to monitor and assess the efficiency in the implementation of the anti-corruption programs and measures

Recommendations to be addressed in the medium term:

a) **Build a nationwide transparency and accountability coalition** including government reform-champions, accountability agencies, civil society organizations (CSOs), the private sector and international development agencies working across sectors.

b) **Digitize the most relevant public services on a step-by-step basis;** from initially enabling provision of service information and downloading of forms, to eventually making them fully transactional. Digitalization and automation of procedures will provide clarity on service requirements, mitigate discretionary processes in service provision, reduce face-to-face interactions between government service staff and constituents, which will contribute to enhancing transparency and accountability. A whole-of-government approach with business process reengineering can also be employed for streamlining the public services.

c) **Upgrade technological capacities, not only technical infrastructure but innovation skills**, of relevant accountability institutions so that they can process the enormous amounts of data available to inform policy formulation. For example, to identify suspicious transactions, prepare for new opportunities such as blockchain technology, etc.

d) **Link financial and regulatory compliance information sources within the country,** so that all authorities (including electoral authorities) have access to all the information on a single entity. This can be done without combining databases, but by providing access across systems to a range of authorized users.

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