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# Mongolia's Proposed Sovereign Wealth Fund

in the Broader Fiscal Framework

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# Introduction

The government of Mongolia has proposed the creation of a new sovereign wealth fund designed to invest in domestic assets, to be managed in whole or in part by state-owned mining enterprise Erdenes Mongol. This new fund would supplement existing extrabudgetary institutions with various macroeconomic and industrial policy objectives, namely the Development Bank of Mongolia LLC, the Future Heritage Fund, and the Fiscal Stability Fund. The fund’s mandate—and consequently its deposit rules, withdrawal rules, and investment guidelines—remain unclear.

The global experience with so-called “strategic investment funds” has been mixed. Whereas some have made important contributions to economic development in their respective countries, sometimes leveraging natural resource revenues to finance large-scale projects that the private sector alone would not finance, others have served as channels for corruption and patronage, wasting scarce resources and empowering certain groups of elites at the expense of others or the general population. Clearly, the objective of the government of Mongolia is to establish a well-governed, independent institution.

The fund is being established in a unique macroeconomic and fiscal environment. Natural resource revenues have already been earmarked for the Future Heritage Fund, and a set of fiscal rules already determines how fiscal revenues will flow between many government entities. Furthermore, Mongolia is heavily indebted and, despite some debt restructuring, is still spending an unusually high proportion of the state budget on debt servicing payments.

Mongolia also has a long history of establishing extrabudgetary institutions that have underperformed or have served special interests. Reforms are underway at the Development Bank of Mongolia and Erdenes Mongol, for example, to improve performance and meet international standards.

This brief aims to describe the Mongolian context so that the new sovereign wealth fund can be designed to fit into the existing fiscal framework rather than undermine public financial management systems and public accountability. The brief then provides a set of lessons for the design of strategic investment funds, drawn from case studies around the world.

# Mongolian context

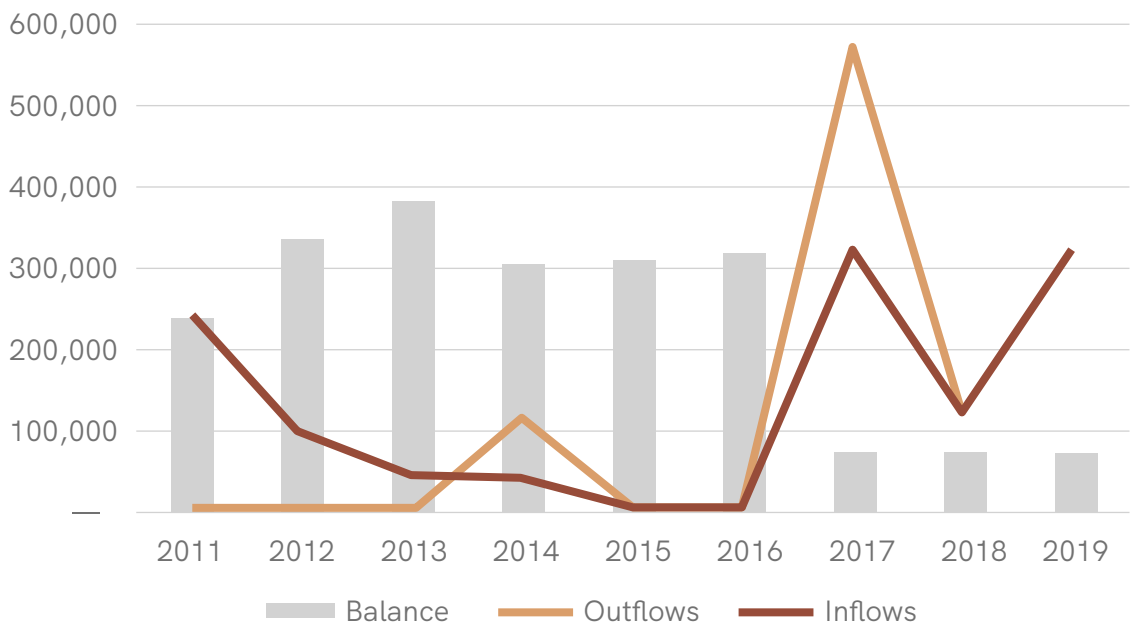
The government introduced fiscal laws with the intention of mitigating procyclical spending amid ever-increasing mining revenues and resource revenue-backed lending. The Fiscal Stability Law (FSL), adopted in 2010, introduced fiscal rules on expenditure, deficit, and debt growth and saved some of the mining revenue going to the Fiscal Stability Fund (FSF) for the purposes of overcoming challenges related to short-term volatility of the commodity revenue. Although the government's priority has rightly been on domestic spending to reduce poverty and grow the economy, the fiscal rules in the law were designed to smooth fiscal expenditures and create a source of precautionary savings. The four fiscal rules, including amendments made subsequently, are:

- **Balanced budget rule:** The fiscal deficit cannot exceed 2 percent of gross domestic product (GDP). (This rule was originally meant to start in 2013, but the starting year was postponed four times and is now set at 2025.) The fiscal deficit target shall be reviewed every four years.
- **Debt ceiling:** Net present value (NPV) of public debt cannot exceed 60 percent of GDP. (Originally the target was 40 percent of GDP, meant to start in 2013, but the rule was modified and is now applicable as of 2024.) For the purposes of this rule, the definition of NPV of public debt does not include government loans related to mining, energy, and railroad projects, nor does it include central bank debt or state-owned enterprise debt without an explicit government guarantee.
- **Expenditure rule:** Expenditure growth limited to the greater of nonmineral GDP growth or nonmineral GDP growth over a 12-year period. (This rule was originally meant to start in 2013 but was postponed until 2017.)
- **Revenue rule:** Fiscal revenue projections will be estimated using “structured procedures.” According to the Ministry of Finance, this is interpreted as a revenue rule requiring savings in the budget stabilization fund in cases of mineral revenue windfall. In practice, when revenues from a single mineral exceed 3 percent of fiscal revenues, the windfall (calculated using a long-term average price) is saved in the FSF. A shortfall triggers a transfer from the stabilization fund under the Law on Government Special Funds (2006). The Fiscal Stability Law (FSL) allows for exceptions in case of recession, natural disaster, or national emergency. Suspension of the rules requires State Great Hural (parliamentary) approval.

The inflows and outflows, as well as estimated balance of the fund, are shown in figure 1 below. These funds are held in commercial banks in Mongolia in nonterm deposits with interest rates of around 7–9 percent; however, the FSF is fairly opaque. For instance, the FSF does not publish annual reports, nor are returns on investments made publicly available in detail.

Because the actual sources of revenue and withdrawal rules for the FSF are regulated by the Law on Government Special Funds, the government can change this law and circumvent the FSL requirements aimed at accumulating significant amounts to the fund. For instance, at the end of 2016, facing a budget deficit, the government amended the law to allow it to withdraw funds from the FSF and cover the deficit. Initially this was planned to be a one-off arrangement, to last until the end of 2017. However, in 2017, the government extended this provision and decided to use all remaining FSF revenues to finance budget deficits until the end of 2023.<sup>1</sup>

**Figure 1. Flows and accumulation in the Fiscal Stability Fund (2011–2019; million tog)**



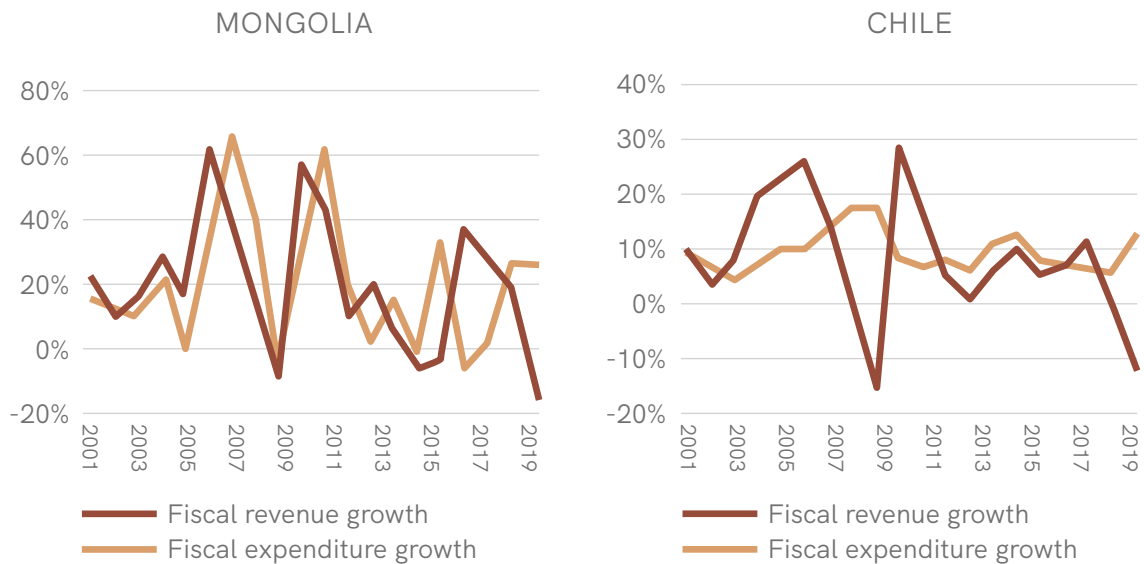
**Source:** Budget Performance Indicators, Ministry of Finance, [www.mof.gov.mn](http://www.mof.gov.mn), and author's calculations.

Despite the establishment of the FSF in 2010 and the fiscal rules described, fiscal expenditures have continued to fluctuate in line with coal and copper prices. The result of this extreme volatility in government spending has been: (1) increasingly inefficient spending during boom times, especially on a plethora of politically motivated local infrastructure projects; and (2) a ratcheting up of public debt with each decline in fiscal revenues. The inability to smooth fiscal

<sup>1</sup> Law on Government Special Funds, additional provisions 9(1).3.4 and 34.2, November 2016 and April 2017. Online: [www.legalinfo.mn](http://www.legalinfo.mn).

expenditures, as Chile, another copper-dependent country, has done, has contributed to Mongolia's fiscal crisis and poor public investment decisions (see figure 2).

**Figure 2.** Fiscal revenue and expenditure growth in Mongolia and Chile (year-on-year percent change)



Source: IMF and authors' calculations.

In 2016, the Future Heritage Fund Law was enacted, establishing a second revenue rule. According to the law, the following revenue flows would be deposited into a new sovereign wealth fund (SWF), the Future Heritage Fund (FHF), to "park" a portion of mining revenues for the benefit of future generations:

- 50 percent of additional, new mining revenue;
- 20 percent of unexpected mineral revenue windfalls (not including state dividends or royalties) (as of 2018);
- 65 percent of royalties from mineral projects, after distribution to the FSF; and
- state dividends from the development of mineral projects.

If we assume that all streams of mineral revenues will continue to constitute on average about 25 percent of fiscal revenues, and if we make a number of assumptions about royalty, state dividend, and tax revenues going forward, then we estimate that approximately 25–50 percent of mineral revenues (not including oil) might be deposited into the FHF in an average year. In other words, under the law, approximately 25–50 percent of mineral revenues would be saved until 2030, after which 10 percent of the FHF's net investment

income, or approximately 0.2–0.5 percent of the value of FHF assets, would be withdrawn annually.<sup>2</sup>

In many countries—especially those with fiscal revenues that are large relative to their populations or economies—it makes sense to set aside a portion of oil or mineral wealth. A government can earn interest on these savings and use that interest to finance crucial social services and public investments. For example, the Texas government uses the earnings from its sovereign wealth fund to finance public university education, Alaska uses its fund to pay cash dividends to each resident, and Norway and Timor-Leste use their funds' interest to finance their national budgets. However, this approach makes less sense where public debt levels are so high that the interest rate paid on borrowed money is higher than the interest earned from SWF savings.<sup>3</sup>

The well-established, larger and more professionally managed SWFs have yielded financial returns in the range of 2–6 percent annually in nominal terms (US dollar denominated). For instance, since its inception in 2006, Chile's Pension Reserve Fund, its long-term savings fund, has yielded an average annual return of 3.2 percent. The Ghana Heritage Fund has yielded an annual return of 1.8 percent since 2011. Since 1990, Norway's SWF has yielded an average annual return of 5.78 percent.<sup>4</sup>

However, it is important to contrast this with the borrowing costs these countries face. Although some Organisation for Economic Co-ordination and Development (OECD) countries are borrowing at near-zero interest rates, emerging market sovereign bond yields are around 4 percent higher on average.<sup>5</sup> The most recent US dollar-denominated debt issues in Mongolia, a US\$ 600 million 5.5-year "Nomad bond" issued in September 2020, was sold for 5.125 percent annually.<sup>6</sup>

Unlike most other sovereign wealth funds, which are financed out of fiscal surpluses (e.g., Chile, Kazakhstan, Norway, Qatar, Saudi Arabia, and Timor-Leste) and/or were established in countries with low or declining public debt levels (e.g., Botswana, the Russian Federation), the FHF is being established in a context of significant budget deficits, a large debt-to-GDP ratio, and high interest rates on sovereign debt. This could lead to a situation in which mineral revenues are deposited into the fund and are being invested in foreign assets at a 2–4 percent real return (the current average real return for low-to-moderate risk profile sovereign wealth fund), at the same as the government is borrowing on international financial markets and paying 5–10 percent real interest (the current rate).

<sup>2</sup> NRG (2015) *Discussion of Mongolia's Draft Future Heritage Fund Law*. Natural Resource Governance Institute.

<sup>3</sup> Andrew Bauer and David Mihalyi (2018) *Premature Funds: How Overenthusiasm and Bad Advice Can Leave Countries Poorer*. Natural Resource Governance Institute.

<sup>4</sup> Ibid.

<sup>5</sup> Aline Oyamada, Philip Sanders, and Liz Capo McCormick (2018) *"JP Morgan Sees ECB and BOJ Adding to Pain for Emerging Bonds"* Bloomberg News. November 29.

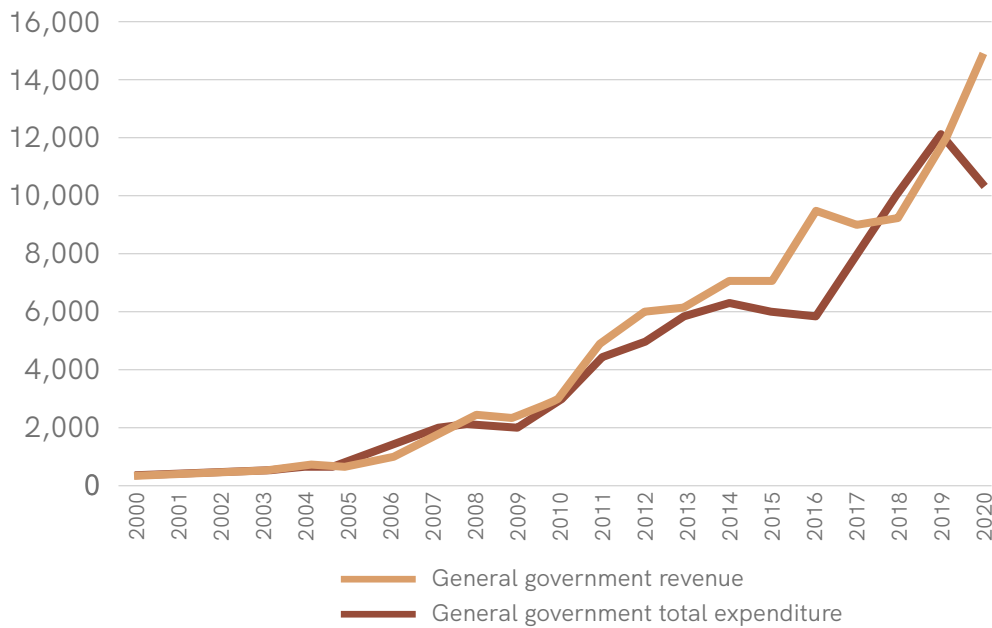
<sup>6</sup> Cbonds (2021) *"Latest issues"* Country: Mongolia.



We have witnessed this situation in other countries, most recently in Argentina, Ghana, and República Bolivariana de Venezuela. In each of these cases, the interest paid on sovereign debt has been higher than the financial return on public savings over the last two years. The policy response has been the same in each: breaking budget rules to draw down on national savings in order to finance spending or reduce the public debt burden. In Argentina, the public pension fund, ANSES, made over US\$ 14 billion in low-interest loans to the government from 2013–14. In Ghana, the government raided the oil-financed Ghana Stabilization Fund using a legal loophole to cap the size of the fund and continues to borrow heavily. The IMF and the government have agreed on a bailout package in 2017 that involves public sector job cuts. In República Bolivariana de Venezuela, the government emptied the Macroeconomic Stabilization Fund, which had stood at US\$ 7.1 billion in 2001. The country now faces a fiscal crisis and violent protests on the streets against economic hardship. These cases highlight the dangers of borrowing at a high interest rate and attempting to save simultaneously.<sup>7</sup>

Government foreign savings make sense when the long-term real return on foreign assets is greater than the interest paid on public external debt. As accumulated funds won't be withdrawn until 2030, Mongolia will benefit from compound interest on these funds. Public debt payments should be reduced to a sustainable level; however, debt reduction can be achieved in a manner that still leaves revenues available for the gradual accumulation of assets and savings in the FHF. Use of Mongolia's natural hedge on minerals such as commodity-linked bonds can be considered to optimize the debt portfolio. In the event of an economic downturn—for example, resulting from falling commodity prices—experience in other countries suggests that sovereign wealth funds can suffer from credibility problems. In other words, maintaining a savings fund while debt levels soar due to an economic downturn may not be credible, as politicians are likely to find ways to make discretionary withdrawals from the fund to assuage debt pressures. In Mongolia, this underlines the importance of the FSF, which, if working well, should allow Mongolia to manage economic cycles without raiding the FHF. The FSF is essential for the credibility of the FHF.

<sup>7</sup> Asian Development Bank (2019) *Improving Management of Natural Resource Revenues in Mongolia*. Observations and Suggestions No. 2019-01.

**Figure 3. Fiscal revenues and expenditures in Mongolia (billion tog)**

Source: IMF, World Economic Outlook database.

The FHF's investment strategy and asset management framework may also be a source of concern. Ideally, investment rules offer an important means of preventing mismanagement and addressing common challenges related to conflicts of interest, lack of managerial capacity, and incentives rewarding excessive risk-taking. "Principal-agent" problems, wherein the managers of government assets act in accordance with personal rather than public interests, are a common source of conflict of interest.

Lack of managerial capacity to manage funds well or to oversee investment managers can lead to large losses. Rules that limit the percentage of fund assets that a single investment manager may control can help spread the risk of large losses due to misconduct or negligence. Similarly, rules can be written to ensure that only qualified managers manage fund investments.

Excessive risk-taking by investment managers can also create challenges. Whereas the executive or ministry of finance is usually responsible for overall management of the fund and sets investment policy, and the central bank or an independent agency acts as day-to-day operational manager, external managers are often hired to make some or all of the actual investments. Because much of their compensation comes from management fees and they can charge higher fees for trading more complex, higher-risk financial products, external managers have an incentive to push funds to invest in risky assets like derivatives. Although high-risk/high-return investments may have a place within even a very conservative private institutional investor's overall portfolio, as custodians of public funds, SWF managers have a responsibility to safeguard assets and prevent waste or excessive risk-taking. Detailed investment rules,

such as those limiting purchases of high-risk assets, can help address excessive risk-taking.<sup>8</sup>

The FHF legislation does not make explicit a list of assets that the fund cannot invest in, such as low-grade securities, real estate, commodities, or derivatives.<sup>9</sup> That said, the government is currently developing investment guidelines that should provide a regulatory framework for asset management. It remains to be seen whether these guidelines are appropriate for the Mongolian context, limit excessive risk-taking, and constrain management fees and conflicts of interest.

Finally, fund management, oversight, and transparency are essential for ensuring that the public's money is well managed through the SWF. Government decisions about the institutional structure, staffing policies, and internal controls have a huge impact on a fund's success. Establishing an effective organizational structure, clear lines of communication between different levels of the institutional hierarchy, and a strong internal chain of accountability, both within an SWF and between the fund and higher authorities, can help the fund meet its objectives, prevent misuse of resource revenues for political purposes, and prevent corruption by officials or external managers.<sup>10</sup>

The FHF legislation establishes the minister for fiscal and budget affairs as the manager of a new corporation that is governed by a board. This is in line with international practice. It remains to be seen whether the selection criteria for board members ensures board independence and effective oversight.

The FHF legislation is fairly comprehensive in its transparency requirements. Disclosure measures include publicly posting annual, quarterly, and monthly statements of asset management activities. However, several additional pieces of information—for instance, a list of individual assets owned, future mineral revenue projections, names of board members, and a list of material transactions of the fund—may be helpful in improving fund oversight.<sup>11</sup>

State Great Hural and Auditor General oversight of the fund will also be essential for minimizing the probability of malfeasance. Oversight bodies identify noncompliance with rules, waste, fraud, abuse, and mismanagement and suggest or enforce corrections. They are a chief force that induces a government to follow its own rules or principles—and meet its own objectives. They can also encourage governments to manage public funds in the public interest, rather than for private gain, and to follow the rule of law.<sup>12</sup> Both the State Great Hural and Auditor General have the right to oversee fund finances and reports and ought to use these powers to promote effective management of the FHF.

<sup>8</sup> Andrew Bauer (ed.) (2014) *Managing the Public Trust: How to Make Natural Resource Funds Work for Citizens*. Columbia Center on Sustainable Investment (CCSI)-Natural Resource Governance Institute (NRGI).

<sup>9</sup> NRGi (2015) *Discussion on Mongolia's Draft Future Heritage Fund Law*. Natural Resource Governance Institute.

<sup>10</sup> Andrew Bauer (ed.) (2014) *Managing the Public Trust: How to Make Natural Resource Funds Work for Citizens*. Columbia Center on Sustainable Investment (CCSI)-Natural Resource Governance Institute (NRGI).

<sup>11</sup> NRGi (2015) *Discussion on Mongolia's Draft Future Heritage Fund Law*. Natural Resource Governance Institute.

<sup>12</sup> Andrew Bauer (ed.) (2014) *Managing the Public Trust: How to Make Natural Resource Funds Work for Citizens*. Columbia Center on Sustainable Investment (CCSI)-Natural Resource Governance Institute (NRGI).

## FISCAL RULE IMPLEMENTATION

The medium-term fiscal framework, Government Action Program, and annual budget should reflect these fiscal rules. The government must report on compliance with the rules. The State Audit Office also oversees compliance. If the government fails to comply with the rules, the budget may be returned, or the resignation of the government may be brought up by the State Great Hural. If the State Great Hural does not comply with the rules, the president may veto the budget bill.

Mongolia's fiscal rules have been circumvented by the government through various channels. For example, Mongolia used off-budget and quasi-fiscal expenditures extensively in the period of 2012–16, and this resulted in significant pressure on the budget and ballooning government debt, forcing the government to use the IMF's Extended Fund Facility to avoid sovereign default in 2016. The main vehicles for such expenditures included the activities of the Development Bank of Mongolia, which used government-guaranteed loans to finance a variety of projects in Mongolia, and the price stabilization programs financed directly by Central Bank, including the mortgage program and fuel and wheat price stabilization efforts. (See box 1 on the Development Bank of Mongolia.)

Another way of circumventing the fiscal rules has been the amendment to the rules through changing the law, through either altering target quantitative indicators or postponing the effective date when these targets are to be achieved. Specifically, the Law on Fiscal Stability was amended more than 13 times since its approval on June 24, 2010. For example, the requirement to amend this law by absolute majority of the State Great Hural was eliminated in April 2015.

Revenue projections from some big mining projects, notably for the Oyu Tolgoi (OT) copper-gold deposit and Tavan Tolgoi (TT) coal deposit, have proven wildly overoptimistic. These unwarranted expectations have undoubtedly contributed to the government's overspending.

Uncontroversially, fiscal rules were again suspended in 2020 in response to the COVID-19 pandemic. In August 2020, the State Great Hural amended the budget, bringing the fiscal deficit to approximately US\$ 1.4 billion.

The failure to implement the FHF law can partly be attributed to Mongolia's excessive public debt burden. Mongolia's public debt-to-GDP ratio was approximately 70 percent as of 2020, leading to high interest rates on external debt. In 2018, debt servicing was expected to cost Tog 1.15 trillion, 50 percent more than the health-care budget and 70 percent of the education budget for the whole country. Mongolia has since managed to restructure some of its sovereign debt, and the debt service costs have declined by approximately 25 percent since 2018. The International Monetary Fund (IMF)-led program and the Mongolian government reforms, as well as strong commodity prices, have partially restored confidence in the sovereign debt of Mongolia, thereby averting default and a banking crisis.

That said, these benefits are vulnerable to an unexpected drop in mineral prices. Based on independent projections, a mere 15 percent decrease in commodity prices from June 2017 levels (the equivalent of an approximately 30 percent drop in the price of coal and a 50 percent drop in the price of copper today) pushes Mongolia back into a debt crisis, even with implementation of the planned reform measures.<sup>13</sup> Furthermore, absolute debt levels continue to rise, especially following the COVID-19 pandemic, although on better terms than previously. As a result, the government continues to transfer money to foreign financial institutions and domestic bank shareholders at the expense of greater social spending and public investment.

#### BOX 1:

### DEVELOPMENT BANK OF MONGOLIA

The Development Bank of Mongolia (DBM) was established in 2011 to finance “strategically significant sectors for Mongolia’s growth.” Among the named sectors were railroads, power plants, housing, and the Sainshand Industrial Complex, a set of projects including a wind farm and oil refinery planned for the crossroads of two railroads in the rural Southeast of Mongolia.

Some of the DBM’s largest loans have been in the mining sector. US\$ 250 million was loaned to Erdenes Tavan Tolgoi LLC for the development of mining, energy, and other strategically important sectors. US\$ 50 million was loaned for the Tavan Tolgoi power plant. US\$ 196.2 million was loaned for the Ukhua-Khudag-Gashuunsukhait railroad, meant to transport coal. The DBM has also loaned US\$ 115 million to MIAT Mongolian Airlines for the purchase of a Boeing aircraft, Tog 718 billion (US\$ 250 million) for rural roads, and Tog 50 billion (US\$ 36 million) for low-interest mortgages.

The DBM has a strikingly high rate of nonperforming loans (NPLs) in its portfolio, 19 percent in 2019. For instance, the conglomerate Erel LLC has failed to pay back a Tog 132 billion loan reportedly used to finance housing construction and a power plant. Also, Khutul Cement LLC owes Tog 236 billion and the State Housing Corporation owes Tog 258 billion. The DBM’s NPL ratio is significantly higher than the NPL ratio for private sector banks in Mongolia and is among the highest among Asian state-owned banks.

The DBM has financed much of its lending by issuing debt or borrowing from creditors.

Since inception, the DBM has borrowed billions of dollars, euros, and yen from foreign creditors at interest rates ranging from 1.5 percent on a 10-year ¥ 30 billion “samurai bond” in 2013 to 9.5 percent on a US\$ 75 million 2-year loan from Cargill International in 2016. Today, the DBM’s outstanding debt is valued at more than US\$ 1 billion; the average interest rate on external debt is more than 5.3 percent.

The DBM’s financial statement from 2016 to 2019 shows a net loss on its operations, largely due to loan impairment. As of the end of 2019, the DBM remained solvent, with equity valued at more than US\$ 400 million. However, the COVID-19 pandemic has increased NPLs from their already high levels and has decreased the value of the bank’s collateral. It is unclear whether the DBM remains solvent.

Even though the DBM has arguably provided financing for projects meant to drive industrial development in Mongolia, lending decisions have largely been driven by political imperatives rather than projected profitability or assessments of broad-based social returns—for instance, job creation or unlocking Mongolia’s growth potential. The DBM has recently been under investigation by the Independent Authority Against Corruption (IAAC) for providing favorable borrowing terms to some companies with links to high-level politicians. The bank has also struggled to objectively measure risk, value collateral accurately, rate borrowers, and monitor borrowers to ensure that the money is being spent on the projects it was meant for.<sup>14</sup>

<sup>13</sup> David Mihalyi, Daniel Baksa, and Balasz Romhanyi (2017) *Mongolia Macro-Fiscal Model*. Natural Resource Governance Institute.

<sup>14</sup> PWC (2018) *Financial Diagnostic of the Development Bank of Mongolia*. PricewaterhouseCoopers Audit LLC.

## THE ROLE OF ERDENES MONGOL IN MANAGING MINERAL REVENUES

The fiscal rules described above assume that the government’s mineral revenue accrues to the Mongolian treasury. However, Erdenes Mongol—the government-owned holding company established in 2007 to manage the state interests in strategic mineral deposits—retains significant mineral revenue through nonpayment of dividends, noncollection of dividends from its subsidiaries, reinvestment, and bloated costs. Erdenes Mongol also spends significant resources on debt servicing.

To date, Erdenes Mongol has not paid any dividends to the state. Not a single subsidiary—including Erdenes Tavan Tolgoi, Baganuur, and Oyu Tolgoi—has paid a dividend to Erdenes Mongol, although some have made profits. Erdenes Mongol and its subsidiaries are also reinvestment machines rather than sources of revenue for the Mongolian treasury, to be spent on other government priorities such as health care and education. For example, although disaggregated cost data is not publicly available by subsidiary, public disclosures show that only 62 percent of Erdenes Tavan Tolgoi’s costs are directly attributable to the production of coal, including machinery and labor. A large percentage of the remaining 38 percent was spent on marketing, benefits, travel, and entertainment.<sup>15</sup>

Erdenes Mongol’s low level of profitability and underperformance can be explained in several ways. First, Erdenes Mongol’s mandate—and more broadly the government’s role in the mining sector—have never been clearly defined in legislation. As a result, its expansion and evolution—for instance, its involvement in power plants, steel production, petroleum exploration, and the hospitality businesses—have not been directed by any objective national development plan. The company has established new subsidiaries operating in sectors of the economy that require varying skills and expertise.

Policy making within the company has also been inconsistent due to high levels of turnover among the board of directors and senior management, which has coincided with political changes such as elections.

Commercial decisions at Erdenes Mongol should be based on assessments of value-for-money, particularly because the victims of poor performance are Mongolian taxpayers and beneficiaries of the state, including doctors, teachers, and citizens more generally. Appointments should also be primarily based on merit rather than political connections. Finally, Erdenes Mongol and its subsidiaries should be subject to independent external audits that are published on the company’s website, as well as a much higher degree of transparency of financial information and operations.

<sup>15</sup> Andrew Bauer and Dorjdari Namkhajantsan (2019) *Wild Growth: An Assessment of Erdenes Mongol*. Natural Resource Governance Institute.

# Extrabudgetary funds including sovereign wealth funds

Within this macroeconomic context, the government of Mongolia aims to establish a new sovereign wealth fund focused on investments in domestic assets. The proposal was first announced by Minister of Mining and Heavy Industry D. Sumiyabazar in 2018. The fund would invest inside Mongolia and be managed by Erdenes Mongol. Financing would come from dividends from state-owned mines, sale of state mining assets, or by floating state-owned mine shares on the stock exchange.<sup>16</sup> Since then, Erdenes Mongol has drafted a bill that is being considered by the government.<sup>17</sup>

Part of the impetus is to bring laws and regulations in line with amendments to the Constitution of Mongolia. The changes made in November 2019 but put in force as of July 2020 include a modification of Article 6 on natural resource management. Previously, the article stated that “the land, its subsoil, ..., and other natural wealth in Mongolia ... be subject to the people’s authority and under the protection of the State” and “the land, except that in private ownership of the citizens..., as well as the subsoil with its wealth, ... be the property of the State.”<sup>18</sup> This section was changed to: “The land, except for the property owned by the citizens of Mongolia, subsoil, its wealth, forests, water resources, and wildlife shall be state public property.”

Many countries use extrabudgetary funds to manage their natural resource revenues. In fact, all but a handful of large oil or mineral producers have established a resource-financed special fund. Together, these funds manage trillions of dollars in resource revenues annually.

In some cases, these funds are merely accounts within the state treasury, created for political purposes to demonstrate a commitment to financing a certain expenditure item (e.g., education) or for accounting purposes. In other cases, they are institutions that are subject to different rules than the rest of the government’s financial transactions. They may even have their own staff and

<sup>16</sup> Dorjdari Namkhajantsan and Andrew Bauer (2018) [New Fund Plans Could Divert Mongolia’s Focus From Mining Sector Reforms](#). Blog. Natural Resource Governance Institute.

<sup>17</sup> G. Iderkhangai (2020) [“A wealth fund too many?”](#) Mongolian Mining Journal. October 2020.

<sup>18</sup> Article 6, The Constitution of Mongolia, 1992.

legal standing. Drawing on the IMF definition, extrabudgetary funds are defined here as “general government transactions, often with separate banking and institutional arrangements, which are not included in the annual state (national) budget law and the budgets of subnational levels of government.”<sup>19</sup>

There are several legitimate reasons why a government might establish an extrabudgetary fund. First, traditional budgets are set on an annual basis, whereas funds can serve as multiyear funds. Timor-Leste’s Infrastructure Fund is essentially a multiyear earmarked budget. Parliament must approve the fund’s budget, and spending must be channeled through normal budget processes. However, the fund retains any unspent funds at the end of the year. Since its inception, the Infrastructure Fund has financed projects that have electrified 75 percent of Timor-Leste territory, rehabilitated ports, irrigated three regions, and paved many public roads.<sup>20</sup>

Second, the budget process sometimes does not function well, especially in low-capacity environments. Extrabudgetary funds can be subject to more stringent transparency, oversight, and governance standards than the budget and be allocated to more qualified staff, in order to create islands of good governance inside the government. Although this may be true in theory, real-world examples of these “islands of good governance” are rare.

Third, funds can be used to earmark revenues for a specific purpose. For example, the oil- and land sales-financed Texas Permanent University Fund in the US earmarks interest earned to the public university system in the state. Similarly, Alabama’s (US) Forever Wild Land Trust Fund, financed by between 3-5 percent of the state’s oil and gas revenues, allocates money to environmental protection. Whereas the Texas fund is a sovereign wealth fund, a special type of extrabudgetary fund discussed below, the Alabama fund is just an account within the budget.

Fourth, funds can protect a specific stock of fiscal revenues from political interference. Most government pension funds are established as extrabudgetary entities in order to safeguard this pool from appropriation for other purposes. This enhances senior citizens’ confidence that they will receive their full pension benefits many years in the future. The Canada Pension Plan and France’s Fonds de Réserve pour les Retraites are good examples of such funds. They both have clear objectives, legal structures, investment strategies, and codes of conduct for staff and managers and publish comprehensive annual and quarterly reports. They also have strong independent audits that are published online and compliance mechanisms to ensure that the funds are managed in the best interest of their ultimate beneficiaries, retired citizens.<sup>21</sup>

<sup>19</sup> Richard Allen and Dimitar Radev (2006) [Managing and Controlling Extrabudgetary Funds](#). IMF Working Paper 06/286.

<sup>20</sup> Government of Timor-Leste (2016) [State Budget 2016 Approved: Infrastructure Fund](#).

<sup>21</sup> Allie E. Bagnall and Edwin M. Truman (2013) [Progress on Sovereign Wealth Fund Transparency and Accountability: An Updated SWF Scoreboard](#). Peterson Institute for International Economics.



Sovereign wealth funds (SWFs) are special types of extrabudgetary funds. According to the International Forum of Sovereign Wealth Funds, an SWF is defined as a government-owned entity that is established for a macroeconomic purpose, does not have liabilities, and invests at least partly in foreign assets.<sup>22</sup> Other definitions cover all state-owned commercial investors, even those that invest exclusively in domestic assets.

As of 2020, there were approximately 60 SWFs that invest in foreign assets financed by hydrocarbon or mineral revenues or by fiscal surpluses in countries dependent on natural resources. These more traditional SWFs are generally created to serve one or several of the following purposes:<sup>23</sup>

- **Smoothing expenditures:** Governments can save a portion of fiscal revenues in funds (sometimes formally called “stabilization funds”) when revenues are high and draw down on these funds when revenues decline in order to prevent “boom–bust” spending cycles. For example, the US state of Wyoming has been able to grow through periods of temporary oil and mineral price declines due in part to the availability of a pool of funds to draw on during downturns.
- **Sterilizing capital inflows:** Sovereign wealth funds can help mitigate “Dutch disease” by sterilizing large capital inflows; in this case, foreign exchange inflows associated with large remittances, foreign aid, or natural resource sector sales. Countries such as Norway and Saudi Arabia have kept their exchange rates under control or inflation lower than it would have been otherwise by saving resource revenues in foreign assets rather than spending them domestically.
- **Saving fiscal surpluses:** Governments may wish to run a fiscal surplus over the long term in order to create an endowment for future generations. Some governments may find it difficult to spend all resource revenues as they are collected without generating significant waste, as they do not have the “absorptive capacity” to spend the entire revenue windfall immediately. That is, they do not have the skills, technology, and administration to spend large amounts of money quickly and efficiently without generating inflation. As a result, some governments have elected to “park” some revenues in foreign assets until they develop enough capacity to spend the money well or until the economy grows enough to absorb the revenues. With small populations, high personal incomes, and vast oil wealth, many Persian Gulf countries, including Kuwait, Oman, Qatar, and the United Arab Emirates, as well as Norway, have chosen to save for these reasons.
- **Earmarking revenues for public investments:** SWFs can be used to limit the discretion of politicians in making spending decisions by earmarking

<sup>22</sup> Website: <http://www.ifswf.org/>.

<sup>23</sup> Andrew Bauer (2017) “Playthings and Parallel Budgets: Sovereign Wealth Fund Economic and Governance Performance” in *The New Frontiers of Sovereign Investment* (eds. Malan Reitveld and Perrine Toledano). Columbia University Press.

revenues for specific public investments like water systems, sanitation, electric power, medications, or education programs. Importantly, *earmarking* does not refer to making public spending decisions through the fund's choices of asset holdings, bypassing the formal budget process. Doing so could damage the integrity of the public financial management system, possibly circumventing accountability mechanisms such as parliamentary oversight and audits, and lead to the use of resource revenues for patronage.

- **Ring-fencing natural resource revenues:** Given natural resource revenues are the product of negotiations with a handful of companies rather than broad-based taxation, as well as the fact that payments are often large and secret, natural resource revenues are often a target of misappropriation. Sovereign wealth funds can help protect public funds from corruption or mismanagement, as long as they are subject to strict transparency provisions and effective oversight. For example, Ghana's Petroleum Funds and the Timor-Leste Petroleum Fund are subject to rigorous disclosure requirements that ensure that fund operations are scrutinized and oil and gas revenues are all accounted for.

The Alaska Permanent Fund, Chile's Pension Reserve Fund, and the Texas Permanent University Fund have each invested oil, gas, or mineral revenues to finance specific expenditure items, in these cases cash dividends for citizens, pensions, and tertiary education, respectively. Chile's Pension Reserve Fund, for instance, is allocated 0.2–0.5 percent of GDP annually, of which a portion is derived from copper sales. Funds from the Pension Reserve Fund can only be used to pay for pension and social welfare liabilities and are capped based on a formula. The fund is subject to strict statutory investment rules, a high degree of transparency, and strong independent oversight.<sup>24</sup>

The Alabama Capital Improvement Trust Fund (US), Ecuador's Fondo para el Ecodesarrollo, Mongolia's General Local Development Fund, and Timor-Leste's Infrastructure Fund and Human Capacity Development Fund have each earmarked natural resource revenues to specific domestic projects ranging from electricity to environmental protection to subnational government treasuries via the budget process.

For example, the Alabama Capital Improvement Trust Fund is allocated 28 percent of the state's oil and gas revenues net of corporate income taxes. Similarly, the Forever Wild Land Trust Fund, which purchases land for nature preserves and public use and carries out educational programs, receives most of its funding from the 3.3 percent of oil and gas revenues and a small share of the earnings of the Alabama Trust Fund, an SWF.<sup>25</sup>

<sup>24</sup> NRG-CCSI (2013) *Chile: The Pension Reserve Fund and the Economic and Social Stabilization Fund*. Natural Resource Governance Institute-Columbia Center on Sustainable Development.

<sup>25</sup> NRG-CCSI (2013) *Alabama Trust Fund*. Natural Resource Governance Institute-Columbia Center on Sustainable Development.

Ecuador collects a dollar per barrel produced in the Amazon region in the Fondo para el Ecodesarrollo and distributes this amount between Amazonian municipalities, provincial councils, and parish councils. Of the 58 percent of Fondo para el Ecodesarrollo revenues designated for Amazonian municipalities, 40 percent is divided equally among all municipalities and 60 percent is distributed based on population.<sup>26</sup>

Timor-Leste's Infrastructure Fund and Human Capacity Development Fund are good examples of earmarking funds linked to strategic development plans. Both behave as multiyear earmarked budgets that finance plans and projects that will boost the low-income Southeast Asian country's long-term economic growth and help alleviate poverty. Their financing comes directly out of Timor-Leste's Petroleum Fund, which in turn is the recipient of all of the government oil and gas revenues. The funds' 5-year budgets are reviewed and approved by the parliament and are executed according to normal budgetary procedures. In 2015, the Infrastructure Fund spent US\$ 292 million on projects, including electricity, irrigation, sanitation, and drainage in the capital; a highway; and an airport rehabilitation.<sup>27</sup> In terms of transparency, governance, and effectiveness, these funds are in many ways models to emulate.

Earmarking can be a useful political messaging tool and can act as a commitment mechanism for current and future government administrations. It can also guarantee a source of funding for certain expenditure items, such as environmental protection, that often receive little or no funding. On the other hand, earmarking suffers from the challenge of fungibility; because money is interchangeable, a government can shift money from one source (e.g., oil revenues) into a project, but then transfer the previous allocation of money from that project to another, leading to a net impact of zero. Thus, earmarking often leads to a negligible change in budget allocations.

For each case of a well-run extrabudgetary fund, there is a case where a fund is simultaneously a macroeconomic tool that serves the personal interests of the political elite, or where the fund is mismanaged or takes excessive risks and is therefore ineffective. In extreme cases, funds are established to avoid public scrutiny or finance pet projects. As the Overseas Development Institute writes, "transactions outside the budget are unlikely to be subject to the same kind of financial discipline as are budget operations (for example, state-owned enterprises may have their own financial regulations and appoint their own auditors), partly because they are financially independent and partly because they are not explicitly compared with other public expenditures. This may result in an increased level of fraud, irregularity, or the use of such funds for unauthorized purposes. In addition, the use of extrabudgetary funds means the reported level of government expenditure may be understated. It also is more

<sup>26</sup> NRGI-UNDP (2016) [Natural Resource Revenue Sharing](#). Natural Resource Governance Institute-United Nations Development Programme.

<sup>27</sup> Government of Timor-Leste (2016) [State Budget 2016 Approved: Infrastructure Fund](#).

difficult to compare the finances of two governments if they have different levels of extrabudgetary funds.<sup>28</sup>

Stories of extrabudgetary funds being mismanaged, not achieving their objectives, or being used for patronage or corruption can be found on every continent. One of the most extreme examples of excessive risk-taking, poor managerial capacity, conflict of interest, and high management fees is the case of the Libyan Investment Authority (LIA). As an example of excessive risk-taking, in 2010 the LIA made a US\$ 1.2 billion bet with Goldman Sachs on a derivatives instrument. It lost US\$ 1.18 billion out of the US\$ 1.2 billion. The LIA's 2012 US\$ 300 million investment in Palladyne International Asset Management, a previously unheard-of fund with links to the former chairman of Libya's National Oil Corporation, is an example of a clear conflict of interest. Of note, despite investing only slightly more than half of these funds, Palladyne recorded more than US\$ 50 million in losses from 2008 to mid-2010. One example of high management fees is the LIA payment of US\$ 27 million in fees on a US\$ 300 million investment with Permal, a fund manager. The fund lost US\$ 120 million with Permal.<sup>29</sup>

The 1Malaysia Development Berhad (1MDB) fund, established in 2009, has proven to be another major source of alleged corruption and mismanagement. Designed to attract investment into Malaysia by forming joint ventures with foreign firms, the fund actually was in debt by over US\$ 11 billion by 2014. Among its more suspect transactions are a US\$ 1 billion investment in a Saudi oil company in 2009 that has gone missing; a diversion of funds in 2012 from an Abu Dhabi state fund to a firm in the British Virgin Islands (a secrecy jurisdiction); and a misappropriation of US\$ 4 billion from Malaysian state firms.<sup>30</sup> The U.S., Switzerland, Singapore, and the UK have brought criminal charges against, or continue corruption and money laundering investigations related to, the fund.

The Iranian fund is an example of an extrabudgetary fund becoming a parallel budget or state-within-a-state, undermining parliamentary accountability, democratic institutions, and public financial management systems. The US\$ 40 billion National Development Fund provides loans to private-sector companies, cooperatives, and economic enterprises owned by public nongovernmental institutions through agent banks. Although the fund does not provide information on the current investment allocation of its portfolio, news reports indicate that fund money has been allocated to the domestic tourism, petrochemical, upstream petroleum, and water sectors, among others. The fund is directly controlled by the executive and therefore some decisions bypass normal budgetary and parliamentary procedures.<sup>31</sup> Similarly, the US\$ 10 billion

<sup>28</sup> IBP (2010) *Guide to Transparency of Public Finances: Looking Beyond the Core Budget*.

<sup>29</sup> Andrew Bauer (ed.) (2014) *Managing the Public Trust: How to Make Natural Resource Funds Work for Citizens*. Columbia Center on Sustainable Investment (CCSI)-Natural Resource Governance Institute (NRGI).

<sup>30</sup> The Economist (2016) *The 1MDB Affair*. May 27.

<sup>31</sup> NRGI-CCSI (2014) *Islamic Republic of Iran: Oil Stabilization Fund and the National Development Fund of Iran*.

Russian Direct Investment Fund, explicitly financed by oil revenues, invests in domestic companies virtually without independent oversight, creating an unaccountable source of financing for supporters of the ruling regime. The fund is currently subject to US sanctions due to management's alleged involvement in corruption.

Of special relevance to the Mongolian context are those SWFs that were established by governments in so-called "debt spirals," situations where increasing levels of debt and interest payments eventually become unsustainable, leading to an excessive portion of the public revenues being allocated to interest payments or some type of default. Most sovereign wealth funds are financed out of fiscal surpluses (e.g., Chile, Kazakhstan, Norway, Qatar, Saudi Arabia, and Timor-Leste) and/or were established in countries with low or declining public debt levels (e.g., Botswana and the Russian Federation). However, sovereign wealth funds are sometimes created prematurely where unsustainable debt levels mean that the earnings from foreign financial investments are lower than the interest rate being paid on public debt.

In these cases, the government is faced with a choice between defaulting or drawing down on savings; many have understandably chosen the latter, even when technically illegal. In Argentina, the public pension fund made over US\$ 14 billion in low-interest loans to the government from 2013–14. In Ghana—where transparent and conservatively managed SWFs yielded a net return of around 1 percent annually but where the country paid more than 9 percent interest on its Eurobond issuances—the government drained the oil-financed Ghana Stabilization Fund by placing a ceiling on the size of the fund.<sup>32</sup> In República Bolivariana de Venezuela, the government emptied the investment fund for the Macroeconomic Stabilization Fund by amending the reference value for oil prices and by increasing presidential discretion for withdrawals.<sup>33</sup> In Algeria, the autocratic government simply drew down on public savings unilaterally. Mongolia already has some experience with this situation, where the return on fiscal savings is less than the interest rate on external debt. This is one reason why the government has chosen not to implement the FHF.

## GOOD GOVERNANCE OF EXTRABUDGETARY FUNDS

While these stories illustrate the downsides and dangers of creating extrabudgetary funds, especially SWFs, in contexts where they are inappropriate, there are measures that governments can take to improve the chances that funds will improve public financial management.

<sup>32</sup> Andrew Bauer and David Mihalyi (2018) *How "Premature Funds" Can Leave Countries Poorer*. IMF PFM Blog.

<sup>33</sup> Asian Development Bank (2019) *Improving Management of Natural Resource Revenues in Mongolia*. Observations and Suggestions No. 2019-01.

Many of the challenges can be addressed through constitutional, legislated, or other statutory rules or institutions, such as:<sup>34</sup>

- **Management and organizational structure:** Strong institutional structure, staffing policies, and internal controls of a fund are essential. This involves clear lines of communication between different levels of the institutional hierarchy and a strong internal chain of accountability, both within the fund and between the fund and higher authorities.
- **Inflow/deposit rules:** Inflow or deposit rules determine which revenue streams (e.g., license fees, royalties, oil revenues) will enter the fund, where the money comes from (e.g., the treasury department, internal revenue department, directly from companies), and the timing of such deposits (e.g., monthly, annually).
- **Outflow/withdrawal rules:** The outflow or withdrawal rules determine how much money, which flows (e.g., interest, a percentage of principal), and when revenues will be transferred from the fund to the treasury to be spent according to the annual budget. These sets of rules are distinct from the allocation of assets for investment purposes. Rather than for loans, these withdrawals are meant for final consumption.
- **Investment rules:** Funds' investment decisions are generally subject to guidelines, constraints, and prohibitions. These are generally meant to prevent excessive risk-taking and conflict of interest. Among the rules commonly prescribed are asset allocation criteria, ethical standards, eligible assets, currency restrictions, minimum credit ratings, limits on high-risk assets, restrictions on private market instruments, and liability limits. The rules and guidelines also specify the remunerations scheme for external managers, limiting fees and risk-taking.<sup>35</sup>
- **Transparency:** Fund transparency involves clear roles and responsibilities of government institutions, public and easy access to financial and operational information, open decision-making and reporting, and assurances of integrity of information; for example, through an external audit. Transparency is important for a number of reasons. For instance, it enables oversight bodies, such as parliament, to monitor fund activities and builds trust with citizens.
- **Oversight:** Oversight bodies identify noncompliance with rules, waste, fraud, abuse, and mismanagement and suggest or enforce corrections. When well designed, they can encourage government to meet its own objectives and follow its own rules. Funds can be subject to oversight from the supreme audit institution, independent external auditor, judiciary, parliament, regulatory agency, or multistakeholder group. In practice, this

<sup>34</sup> Andrew Bauer (ed.) (2014) [Managing the Public Trust: How to Make Natural Resource Funds Work for Citizens](#). Columbia Center on Sustainable Investment (CCSI)-Natural Resource Governance Institute (NRGI).

<sup>35</sup> Ibid.

means setting up an institutional structure whereby all decisions are being overseen by at least two organizations, one internal and one external.

Consensus building is also important, as politicians and oversight bodies are unlikely to enforce the rules unless they have a feeling of ownership over those rules. There are many models of consensus building, from parliamentary debates to public surveys to political ententes.

There is no best practice with regard to organizational structure, inflow and outflow rules, or investment rules, although there are international standards for transparency, oversight, and management structure. The most well-known of these are the *Santiago Principles*, and the IMF's *Guide on Resource Revenue Transparency and Manual on Fiscal Transparency*. Good governance of state-owned companies—especially strategic development funds, public-private partnership (PPP) funds, and national development banks financed by natural resource revenues—are informed by a set of general standards developed by international organizations and think tanks. The Organisation for Economic Co-operation and Development's (OECD) *Guidelines on Corporate Governance of State-Owned Enterprises* and its guide for practical implementation, *Accountability and Transparency: A Guide for State Ownership*, represent a list of standards for all state-owned enterprises endorsed by a set of governments. The World Bank's *Corporate Governance of State-Owned Enterprises: A Toolkit* is a more comprehensive resource for state-owned company governance, although not a set of standards. The Extractive Industries Transparency Initiative's (EITI) new standard also requires that implementing countries indicate which extractive revenues are recorded in the national budget and allocated to special funds such as sovereign wealth funds or state-owned enterprises.<sup>36</sup>

<sup>36</sup> Section 5.1 of the EITI Standard 2016.

# Strategic investment funds and state-owned holding companies

Governments around the world have, throughout recorded history, invested directly in commercial enterprises as shareholders. In the extreme, communist countries have restricted private ownership of businesses. However, degrees of state equity exist in nearly every country today.

A state-owned enterprise (SOE) is a commercial entity more than 50 percent owned by the government and whose operations and finances are controlled by the government. Whereas significant research has been carried out on the governance and performance of SOEs, minority shareholdings by the state have received less attention, although they are also relatively common. Minority state ownership has generally emerged as a result of a privatization process where the state retained some shares. In other cases, especially in the oil, gas, and mining sectors, laws require the state be offered a minority equity share in designated projects. Still in others, the state has decided to purchase a minority equity share either as an investor or to support existing shareholders.

Although state shares can be held by any government entity, in recent years some countries have consolidated their equity under a single roof. Names for such commercial entities vary from country to country, including sovereign wealth fund, strategic investment fund, or state-owned holding company. The nomenclature matters less than the mandate of the entity, the rules governing it, and whether decision-makers are held accountable for their actions.

The government of Mongolia has made clear its intention to establish a new sovereign wealth fund. It is as yet unclear whether it will be designed to resemble a strategic investment fund (SIF) or state-owned holding company; however, it will be some type of state-owned institutional investor. Given the early stages of fund design, this section of the report will attempt to inform decision-makers by examining the global experience with funds that invest in domestic equity, whether as minority or majority shareholder. Because SOE governance is well covered in other publications, we will begin by discussing the advantages and disadvantages of minority shareholding by the state, whether by an SIF or another state entity. This will be followed by a discussion of state-owned holding companies. Finally, we will provide lessons from case studies of SIFs around the world.



## ADVANTAGES AND DISADVANTAGES OF MINORITY SHAREHOLDING

Minority state ownership in privately controlled companies is a fairly common practice in emerging markets; among the companies where governments have a direct ownership stake, 20–30 percent are cases of minority shareholding.<sup>37</sup> In theory, minority shareholding provides the government with a degree of insider information and comfort in knowing that the figures that the tax administration and regulator are receiving are correct. Government representatives may sit on the board of directors, in which case they can learn about company strategy and receive information not normally transmitted to regulatory authorities, such as technical designs and plans, quarterly updates, and safety issues.<sup>38</sup>

There is also some evidence that minority state ownership protects other minority shareholders from misappropriation or mismanagement. Tunneling, whereby assets and profits are transferred out of a firm for the benefit of the controlling shareholders—for instance, through transfer pricing, excessive compensation, or asset sales—is a common practice worldwide. As the state is also the regulator, it has an interest in preventing such behavior.<sup>39</sup>

State minority ownership can also align state and corporate interests, easing business for corporate elites by opening up direct channels of communication with the managers of state equity, whether at a ministry or in an institutional investor like a sovereign wealth fund. For instance, board members appointed by the government can act as spokespeople for the company within the government. This can be helpful for corporate interests when there are conflicts with state regulatory authorities. Operators of mining companies often want government-appointed board members to serve for this reason.<sup>40</sup> Additionally, state minority ownership can act as a means for business elites to build political ties as a way to overcome institutional voids or to motivate state actors to provide them with resources and preferential treatment.<sup>41</sup>

On the other hand, company managers are less keen about the financial implications of state minority ownership. Budget cycles are often delinked from project cash calls, which are common in the extractive sector, for example. Thus companies must hold more cash-on-hand than is optimal, or government entities must borrow to cover their cash calls.

<sup>37</sup> Aldo Musacchio and Sergio Lazzarini (2014) *Reinventing State Capitalism: Leviathan in Business, Brazil and Beyond*. Harvard University Press.

<sup>38</sup> Interview with international mining company executive.

<sup>39</sup> Mihail Miletkov (2014) “A Cure Rather Than a Disease: Government Ownership and Minority Shareholder Protection” *Multinational Finance Journal*. Vol. 18, No. 1/2.

<sup>40</sup> Interview with senior mining company official.

<sup>41</sup> M. Faccio, R. W. Masulis, and J. McConnell (2006) “Political Connections and Corporate Bailouts” *The Journal of Finance*. Vol. 61, No. 6, pp. 2597–2635.

Governments are also regularly disappointed by the returns on minority state equity. Majority owners can establish corporate structures that channel profits to offshore companies while channeling costs to the entity that is partly state owned. Tax rules can minimize the impact of transfer pricing and other types of base erosion and profit shifting; however, dividends on state equity have generally been disappointing, particularly in the mining sector. Minority state ownership is no substitute for a high degree of public transparency and accountability (e.g., published external audits), hiring professional managers, and regulatory oversight.

For these and other reasons, several governments have divested themselves of minority shares in private enterprises. For example, Singapore's Temasek Holdings, originally established to manage the government's equity in commercial enterprises, sold all its minority shares in 1985, although its subsidiaries do hold minority shares. It has focused instead on professionalizing and growing majority-held state-owned enterprises.<sup>42</sup>

## GLOBAL EXPERIENCE WITH STATE-OWNED HOLDING COMPANIES

Several governments have established state-owned holding companies (SOHCs) to manage state equity and act as the principal shareholder. They buy and sell state equity, oversee state-owned company management and operations, and ensure they are meeting their business objectives. Examples include Bhutan's Druk Holding and Investments Limited, China's Central Huijin Investment Company (a subsidiary of the China Investment Corporation that controls eight state-owned financial institutions and owns minority shares in nine others), Kazakhstan's Samruk-Kazyna, Malaysia's Khazanah Nasional Berhad, Peru's FONAFE, Qatar Holding, and Singapore's Temasek Holdings. China's State-Owned Assets Supervision and Administration Commission, although not a state-owned company, essentially has the same mandate.

SOHCs can help governments consolidate their state-owned company monitoring and management expertise under a single roof. Procurement, IT, human resources management, and auditing capacity can each be centralized easily. SOHCs can also train managers, test them in some firms, and rotate the most capable ones to run underperforming companies. Sometimes an SOHC can also restructure firms and fire and hire workers with more flexibility than under a structure where companies fall under the jurisdiction of a line ministry.

SOHCs are not a replacement for regulatory agencies. Furthermore, the larger an SOHC's holdings, the more difficult its job becomes in monitoring state-owned companies effectively. As a result, some governments, such as those

<sup>42</sup> Christopher Balding (2012) *Sovereign Wealth Funds: The New Intersection of Money & Politics*. Oxford University Press.

in Brazil and Spain, have established multiple SOHCs for different industries, including mining.<sup>43</sup>

Other countries permit their ministries to hold state equity while establishing a coordinating agency to monitor state-owned company performance or act as advisers to line ministries that maintain control over their companies. For example, India's Department of Public Enterprises under the Ministry of Heavy Industries and Public Enterprises is responsible for monitoring state-owned company performance. Powers over budgeting and human resources remain with other government entities. Indonesia's Ministry of State Owned Enterprises has a similar mandate, although it also has authority to determine remunerations policy, propose members of state-owned company boards, and prepare regulations governing state-owned company activities.<sup>44</sup> The Philippines' Governance Commission for Government Owned or Controlled Corporations, consisting of five members of the executive and sitting under the Office of the President, has a slightly stronger mandate. It advises, monitors, and oversees state-owned companies and may formulate and implement policies in coordination with line ministries.<sup>45</sup>

This model is similar to the SOHC model with two important differences. First, other entities such as line ministries or the president's office remain company shareholders rather than the commission or ministry. Second, commissions and state-owned company ministries' mandates are usually limited to advising on policy or helping to implement, rather than enforcing, policy. In general, SOHCs are stronger at enforcing their decisions.

## GLOBAL EXPERIENCE WITH STRATEGIC INVESTMENT FUNDS

Governments often establish so-called "strategic investment funds" (SIFs), sometimes referred to as sovereign development funds or a subset of sovereign wealth funds, to manage state equity in domestic commercial projects, whether majority or minority state owned. In practice, SIFs have similar mandates to national development banks except that, instead of only financing private sector activities through debt instruments, they purchase equity in domestic assets, sometimes also offering loans. SIFs explicitly financed by extractive revenues or established by governments dependent on natural resource revenues include the Fundo Soberano de Angola, Bahrain's Mumtalakat, the Gabonese Strategic Investment Fund, the Libyan Local Investment and Development Fund (a subsidiary of the Libyan Investment Authority), the Nigeria Infrastructure Fund

<sup>43</sup> Aldo Musacchio et al. (2015) "State-Owned Enterprise Reform in Latin America: Issues and Possible Solutions." Discussion Paper No. IDB-DP-401. Inter-American Development Bank (IADB).

<sup>44</sup> World Bank (2014) *Corporate Governance of State-Owned Enterprises: A Toolkit*. International Bank for Reconstruction and Development (IBRD)-World Bank.

<sup>45</sup> OECD and KIPF (2016) *State-Owned Enterprises in Asia: National Practices for Performance Evaluation and Management*. Organisation for Economic Co-operation and Development (OECD) and Korea Institute of Public Finance (KIPF).

(a subsidiary of the Nigeria Sovereign Investment Authority), the Government Pension Fund of Norway, and the Russian Direct Investment Fund.<sup>46</sup> The Ireland Strategic Investment Fund, Italy's Cassa Depositi e Prestiti (CDP) Group, the Palestine Investment Fund, and Senegal's FONSIS are among the SIFs in nonresource-dependent countries.

Like development banks, SIFs usually operate under a double bottom line—profitability and social returns (e.g., jobs, economic development). Their aim is to “crowd-in” private sector investment and provide long-term, patient capital in strategic projects. SIFs can fill market gaps and leverage resource revenues to finance development projects. (See table 1 for examples of fund objectives.) Public pension funds are not considered SIFs, even when they invest domestically, because their fiduciary duty to their beneficiaries prevents them from applying a double bottom line. However, pension reserve funds financed out of fiscal surpluses and without liabilities attached to individual contributors, such as Australia's Future Fund, Ireland's Strategic Investment Fund, and the Government Pension Fund of Norway, would qualify as SIFs.

Examples of long-term patient state investors can be found around the world, from Bahrain to Norway to Brazil. Despite being a state-owned bank rather than an SIF, Brazil's Banco Nacional de Desenvolvimento Economico e Social (BNDES) has, since its founding in 1952, sequentially invested directly in infrastructure, capital goods, the industrial sector (especially petroleum, mining, and energy), and finally small and medium-sized enterprises. Today, it holds equity in, among other companies, a Brazilian power company, a meatpacker, a pulp maker, and state pension fund-owned mining company Vale.<sup>47</sup> The institution is well-known for its long-term outlook, crowding-in private investment and filling the investment gap during Brazil's debt crisis. Although the bank has been criticized for relying too much on state subsidies, it is widely cited as an example of an effective domestic investment institution.<sup>48</sup>

SIFs will sometimes act as “cornerstone investors,” signaling to private sector investors that the government is committed to a given project or company, and as a catalyzer for investments in new industries or projects that may have a social benefit but that the private sector has chosen to avoid.<sup>49</sup> For example, Quebec's Caisse de dépôt et placement (“Caisse”) invested in several nascent renewable energy companies to accelerate the energy transition and technology start-ups to develop their businesses. The Caisse also facilitates Quebec businesses' expansion into new markets by helping to finance their internationalization.<sup>50</sup>

<sup>46</sup> Havard Halland et al. (2016) *Strategic Investment Funds: Opportunities and Challenges*. World Bank Policy Research Working Paper 7851.

<sup>47</sup> Marcela Ayres (2019) “Brazil Development Bank BNDES Eyes Sale of \$27 Billion in Listed Assets” Reuters. July 16.

<sup>48</sup> UNCTAD (2016) *The Role of Development Banks in Promoting Growth and Sustainable Development in the South*.

<sup>49</sup> Ibid.

<sup>50</sup> CDPQ (2021) *Impact of Our Activities in Quebec*.

In other cases, SIFs represent extrabudgetary “slush funds” controlled by the executive and designed to circumvent public financial management systems or legislative oversight. The Fundo Soberano de Angola (FSDEA), for example, was provided US\$ 5 billion to generate new sources of income for the state and benefit the economy and national industry while generating financial returns. While the FSDEA has supported laudable programs such as One Laptop Per Child and the US\$ 32.5 million development of fiber plantations, the much larger investments have emerged as disadvantageous to Angola or channels for corruption. For example, a port concession, originally estimated at US\$ 540 million but that is costing more than US\$ 830 million, was offered to private sector company Caioporto without tender. Eighty-five percent of the construction costs came from the Angolan state, whereas 15 percent theoretically came from Caioporto, although the money was loaned by the FSDEA. The contract was structured such that all the operating profits and a guaranteed minimum payment would go to Caioporto; in other words, Caioporto receives all the profits while the state takes all the risk. Additionally, the FSDEA transferred US\$ 56 million more than the 15 percent share to Caioporto for unknown reasons. Caioporto is owned by the FSDEA’s manager, Jean-Claude Bastos de Morais, a friend of the fund’s manager at the time, the president’s son. Following the election of a new president in 2018, the government decided to remove Caioporto from the project.<sup>51</sup>

Similarly, the fund’s principal asset manager, Quantum Global, headed by the same Mr. Bastos, was handed US\$ 3 billion to manage it. Quantum Global, and Mr. Bastos specifically, received US\$ 42 million in management fees in the first seven months of operations without generating financial returns. One of the FSDEA’s investments was a US\$ 157 million placement in a hotel complex to be built by a company owned by Mr. Bastos on land owned by Mr. Bastos.<sup>52</sup> As of 2017, the value of the fund was less than the US\$ 5 billion in initial capital.<sup>53</sup> In 2018, the new president of Angola replaced the board members and the fund’s external asset managers.<sup>54</sup> In 2019, the government withdrew US\$ 2 billion from the FSDEA to finance the Integrated Municipal Intervention Plan, focusing on municipal infrastructure development including energy, water, education, health, basic sanitation, and road construction.<sup>55</sup>

SIFs generate lower returns, on average, than equivalent private sector investors. To be fair, generating high financial returns is not the only, or even principal, objective of most SIFs; we would expect their double bottom line to affect profitability. However, although each fund faces its own challenges, SIFs often suffer from weak capacity to measure economic and financial performance,

<sup>51</sup> PortStrategy (2018) [Angola to End Caioporto Concession](#).

<sup>52</sup> David Pegg (2017) [“Angola Sovereign Wealth Fund’s Manager Used Its Cash for His Own Projects”](#) The Guardian. November 7.

<sup>53</sup> Fundo Soberano de Angola (2017) Quarterly Report on Activities (July–September).

<sup>54</sup> Fundo Soberano de Angola (2018) [Sovereign Fund Takes Action to Preserve Assets Allegedly Diverted](#).

<sup>55</sup> EIN Presswire (2019) [PIIM to Get USD 2 Billion Funding](#).

strict rules that limit flexibility of investment guidelines, and political interference in investment decisions. Furthermore, state involvement can, in certain circumstances, crowd out the private sector and serve parochial political rather than public interests.

Many sovereign wealth funds have multiple mandates and simultaneously serve different economic and political objectives. The Libyan Investment Authority, for example, consists of a parent company mandated to invest for the long term in foreign assets, but that also invests in strategic petroleum projects domestically, and in subsidiaries with mandates ranging from domestic infrastructure financing to serving the government's political ambitions across Africa. Quebec's (Canada) Caisse manages the province's public pension contributions while also managing the province's traditional SWF and its SIF. Each subfund is subject to its own unique investment guidelines and risk tolerance; the Caisse has placed institutional firewalls between the subfunds. Similarly, Azerbaijan's SOFAZ invests primarily in foreign assets for savings and stabilization purposes while delineating several billion dollars in assets for "special projects of the President," generally domestic infrastructure projects such as a railway and irrigation system.<sup>56</sup>

Some SIFs' mandates have changed over time. For instance, Bahrain's Mumtalakat (meaning "assets" in Arabic) was established in 2006 as an SOHC managing 29 state-owned enterprises. Today, Mumtalakat holds assets in 13 countries while expanding its involvement in the Bahrain economy.<sup>57</sup>

Some SIFs' investment decisions are driven by a national development plan, whereas others provide managers with extensive discretion in determining asset placements. Senegal's FONSI, for instance, has invested heavily in agribusiness and solar power, despite lower expected long-term returns than alternative choices.<sup>58</sup> The Palestine Investment Fund is explicitly aligned with the national economic agenda of the West Bank and Gaza.<sup>59</sup> The Government Pension Fund of Norway is focused on generating stable long-term returns for the state, although it has also been mandated to promote good environmental, social, and governance practices among Nordic companies and supporting Norwegian companies during crises, such as during the COVID-19 pandemic.<sup>60</sup> France's Caisse des Dépôts et Consignations must support public housing, develop rural areas, and invest in the energy transition and ecologically friendly projects.<sup>61</sup> On the other hand, no such obligations exist for the Russian Direct Investment Fund, for example.

<sup>56</sup> SOFAZ (2019) [Annual Report 2019](#).

<sup>57</sup> Mumtalakat (2021) [Our Story](#).

<sup>58</sup> Interview with FONSI officials.

<sup>59</sup> Palestine Investment Fund (2019) [Annual Report 2019](#).

<sup>60</sup> Rachel Fixsen (2020) "[Norway's Domestic SWF Gets Specific on ESG Demands for Bonds](#)" IPE. November 9.

<sup>61</sup> Caisse des Dépôts Groupe (2021) [Our Tasks](#).

Table 1. Selected SIFs investment objectives

COUNTRY	ASSETS UNDER MANAGEMENT	INVESTMENT OBJECTIVE(S)	DIFFERENTIATION FROM PRIVATE SECTOR INVESTORS
Mumtalakat (Bahrain)	US\$ 19 billion	Achieving “sustainable investment returns” and acting as a state-owned holding company	<ul style="list-style-type: none"> <li>• Long-term investor partnering with companies with good managers and proven track records</li> <li>• Activist investor that works with companies to help them grow</li> </ul>
Ireland Strategic Investment Fund	US\$ 4.9 billion	Double bottom line: commercial return (greater than the cost of sovereign debt) and economic impact/employment	Focus on projects with social benefits, including housing, climate change, and regional development.
Nigeria Sovereign Investment Authority (Nigeria Infrastructure Fund)	US\$ 2.3 billion	Must return CPI + 5% over 20+ years, create local jobs, and diversify the economy	Key infrastructure sectors (e.g., power generation, health care, tourism, real estate, technology and communications infrastructure, agriculture, water and sewage, rail).
Government Pension Fund of Norway	US\$ 34 billion	Maximize long-term returns	Fills market gaps by: <ul style="list-style-type: none"> <li>• Taking on more risk than private investors,</li> <li>• Focusing on extremely long term,</li> <li>• Taking active ownership to ensure sustainable practices, and</li> <li>• Focusing on “good companies” with good managers</li> </ul>
Palestine Investment Fund	US\$ 1 billion	Invest in projects aligned with the national economic agenda while generating a “reasonable return”	Focus on projects that will reduce reliance on imports, create jobs, and grow the economy, especially in the energy, health-care, and agricultural sectors.

To inform the government of Mongolia in its decision-making around the development of a new SWF, we will discuss the different governance models and performance of funds that invest in domestic assets. The section below examines four relevant issues: corporate structure, investment guidelines, financial and nonfinancial performance, and oversight and transparency.

## CORPORATE STRUCTURE

Government decisions about the institutional structure, staffing policies, and internal controls of an SWF have a huge impact on a fund’s success. Establishing an effective organizational structure, clear lines of communication between

different levels of the institutional hierarchy, and a strong internal chain of accountability, both within an SWF and between the fund and higher authorities, can help the fund meet its objectives by aligning the goals and strategic direction set by political authorities with the day-to-day decisions taken by operational and investment managers. It can also help prevent corruption by officials or external managers.

By contrast, a poorly designed management system can undermine government strategy and impede good governance. In particular, a failure to clarify roles and responsibilities of different bodies—such as internal advisory committees, board members, and managing directors—can lead to turf wars or, at the other extreme, neglect of essential work.

The macromanagement structure involves the relationship between lawmakers, the executive, various advisory bodies, the auditor-general, and the operational manager, usually a state-owned company in the case of SIFs. The internal management structure of the operational management entity involves a governing or supervisory board, the fund's executive office or committee, and various units organized around its front, middle, and back office, which deal with investments (and possibly external fund managers), risk management, and settlements, respectively. The operational manager must also set standards for staff compensation and ethical behavior, as well as ensure appropriate administrative capacity to meet the fund's mandate.

SIFs are often established through legislation, such as Australia's Future Fund Act (2006), the Nigeria Sovereign Investment Authority Act (2011), Libya's Law 13 (2010), or Senegal's Law 34 (2012). They often cover the investment mandate, eligible or prohibited asset classes, fund governance, management structure, deposit and withdrawal rules, monitoring framework, and public disclosure requirements. In other cases, existing institutions are mandated by law or regulation to invest domestically, as in France, Ireland, Italy, and Quebec (Canada), or simply established by government or presidential decree, as in Angola, Azerbaijan, West Bank and Gaza, Oman, the Russian Federation, and the United Arab Emirates.

Political independence remains a challenge for most SIFs. As state-owned entities, SIFs are ultimately controlled, directly or indirectly, by politicians. Board members, senior managers, or oversight bodies must be appointed by either the executive or the legislature. Sometimes, as in the case of France's Caisse des Dépôts et Consignations or most of the United Arab Emirates funds, politicians or the ruling family sit on the board themselves.

In democratic contexts, there may be good reason for political interference in fund decision-making. After all, SIFs are meant to serve public policy and therefore should be directed by the elected representatives whose job it is to interpret the public will. For example, the Singaporean sovereign wealth funds, one of which is a traditional SWF that invests in foreign assets whereas the other one is an SOHC, are explicitly managed and beholden to government



officials. Senior officials sit on the boards of state-owned enterprises, the SWFs represent the government in meetings, and government officials promote SWF interests abroad. In benevolent dictatorships, political interference might actually improve outcomes by holding senior managers to account. The United Arab Emirates funds function in this way largely because the funds, and perhaps the state, can be considered “family businesses.” Political interference is potentially harmful when politicians aim to use SIFs to serve their personal or party interests *at the expense of public welfare*.

Although there is no silver bullet for making SIFs or any extrabudgetary entity fully politically independent, there are several steps that governments can take to improve decision-making by fund managers. Perhaps the most important is for decision-making to be *rules-based* rather than allowing senior managers significant discretion. In clientelist or low-capacity contexts, detailed investment guidelines, risk management frameworks, codes of conduct, procurement procedures, and job descriptions help constrain decision-makers. Sometimes even poorly designed rules are better than no rules at all. The best managed funds are also usually subject to the Companies Act or equivalent, requiring them, among other things, to abide by international accounting standards, publish audited financial reports, and follow meritocratic board appointment procedures.

There should also be a division of labor between the fund manager, the operational manager, and oversight bodies. In general, the fund manager determines the investment strategy, which is then implemented by the operational manager, with or without the help of external asset managers. Unlike traditional SWFs where ministries of finance or the president are often fund managers and central banks or existing public pension fund managers are the operational managers, fund management and operational management are usually placed in the same institution at SIFs. In many cases, including the Libyan Investment Authority and the Russian Direct Investment Fund, a state-owned enterprise is established where the board of directors sets the investment guidelines, which are implemented by a CEO or executive director.

Some SIFs are required to be monitored by a special oversight body, a recognition of the politically fraught nature of SIFs. The Nigeria Sovereign Investment Authority, for example, is overseen by a 35-member governing council. Although it includes the president, minister of finance, Central Bank governor, and state governors, members of academia, civil society, young people, and professionals also sit on the council. The council reviews the fund’s policies and performance.

## INVESTMENT GUIDELINES

Successful achievement of an SIF’s double bottom line requires that fund managers invest in projects that achieve adequate financial returns while meeting economic policy objectives. In practice, SIFs use a simplified approach to determine which projects they will invest in: they assess investment

opportunities that satisfy a financial return benchmark, then measure the economic impact using a proxy measure such as jobs created, new production, or the reduction of carbon emissions.<sup>62</sup> For example, the Ireland Strategic Investment Fund measures a given project's impacts on employment and economic growth.<sup>63</sup>

SIFs also usually delineate the sectors in which they will invest. For example, the Palestine Investment Fund (PIF) has identified energy, health care, agriculture (including animal husbandry), and food processing as keys to unlocking the territory's economic potential or as potential growth sectors. In practice, however, the PIF has also locked up significant capital in Amaar, its real estate subsidiary, that invests in luxury hotels and condominiums.

Investment guidelines should state clearly the fund's target rate of return, non-financial thresholds for proceeding with an investment, and target asset allocation. They should also explicitly list eligible and prohibited asset classes and instruments. Finally, many investment guidelines include policies on external managers (e.g., fee structure), monitoring performance, and public reporting.

## FINANCIAL AND NONFINANCIAL PERFORMANCE

SIFs and their governments often keep financial performance secret. Less than 50 percent of the SIFs and SOHCs measured in the Peterson Institute for International Economics' (PIIE) SWF scoreboard (2016) published annual returns regularly.<sup>64</sup> One interpretation of this lack of transparency can be that governments, recognizing the long-term nature of SIF investments and noisy year-to-year volatility in asset values and returns, wish to avoid knee-jerk criticism from politicians and the public. Another interpretation may be that SIFs often underperform relative to similar private sector investors or do not meet their objectives, and managers wish to avoid embarrassment, criticism, or accountability.

Figure 4 shows financial returns of SIFs where data is publicly available. Fund returns can be difficult to compare because each fund uses its own methodology to calculate returns, currency fluctuations can significantly affect returns, and fiscal years differ from country to country. Furthermore, each fund has a unique mandate.

Traditional SWF annual returns have ranged from 0.6 percent for the Peru Fiscal Stabilization Fund to 15.2 percent for the New Zealand Superannuation Fund from 2010 to 2018, although average savings funds can expect returns between 3 percent and 10 percent per year over the long run, depending on the fund's investment mandate, strategy, and risk profile. Given their double bottom line, SIFs cannot expect similar returns. Still, SIFs ought to generate a dividend for their shareholders or the state, or at least become self-sufficient so as not to become a burden on government finances.

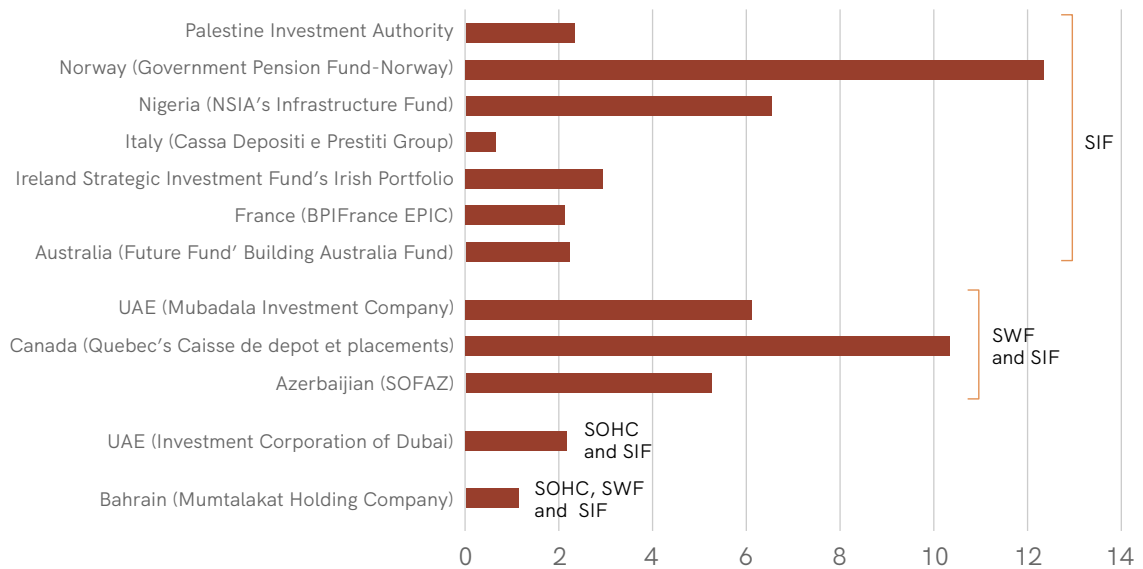
<sup>62</sup> Havard Halland et al. (2016) *Strategic Investment Funds: Opportunities and Challenges*. World Bank Policy Research Working Paper 7851.

<sup>63</sup> Interview with ISIF.

<sup>64</sup> Sarah E. Stone and Edwin M. Truman (2016) *Uneven Progress on Sovereign Wealth Fund Transparency and Accountability*. Peterson Institute for International Economics (PIIE).

Pure SIF returns seem to average between 2 percent and 3 percent per year in nominal terms, not much greater than the rate of inflation in many countries. Norway represents an outlier, with the Government Pension Fund of Norway regularly earning more than 10 percent per year. This can be explained by the fund's mandate not to employ a double bottom line but to instead focus exclusively on financial returns, albeit through asset placements in the Nordic market.

**Figure 4. 2019 Estimated SIF returns (percentage)**



**Sources:** Annual reports and press releases; fiscal years differ between funds; calculated in local currency.

Of course, SIF performance cannot simply be measured in terms of returns; their mandates often include generating jobs, crowding in private investors, driving growth in targeted sectors, and more nebulous goals such as internationalizing local companies and spurring innovation. Objective assessments of SIF performance in achieving these objectives are rare. We must rely largely on anecdotes and self-reporting by SIFs.

What we can state with certainty is that certain governments have been effective at developing their economies and professionalizing their companies, and that SIFs or SOHCs have played a constructive role in this regard. Singapore's Temasek Holdings, for example, has played an essential role in internationalizing Singaporean businesses.<sup>65</sup> Many of the United Arab Emirates funds have driven project financing in the Gulf region, including financing downstream petroleum operations and hospitals in Abu Dhabi and making trade, hospitality, and real estate investments in Dubai.<sup>66</sup>

<sup>65</sup> Christopher Balding (2012) *Sovereign Wealth Funds: The New Intersection of Money & Politics*. Oxford University Press.

<sup>66</sup> Mubadala (2021) [Responsible Investing](#); Dubai Maritime City (2021) [Dubai Maritime City](#); Istithmar World (2021) [Home](#).

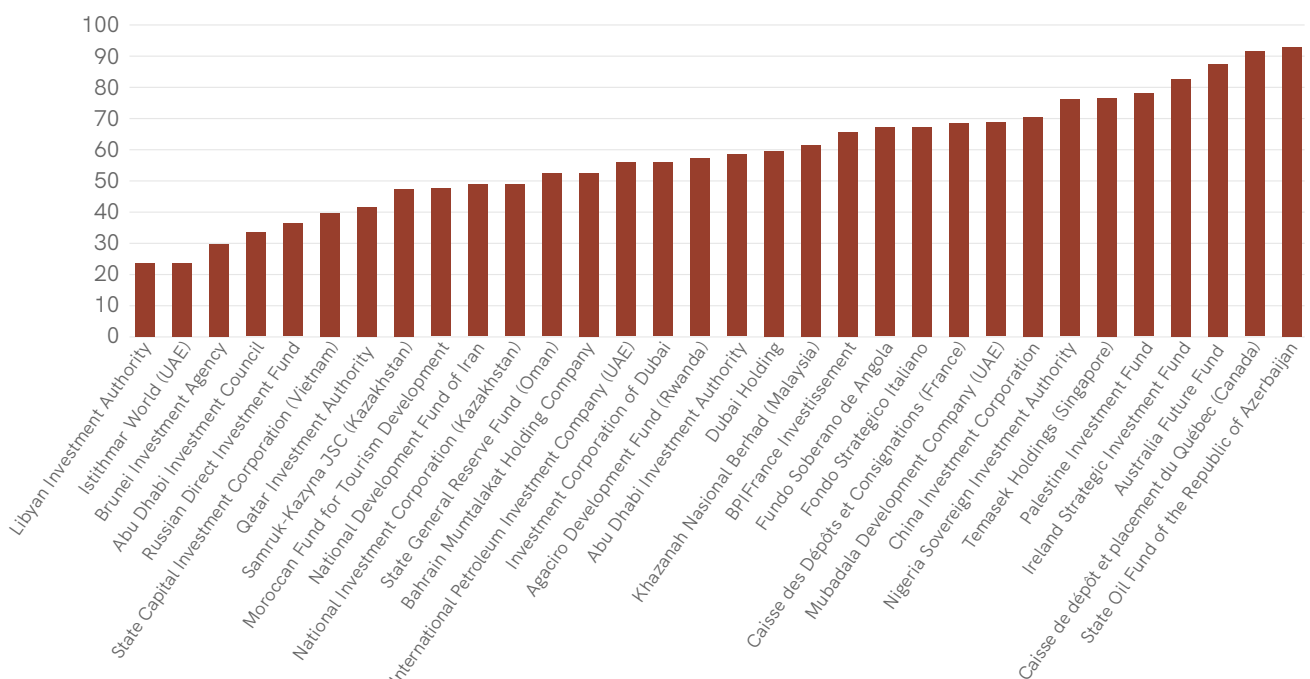
In other contexts, SIFs have undermined national development objectives by directing scarce resources to “white elephants” or into corrupt officials’ and fund managers’ bank accounts. The Angola case cited above is a prime example of this, although there are similar experiences in the Russian Federation, the West Bank and Gaza, and elsewhere.

## OVERSIGHT AND TRANSPARENCY

Effective and independent external oversight and transparency are essential for holding any SWF accountable and ensuring good performance. However, given the unavoidable political implications of state involvement in domestic businesses, it is particularly important in the case of SIFs to avoid the perception that the state is engaging in patronage. In practice, this means publishing independent external audits, financial statements, annual reports, policies and procedures, and other important operational information. It also implies that the legislature is provided a formal oversight role and that the fund communicates well with the public via the media.

Transparency and accountability of SIFs varies enormously from country to country. At the one extreme, the Azerbaijan, Quebec (Canada), Australia, and Ireland funds are the most transparent and meet most of the *Santiago Principles’* good governance standards, although this in no way denotes high performance. At the opposite extreme, the Libyan, Brunei, Russian, and some United Arab Emirates funds are among the least transparent and accountable. The difference between the two groups is a function of several variables, including publication of their assets and investment strategies, public explanations of their decisions, existence of a monitoring and risk management framework, and whether the fund is subject to external audits.

**Figure 5.** Transparency and accountability ranking for sovereign wealth funds that invest a significant portion of assets domestically and in state-owned holding companies (subset of funds)



Source: PIIE SWF Scoreboard 2016.

## LESSONS FOR MONGOLIA

Many of the lessons learned from SWF and state-owned company governance can be applied to SIFs. Good governance standards for SWFs have been codified in the *Santiago Principles*. Good governance of state-owned companies—especially strategic development funds, PPP funds, and national development banks financed by natural resource revenues—are informed by a set of general standards developed by international organizations and think tanks. The OECD’s *Governance of State-Owned Enterprises* and its guide for practical implementation, *Accountability and Transparency: A Guide for State Ownership*, represent a list of standards for all state-owned enterprises endorsed by a set of governments. The World Bank’s *Corporate Governance of State-Owned Enterprises: A Toolkit* is a more comprehensive resource for state-owned company governance, although not a set of standards. More recently, the International Monetary Fund (IMF) released *How to Improve the Financial Oversight of Public Corporations*, a how-to guide for ministries of finance.

Even though not every standard is applicable in every context, in general these standards highlight the need for clear ownership policy, legal framework, and performance monitoring framework. Funds should have clear objectives and mandate, and the government should clarify their functions as their owner, ensuring a high degree of professionalism and effectiveness. The legal framework should provide the government with powers to control fund finances and require that they publish accurate and audited financial statements and annual reports on operations. There should also be clear investment guidelines that constrain excessive risk-taking and encourage funds to meet their double bottom line, profitability and crowding-in private investment. Finally, fund performance should be measured against its objectives, which requires clear benchmarks and monitoring of performance by an independent government entity; for example, an independent board, president’s office, ministry of finance, or state-owned holding company.

# Conclusion

Over the last few years, the Mongolian government has made significant efforts to improve fiscal sustainability and streamline public investment projects. Although the COVID-19 pandemic has undermined some of these efforts, the government responded better than most by protecting the health and livelihoods of its population, underpinned by a generous direct household transfer program. At the same time, Mongolia's government remains highly indebted, although less than previously thanks to debt restructuring and improved fiscal responsibility. Still, the World Bank predicts that, under realistic revenue projections, financial support from multilateral and bilateral donors would be necessary to ensure sustainable financing of the deficit from 2021 to 2023.<sup>67</sup> Debt servicing costs remain high, and government finances are susceptible to a crisis if subjected to a negative shock, such as a sudden decrease in commodity prices or a banking crisis.

Given this context, the government must find a balance between allocating resources to social programs and infrastructure via the budget, paying down public debt, saving for a rainy day in the Fiscal Stability Fund and Future Heritage Fund, and allocating money to (or permitting revenue retention by) extrabudgetary institutions such as state-owned enterprises (e.g., Erdenes Mongol, Development Bank of Mongolia).

The government's proposed sovereign wealth fund would add a new institution to the list of entities to which public money could flow. In the best case scenario, the new fund would either: (1) fill market gaps by crowding-in private investment and driving growth in sectors that improve Mongolian livelihoods, such as renewable energy, public transportation, housing, or tourism, while generating a profit for the government; or (2) serve as a state-owned holding company, improving the management and performance of existing state-owned enterprises. The government may wish to avoid establishing a new fund that diverts scarce resources away from education, health care, and productive infrastructure projects financed by other public entities and into speculative large-scale projects.

Even though the fund's mandate—and consequently its deposit and withdrawal rules and investment guidelines—remain unclear, the government can work to incorporate internationally accepted good governance standards for extra-budgetary funds in the draft law. These would include stringent auditing and public disclosure requirements, clear roles and responsibilities of managers and

<sup>67</sup> World Bank (2021) [Mongolia Economic Update, February 2021: From Relief to Recovery](#). Ulaanbaatar: World Bank.

operational managers, and an independent supervisory council to oversee the fund's operations and performance.

In order to maximize the fund's potential for success, we would recommend a wide consultation on conceptual framework for the fund and draft law. Most of the poorly functioning sovereign wealth funds were ill-conceived or did not gain broad-based support before being implemented. The greatest success among both traditional sovereign wealth funds and strategic investment funds has been where the public feels a sense of ownership over the institution, including those in Ghana, Singapore, and Quebec (Canada).