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MONGOLIA ECONOMIC UPDATE

Sustaining the Gains

Special Focus – Distributional Impacts of Mongolia's Fiscal System

November 2024

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ABBREVIATIONS

BOM	Bank of Mongolia
CEQ	Commitment to Equity
CIT	corporate income tax
CMP	Child Money Program
CPI	consumer price index
DBM	Development Bank of Mongolia
DF	Development Fund
ES	executive summary
FDI	foreign direct investment
FHF	Future Heritage Fund
FSF	Fiscal Stabilization Fund
FSP	Food Support Program (former Food Stamp Program)
GDP	gross domestic product
HSES	Household Socio-Economic Survey
LFPR	labor force participation rate
LMIC	lower-middle-income country
MEU	Mongolia Economic Update
MOF	Ministry of Finance, Mongolia
MUB	Municipality of Ulaanbaatar
NPL	non-performing loan
NSO	National Statistics Office, Mongolia
OT	Oyu Tolgoi
PBOC	People's Bank of China
PF	Provident Fund
PIT	personal income tax
PPP	purchasing power parity
PPI	producer price index
SOE	state-owned enterprise
SSC	social security contributions
SWF	Sovereign Wealth Fund
UMIC	upper-middle-income country
VAT	value added tax

ACKNOWLEDGEMENTS

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The findings, interpretations, and conclusions expressed in this update are those of World Bank staff and do not necessarily reflect the views of the Executive Board of the World Bank or the governments they represent. For information about the World Bank and its activities in Mongolia, please visit https://www.worldbank.org/en/country/mongolia. For questions and comments on the contents of this publication, please contact Undral Batmunkh (ubatmunkh@worldbank.org). The cutoff date for this edition of the MEU is September 30, 2024.

EXECUTIVE SUMMARY

Mongolia's coal-driven economic growth since 2023 has elevated the country to upper-middle-income status (UMIC) in 2024 (Figure ES1). The mineral boom has significantly boosted both private sector incomes and public finances, fueling a surge in domestic demand. However, this surge is putting pressure on the balance of payments, as imports outpace revenues from commodity exports. While advancing major infrastructure projects could prop up growth, the rapid scale-up of investments and procyclical fiscal spending also risks creating inflationary pressures and imbalances in both external and fiscal accounts. Additionally, ongoing reliance on mining leaves Mongolia vulnerable to external shocks while the focus on coal further exacerbates climate and development challenges (Figure ES1).

Real GDP growth has remained robust, driven by mining and transport services, despite a sharp contraction in the agriculture sector. Economic growth held steady at 5.7 percent year-on-year (y-o-y) in the first half of 2024, with recent high-frequency data indicating continued momentum into the third quarter (Figures ES2). The strong performance is largely attributed to a sustained surge in mining (principally coal, and, to a lesser extent, copper) and transportation services for exports, supported by strong demand for Mongolian coal from China. In contrast, agricultural production experienced a substantial decline due to the most severe dzud—a natural disaster marked by extreme cold and heavy snowfall—since 2009–2010. Other sectors, such as trade and other services, showed solid growth, supported by rising incomes.

On the demand side, domestic demand was a key driver of growth, while the contribution of net exports to economic growth turned negative despite strong export performance (Figure ES3). Procyclical fiscal spending fueled significant growth in public consumption and investment, both increasing by over 45 percent y-o-y in the first half of the year. Private consumption surged by 16.9 percent y-o-y, the highest in the past decade, supported by rising real incomes from gradually declining inflation, wage growth, improved labor market conditions, and an acceleration in consumer lending. Meanwhile, private investment rose by 10.9 percent y-o-y in H1 2024, bolstered by bank lending and foreign direct investment (FDI). However, the strong growth in domestic demand led to a sharp increase in import volumes, particularly for investment goods and consumer durables, which rose by about 20 percent y-o-y. This import surge more than offset the positive contributions from robust exports to GDP growth.

Headline inflation remained within the central bank's target range (6±2 percent), prompting the Bank of Mongolia (BOM) to lower the policy rate by a total of 300 basis points in 2024. Inflation fell to 6.7 percent by September 2024, down from 7.9 percent at the end of 2023. Imported inflation eased gradually, supported by declining international food and fuel prices and a stable exchange rate, while price increases for domestically produced goods (excluding meat) moderated throughout the year. In response to declining inflationary pressures, the BOM reduced the policy rate three times in 2024, from 13 percent to 10 percent (Figure ES4). Although this easing has had limited impact on lending rates — partly due to the continuation of substantial subsidized lending programs — credit growth has accelerated, fueled by strong expansion in both consumer and business lending.

Boosted by increased income and trade-related revenues, the fiscal balance remained in surplus despite sustained high spending (Figure ES5). Higher wages in both the private and public sectors and increased corporate income (including from coal revenue) contributed to robust revenue gains. At the same time, both current and capital expenditures rose significantly. Overall, in the first nine months of 2024, Mongolia recorded a budget surplus of 3.1 percent of GDP, as strong revenue growth outpaced the rise in spending. Combined with strong nominal GDP growth, this surplus helped reduce the public debt-to-GDP ratio to 38.2 percent by mid-2024, down from 44.4 percent at the end of 2023.

The current account balance shifted to a deficit amid a soaring import bill, limiting reserve accumulation despite improvements in net FDI inflows (Figure ES6). While increased coal exports, and to a lesser extent, copper exports, supported steady export revenue growth, a rapid expansion of imports—driven by strong domestic demand—pushed Mongolia's current account back into deficit (5.6 percent of GDP by September 2024, compared to a surplus of 2.1 percent during the same period in 2023). Despite improved net FDI inflows, weaker current account performance, increased interventions by the BOM to stabilize the nominal exchange rate, and BOM's repayment of US$620 million on its currency swap line with the People's Bank of China, constrained reserve accumulation. As a result, gross international reserves remained broadly stable at US$4.7 billion (equivalent to 3.0 months of imports) by September 2024, down from US$4.9 billion at the end of 2023.

After steady growth in 2024, Mongolia's economic expansion is expected to accelerate in 2025, driven by increased OT mining production more than offsetting weaker coal output. Growth is projected to reach 5.3 percent in 2024, supported by strong private consumption and procyclical fiscal spending(boosted by the 2024 supplementary budget), though tempered by rising imports. In 2025, growth is projected to rise to 6.5 percent (Table ES1), with the boost primarily coming from higher OT mine production and a modest recovery in agriculture following the 2024 dzud which together will compensate for lower coal production. On the demand side, public and private consumption are expected to remain robust and continue to drive growth. Exports—led by increased copper and gold—together with public investment under the government's four-year action plan and private investment bolstered by expanded bank lending amid a less restrictive monetary policy, are also projected to sustain growth. However, this impact may be partially offset by an increase in imports of investment goods.

Robust domestic demand is expected to drive inflationary pressures, and lead to moderate fiscal deficits and sizable current account deficits. Procyclical fiscal spending, combined with rising household incomes, is projected to revive demand-driven inflation in the second half of 2024, pushing average headline inflation to 7.0 percent for the year and to rise further to 8.0 percent in 2025. These factors are also expected to result in a moderate fiscal deficit for the next two years (0.8 percent of GDP in average over 2024-2025), despite sustained mining and non-mining revenues. Together with declining commodity prices, robust domestic demand is expected to result in widening current account deficits (7.0 percent of GDP in average over the same period).

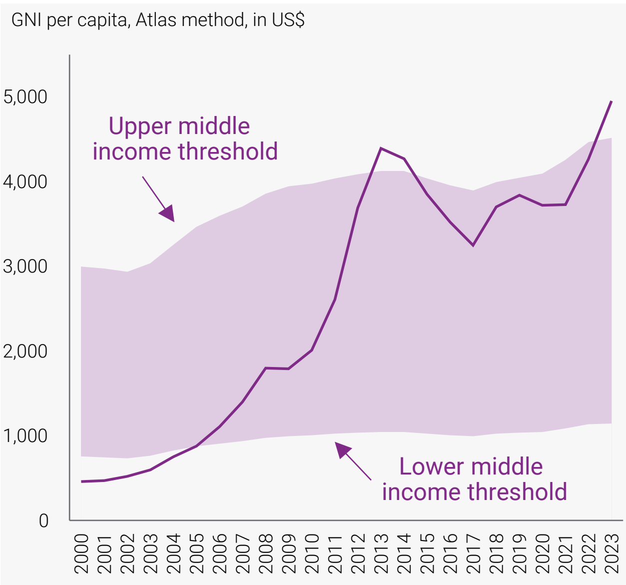
The medium-term growth outlook remains favorable, supported by both mining and non-mining sectors. After the 2025 surge in OT's mineral output, mining production is projected to moderate, with non-mining sectors—such as trade and services, and agriculture—driving economic growth, which is forecast to average 6.0 percent in 2026-2027. On the demand side, public consumption and investments under the government's four-year action plan are expected to fuel growth.

The outlook is subject to significant downside risks. Domestically, greater-than-expected fiscal spending could stimulate economic growth but also stoke inflationary pressures and widen fiscal and current account deficits. Climate change heightens the risk of more frequent and severe natural disasters with potential significant economic consequences, especially for poor and vulnerable households, as highlighted in the World Bank's 2024 Mongolia Country Climate and Development Report. Externally, Mongolia faces potential challenges from slower-than-expected global growth, which could weaken external demand and lower prices for key export commodities. Additionally, escalating geopolitical tensions could drive up fuel prices, resulting in higher imported inflation, increased production costs, and a larger import bill.

Maintaining the macro-fiscal gains from the ongoing mineral export boom will require prudent macroeconomic management. A recent World Bank report[1] recommends policies to strengthen fiscal sustainability and support an independent monetary policy to anchor inflation to enhance macroeconomic stability. Fiscal reforms should focus on: (i) gradually scaling back pandemic-era social assistance while making it more progressive and responsive; (ii) reforming subsidies in energy, agriculture, and pensions; and (iii) reducing fiscal risks from contingent liabilities. Phasing out quasi-fiscal activities, such as the subsidized mortgage program, and prohibiting such financing under the central bank's mandate will enhance the central bank's independence and credibility in anchoring inflation, while enabling for greater exchange rate flexibility.

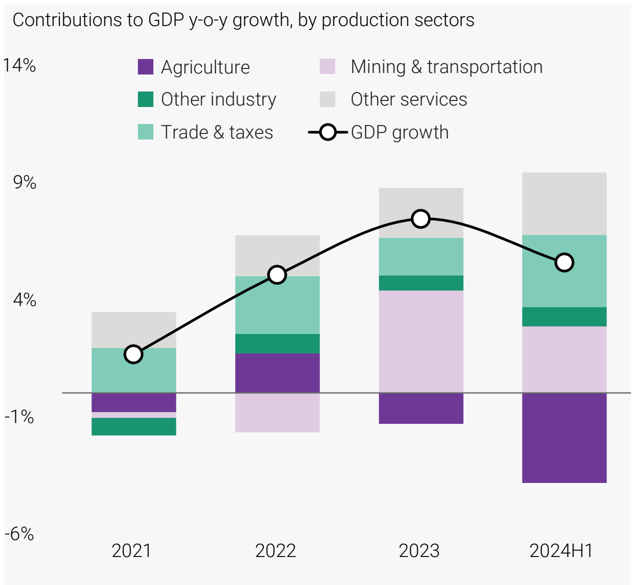
In addition, Mongolia should consider reforms to its fiscal system to enhance its effectiveness and efficiency in tackling poverty and income inequality. The special chapter of this MEU (Chapter 2) summarizes the findings from a forthcoming World Bank analysis ("Commitment to Equity") on the distributional impacts of the Mongolia's fiscal system. This analysis reveals that while the fiscal system—encompassing both taxation and transfers—has a marginal effect on reducing poverty, it exhibits strong broad-based redistributive effects. The chapter proposes recommendations for achieving more equitable outcomes while further reducing poverty. The chapter recommends: i) undertaking revenue reforms to enhance the fiscal system's redistributive effect; ii) allocating revenue to more cost-effective and poverty-targeting transfer programs; and iii) establishing a comprehensive reform strategy that balances measures for short-term poverty and inequality reduction with those that offer longer-term benefits, such as investments in human capital, physical infrastructure, and institutional development.

Figure ES. 1 **Mongolia is re-classified as an upper middle income country after nearly a decade**



Source: NSO; World Bank staff estimates.

Figure ES. 2 **The loss in agriculture production was mainly offset by greater activities of trade, services, and mining**

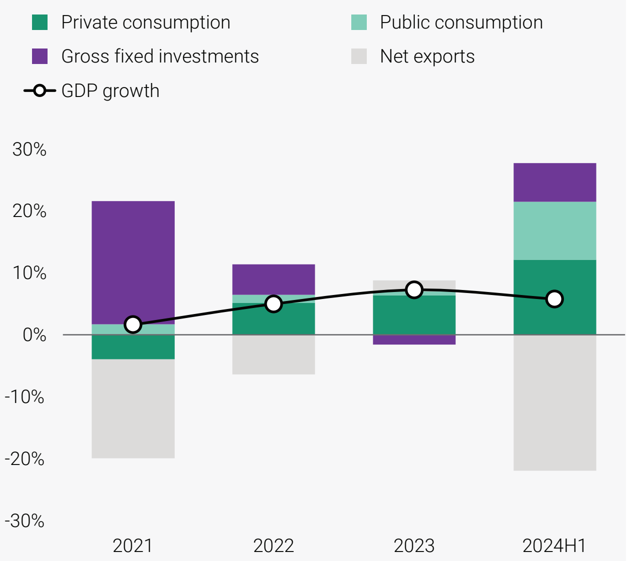


Source: NSO.
Note: Bars reflect percentage contributions to y-o-y GDP growth

1 World Bank, 2024. "Agenda for Action: Key Policy Recommendations for Mongolia's Sustainable Development Vision".

Figure ES. 3 Increased domestic demand drove economic growth, though part of this was offset by rising imports

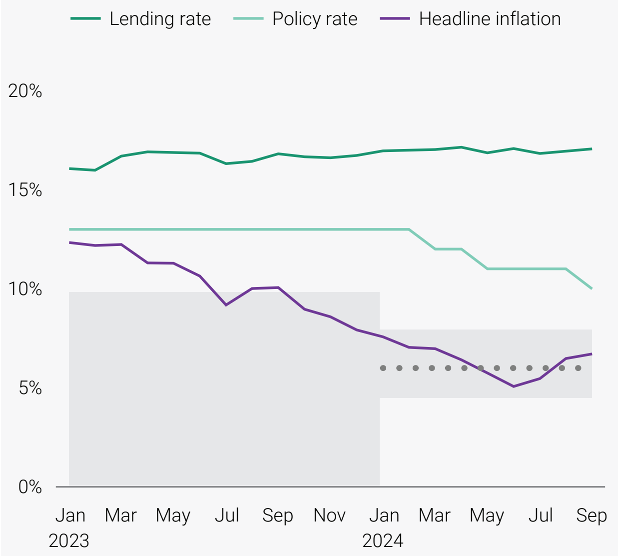
Contributions to GDP y-o-y growth, by demand components



Source: NSO.
Note: Bars reflect percentage contributions to y-o-y GDP growth.

Figure ES. 4 Headline inflation fell within the BOM's target range, prompting a reduction in the policy rate

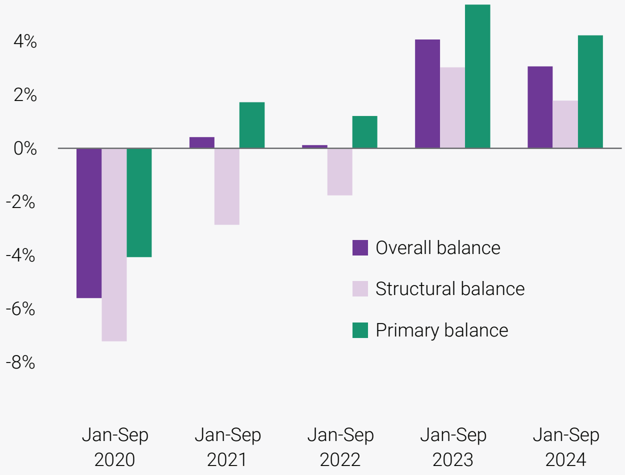
Monetary policy rate, inflation target, and headline inflation



Source: BOM and NSO.
Note: The figure shows the average lending rate on newly issued loans outside the government's subsidized programs.

Figure ES. 5 Government budget is in surplus for the second consecutive year

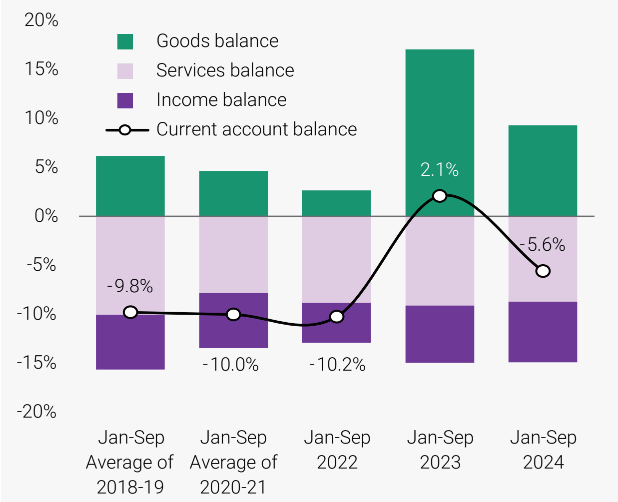
Fiscal balances, percent of GDP



Sources: MoF; World Bank staff estimates.
Note: Structural balance is defined by the government as the overall fiscal balance net of fiscal saving funds.

Figure ES. 6 The current account deficit re-emerged with a shrinking goods trade balance

Current account balance and its components, in percent of GDP



Source: BoM.

Table ES. 1 **Selected macroeconomic indicators**

	2022	2023	2024f	2025f	2026f	2027f
Real GDP Growth, at constant market prices	**5.0**	**7.2**	**5.3**	**6.5**	**6.1**	**5.9**
Private Consumption	8.1	9.7	8.4	5.0	6.8	6.4
Government Consumption	6.9	3.2	22.0	4.6	6.8	5.9
Gross Fixed Capital Formation	13.2	5.3	18.0	7.9	6.2	4.1
Exports, Goods and Services	32.3	33.2	5.1	23.9	2.4	5.7
Imports, Goods and Services	29.1	18.9	10.2	15.9	3.9	5.5
Real GDP Growth, at constant factor prices	**4.2**	**7.5**	**5.3**	**6.5**	**6.1**	**5.9**
Agriculture	12.0	-8.9	-23.0	5.0	6.5	4.5
Industry (including mining)	-4.5	12.9	8.3	11.5	6.1	6.2
Services	6.9	9.9	11.0	4.1	6.1	6.0
Inflation (CPI, period average)	**15.2**	**10.4**	**7.0**	**8.0**	**8.5**	**8.5**
Current Account Balance (% of GDP)	**-13.2**	**0.6**	**-7.8**	**-6.2**	**-7.1**	**-10.9**
Net FDI, Inflow (% of GDP)	**13.9**	**7.3**	**8.7**	**6.7**	**6.2**	**8.0**
Fiscal Balance (% of GDP)	**0.7**	**2.6**	**-0.9**	**-0.7**	**-1.0**	**-1.1**
Primary Balance (% of GDP)	**2.1**	**4.2**	**0.6**	**0.8**	**0.6**	**0.3**
Debt (% of GDP)	**62.1**	**44.4**	**43.3**	**42.2**	**42.0**	**40.6**

Source: World Bank staff estimates.
Note: Public debt does not include the BoM's liability under the PBOC swap line (3.4 percent of GDP as of Sep 30, 2024).

CHAPTER 1

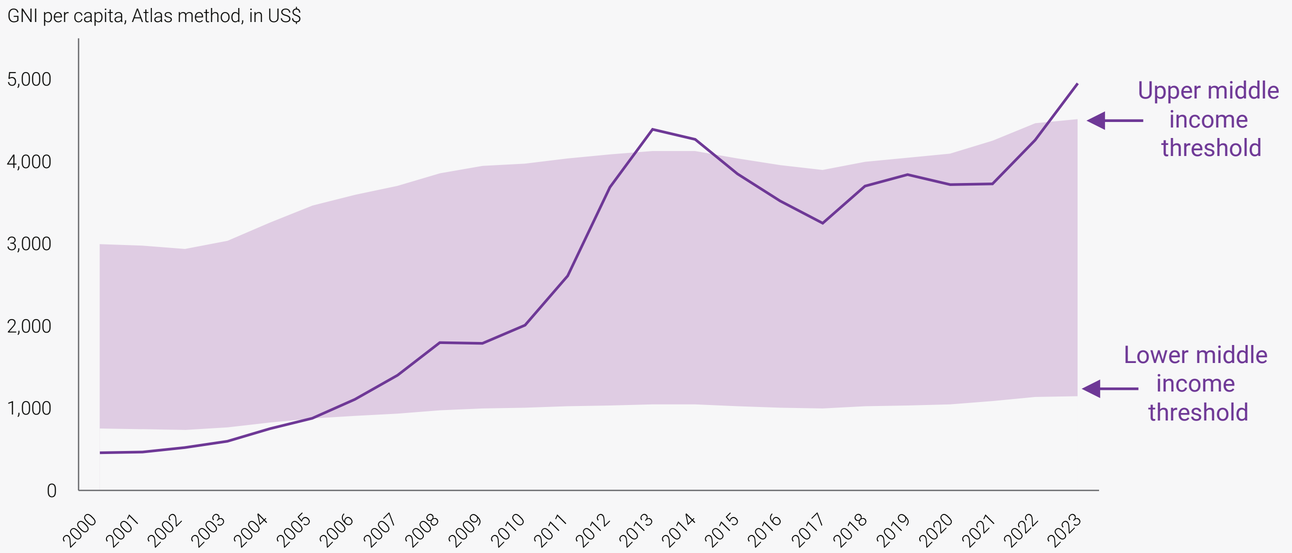
RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

Mongolia's coal-driven economic growth since 2023 has lifted the country to upper-middle-income status (UMIC) in 2024 (Figure 1). The mineral boom has significantly boosted both private sector incomes and public finances, sparking a surge in domestic demand. However, this surge is generating balance of payments pressures as imports outpace revenues from commodity exports.

While major infrastructure projects could prop up growth, the rapid scale-up of investments and fiscal expansion also poses risks of inflationary pressures, fiscal inefficiencies, and imbalances in both fiscal and external accounts. Additionally, continued reliance on mining leaves Mongolia vulnerable to external shocks. The focus on coal further exacerbates both climate and development challenges.[2]

2 Mongolia first attained UMIC status in 2015, following years of a mineral boom. However, this status was short-lived, lasting only a year, as external shocks to the mineral sector and expansionary macroeconomic policies led to a twin crisis in 2016.

Figure 1. **Mongolia is re-classified as an upper middle income country after nearly a decade**



Source: NSO; World Bank staff estimates.

1. RECENT ECONOMIC DEVELOPMENTS

1.1. Economic growth is driven by mineral production and boosted through domestic demand

Mongolia's economic growth has remained strong, driven by mining and transport services offsetting a decline in agricultural production. Growth reached 5.7 percent year-on-year (y-o-y) in the first half of the year, down from 7.2 percent in 2023, with more recent higher-frequency data indicating that this momentum continued into the third quarter. The mining and transportation sectors expanded by 15.4 percent and 24.7 percent y-o-y, respectively, contributing nearly half of total economic growth in H1 2024 (Figure 2). Coal production surged by 36.4 percent y-o-y, accounting for almost the entire mining sector's growth (Figure 3),[3] and driven by strong demand from steel producers and power plants in northern China.[4] As a result, total freight transported via road (principally coal) increased by 34.0 percent y-o-y, becoming the main driver of the transportation sector's expansion. In contrast, as the Oyu Tolgoi (OT) underground copper mine continues to build the infrastructure required for full capacity, copper concentrate output increased by just 4.3 percent y-o-y in the first half of 2024. Nevertheless, this modest growth partially offset declines in the production of other commodities, such as crude oil and gold.

The agriculture sector was severely impacted by the dzud, a natural disaster. This extreme weather event, marked by severe cold and heavy snowfall, struck Mongolia at a scale not seen since the devastating dzud of 2009–2010. The disaster led to the loss of 8.1 million livestock by the middle of the year, representing 12.5 percent of the national herd, with nearly half of the breeding stock either miscarrying or perishing. As a result, the agriculture sector contracted by 26.7 percent y-o-y in the first half of 2024, following an

3 By mid-2024, Mongolia's coal production (both coking and thermal coal) reached 47.8 million tons, rising further to 72.2 million tons by September, a 28.0 percent y-o-y increase. Approximately one-third of this total was produced by the state-owned coal miner, Erdenes Tavan Tolgoi JSC.

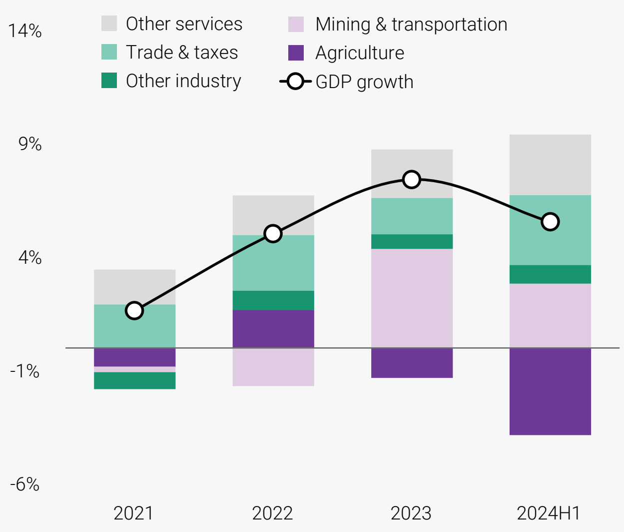
4 Despite a weakening property market in China, overseas demand for Chinese steel remained strong this year, driving high demand for coking coal. Mongolia's coking coal was also preferred due to its discounted price (a 30 percent discount compared to its competitors).

8.9 percent decline in 2023, marking the second consecutive year of decline due to harsh winters.

Other sectors, such as trade and other services, experienced robust growth driven by accelerating domestic demand. Excluding mining, agriculture, and transportation services, growth in the remaining sectors surged to 9.4 percent in the first half of 2024, up from 6.3 percent in 2023. This was largely fueled by increased activity in wholesale and retail trade and other services sector, supported by rising incomes and fiscal expansion. The construction sector also contributed to this growth, albeit to a lesser extent, driven by significant public capital investments in infrastructure projects (see subsequent section on demand).

Figure 2. The loss in agriculture production was mainly offset by greater activities of trade, services, and mining

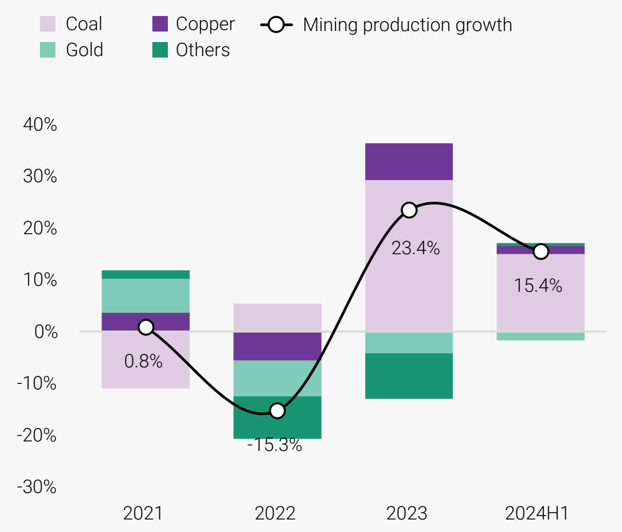
Contributions to GDP y-o-y growth, by production sectors



Source: NSO.
Note: Bars reflect percentage contributions to y-o-y GDP growth.

Figure 3. … with the mining sector still dominated by coal

Contributions to nominal growth of gross fixed capital formation



Source: World Bank staff estimates based on NSO database.
Note: Bars reflect percentage contributions to y-o-y growth in mining GDP.

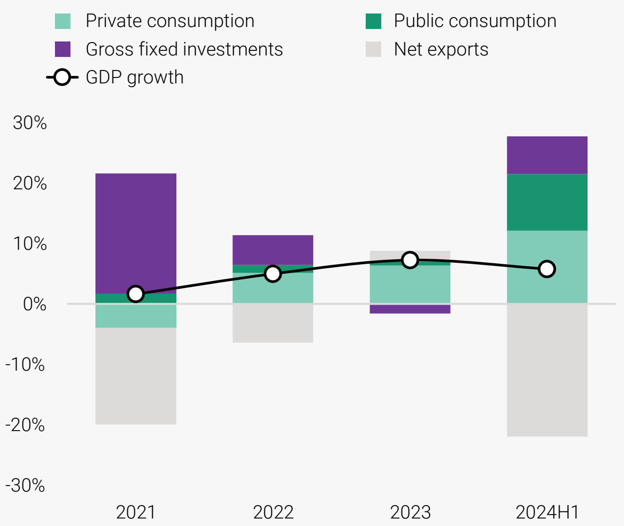
On the demand side, public consumption and investment were key drivers of growth. Public consumption surged by 46.9 percent y-o-y in H1 2024, while public investment grew by 49.1 percent (see Section 1.3). Public consumption alone contributed 9.3 percentage points to overall GDP growth, with public investment adding an additional 3.1 percentage points.

Private investment also increased by 10.9 percent y-o-y in H1 2024, bolstered by bank lending and foreign direct investment (FDI).[5] However, the severe loss of adult livestock due to the harsh weather conditions significantly depleted livestock capital, leading to a reduction in inventories as fewer offspring were born (Figure 5).

5 See Sections 1.2 and 1.4 for details on bank lending and foreign investment.

Figure 4. **Increased domestic demand drove economic growth, though part of this was offset by rising imports**

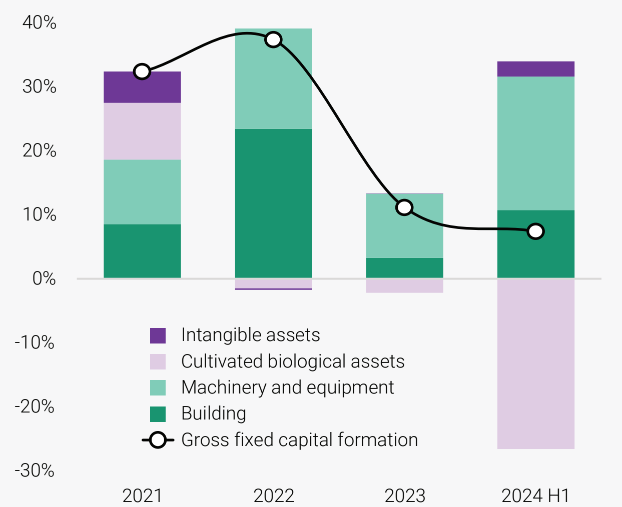
Contributions to GDP y-o-y growth, by demand components



Source: NSO.
Note: Bars reflect percentage contributions to y-o-y GDP growth.

Figure 5. **… and loss of adult livestock undermining investment growth**

Contributions to nominal growth of gross fixed capital formation



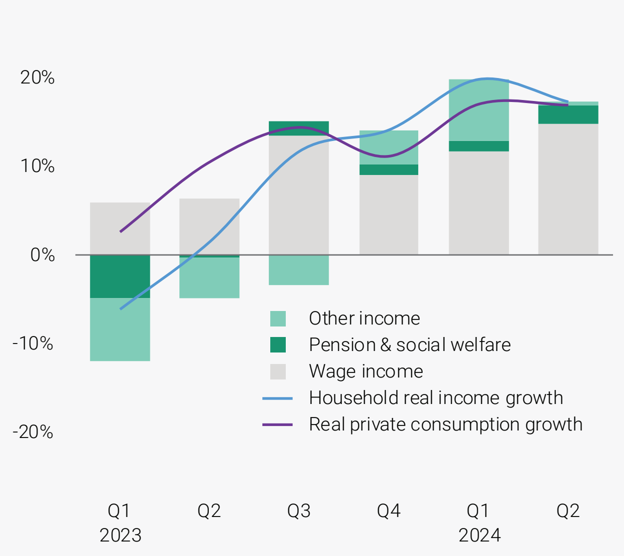
Source: NSO.
Note: Nominal decomposition of gross fixed capital formation is depicted due to data availability. Cultivated biological assets mostly refer to the herd of adult livestock.

Private consumption expanded significantly in the first half of 2024, driven by rising real incomes and strong growth in personal lending. Private consumption growth accelerated to 16.9 percent y-o-y, up from 9.7 percent in 2023, contributing 12.1 percentage points to overall economic growth (Figure 4). This momentum was largely fueled by a substantial increase in household real income, which rose by 18.5 percent y-o-y (Figure 6). Over 70 percent of the real income boost came from rising wages and improved labor market conditions.[6] Additionally, two rounds of pension increases since mid-2023, along with the distribution of dividend earnings from a state-owned coal mine (Erdenes Tavan Tolgoi JSC)—equivalent to about 40 percent of the average household's monthly income—further bolstered private consumption. The gradual decline in inflation (Section 1.2) also enhanced households' purchasing power, further supporting consumption growth.

Labor market conditions improved, marked by rising labor force participation and sustained employment growth. In the first half of 2024, the labor force participation rate averaged 61.7 percent, surpassing its pre-pandemic average (2018–2019) for the first time in four years (Figure 7). Growing labor demand, as reflected in employment growth of 5.8 percent in H1 2024—particularly in the trade and services sectors—combined with rising wages, encouraged previously inactive individuals to reenter the workforce. Discouraged workers and women returning from maternity leave were key drivers of this recovery. The unemployment rate remained low at 5.4 percent in the first six months of 2024, well below the pre-pandemic average of 8.9 percent (2018–2019).

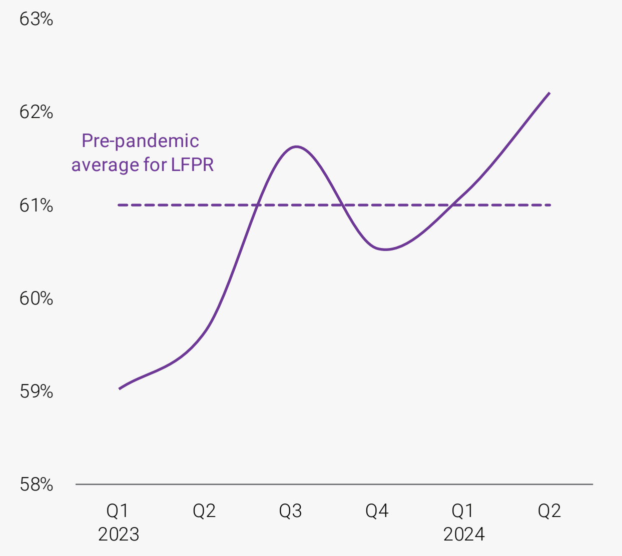
6 The national average wage increased by 20.5 percent y-o-y in real terms (or by 27.6 percent in nominal terms) in H1 2024. Wage increases were particularly pronounced in the public sector, with nominal raises of approximately 50 percent in public administration, 40 percent in public education, and 30 percent in public health sectors. In the private sector, nominal wages rose by an average of around 20 percent. Additionally, the legal minimum wage was raised by 20 percent, effective January 1, 2024.

Figure 6. A substantial rise in household real income fueled the growth in private consumption



Source: NSO.
Note: Bars reflect percentage contributions to y-o-y growth of household real income

Figure 7. Labor force participation improved beyond its pre-pandemic average



Source: NSO.

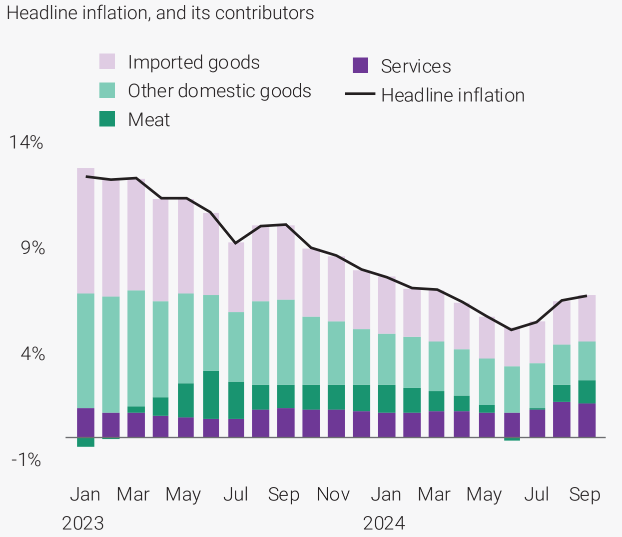
Despite strong coal exports, the contribution of net exports to economic growth turned negative in H1 2024. While Mongolia's coal export volume increased by 39.1 percent y-o-y in the first half of 2024, the net export contribution to growth deteriorated sharply to -21.9 percentage points, down from 1.8 percentage points in 2023. This decline occurred as exports of other commodities remained weak, while real imports of goods and services, particularly non-durable consumer goods and investment goods (see Section 1.4), surged by 20.6 percent y-o-y, compared to 18.9 percent in 2023.

1.2. Headline inflation gradually declined, prompting the central bank to cut its policy rate

Headline inflation remained within the central bank's target range, primarily due to a gradual decline in imported inflation. Nationwide, headline inflation dropped to 6.7 percent y-o-y in September, down from 7.9 percent at the end of 2023 (Figure 8). This decline is largely attributed to lower import prices, as imported inflation fell from 5.8 percent y-o-y at the end of 2023 to 4.6 percent y-o-y by September 2024, driven by decreasing global food and fuel prices and a stable exchange rate.

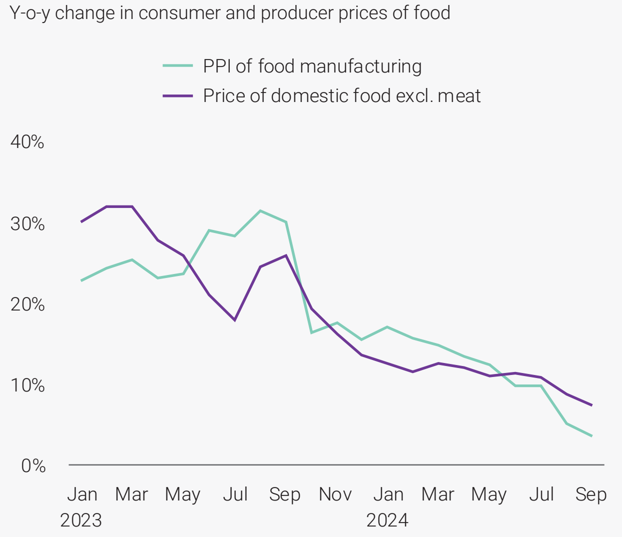
Consumer price increases for domestically produced goods, excluding meat, eased throughout the year. This reflected a gradual decline in producer price inflation, driven by lower production costs from flour and flour related goods (Figure 9). However, the recent dzud led to reduced domestic meat supply, keeping meat prices elevated throughout the year. Additionally, price growth in services was fueled by rising household incomes, which increased demand pressures.

Figure 8. **Inflation pressure from imported prices moderated …**



Source: NSO.
Note: Bars reflect percentage contributions to y-o-y headline inflation.

Figure 9. **… while domestic food prices (excluding meat) remain elevated**



Source: NSO.

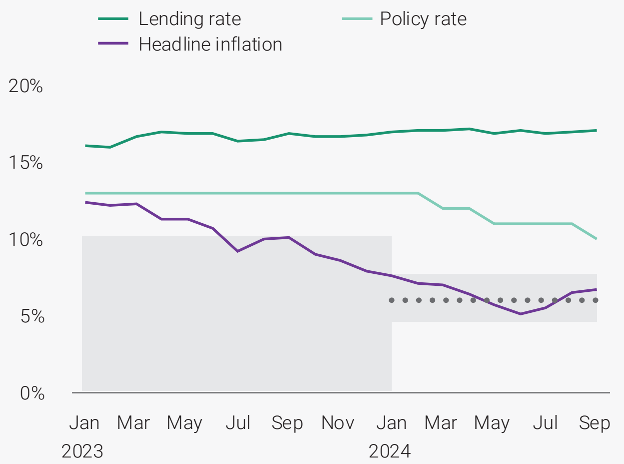
In response to declining inflationary pressures, the Bank of Mongolia (BOM) cut the policy rate three times in 2024, by a total of 300 basis points. Despite rising household consumption and fiscal expansion continuing to exert demand-side pressures, the BOM reduced the rate from 13.0 percent, maintained since December 2022, to 10.0 percent by September 2024 (Figure 10).[7] The latest interest rate cut was accompanied by additional policy measures. These included an increase in banks' reserve requirement ratio on domestic currency liabilities (from 8.0 percent to 10.0 percent), aimed at "preventing excessive credit growth and ensuring financial stability." This policy mix reflects the BOM's cautious stance, signaling concerns about financial stability and the potential risk of overheating in the economy.

Credit growth accelerated, fueled by strong expansion in both consumer loans and business lending, despite persistently high lending rates. Although the BOM lowered its policy rate, lending rates remained elevated (Figure 10), indicating weak monetary policy transmission. Nevertheless, outstanding credit grew by 31.4 percent y-o-y in September 2024 (Figure 11). Consumer loans backed by wages and pensions experienced robust growth, contributing about one-third of the total credit expansion by September 2024. Business lending also accelerated from early 2024, adding another one-third to the overall credit growth. Improvements in the quality of business loans, along with strong economic activity, likely reduced banks' risk aversion toward business lending. For instance, the non-performing loan (NPL) ratio for business loans declined from 12.0 percent at the end of 2023 to 9.5 percent by September 2024, as businesses in sectors such as construction, real estate, and mining flourished. Additionally, various government lending programs with subsidized interest rates contributed to overall credit growth. These included the long-standing subsidized housing mortgage program and agriculture-related programs, which together accounted for 19.6 percent of total outstanding loans by September.

7 In its 2025 Monetary Policy Guidelines, the BOM plans to reduce its inflation target from the current 6 ± 2 percent to 5 ± 2 percent starting in 2027, reflecting expectations of lower inflation in the medium term.

Figure 10. **Headline inflation fell within the BOM's target range, prompting a reduction in the policy rate**

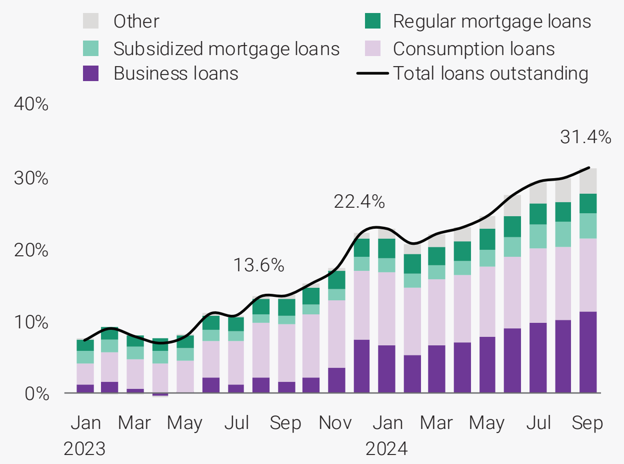
Monetary policy rate, inflation target, and headline inflation



Source: BOM and NSO.
Note: The figure shows the average lending rate on newly issued loans outside the government's subsidized programs.

Figure 11. **Lending to businesses recovered**

Y-o-y growth of total outstanding credit



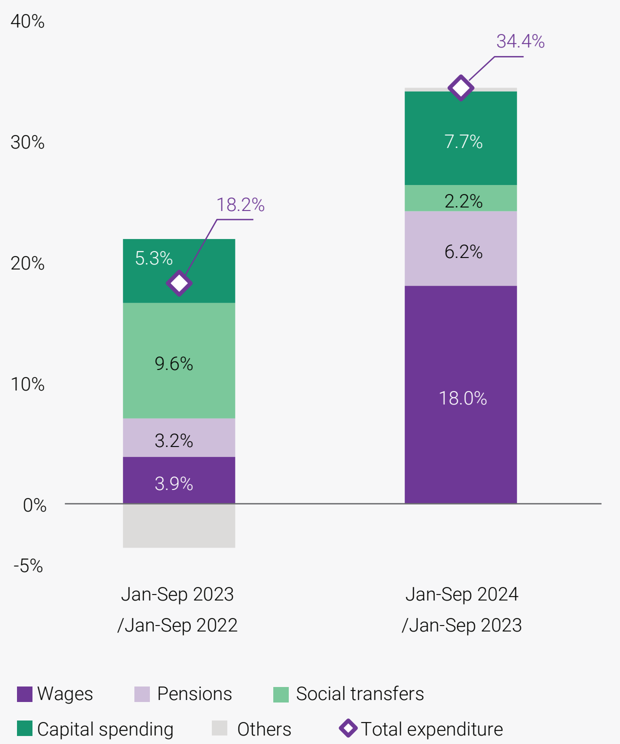
Source: BOM.
Note: Total outstanding loans include mortgage loans securitized by the Mongolian Mortgage Corporation, which are removed from the banks' balance sheets. Bars reflect percentage contributions to total credit growth, y-o-y.

1.3. Despite continued high spending, the budget remains in surplus

Fiscal spending experienced a procyclical surge, with both current and capital expenditures rising significantly. In the first nine months of 2024, total public expenditure grew by 34.4 percent y-o-y, reaching 24.1 percent of GDP by September, up from 20.7 percent of GDP during the same period in 2023. A significant portion of this increase was driven by higher public sector wages and pensions, which together accounted for about three-quarters of expenditure growth. Spending on public wages and performance-based bonuses more than doubled y-o-y by September, following two rounds of salary increases in July 2023 and April 2024, contributing 18.0 percentage points to overall expenditure growth (Figure 12). Pension spending also rose by 31.6 percent y-o-y after consecutive increases in the same months. In addition, capital spending, mainly focused on infrastructure projects in Ulaanbaatar, accounted for 4.8 percent of GDP during the first nine months of the year. For the remainder of 2024, the newly formed government plans to accelerate capital spending through a recently approved supplementary budget, aligned with its four-year government action plan (see Box 1 and Section 2).

Figure 12. **Public sector wages strongly increased**

Contributions to y-o-y growth of budget expenditure



Sources: MoF; World Bank staff estimates.
Notes: Stacked bars indicate decomposition of budget expenditure in percentage points.

Box 1. Government Action Plan 2024-2028

The newly established coalition government's four year action plan is structured around four pillars: regional development, human development, economic policy, and human rights and governance. Following the parliamentary election held in June 2024, a coalition government of three parties was formed, and on August 27th, the parliament enacted the government action plan for 2024-2028. While the plan aligns with existing medium-long term priorities (such as Vision 2050, the New Recovery Policy, and the Regional Development framework) introduced by the previously ruling party, it now also incorporates priorities of the two other coalition parties aiming at ensuring timely, effective, productive, and sustainable collaboration. Key features of the four main pillars include: [a]

- Regional Development: Grouping the country into six regions and establishing hubs for industry, agriculture, tourism, and energy based on each region's comparative advantages. Re-branding Ulaanbaatar city as a "20-minute city" by addressing its energy, transporation, and housing crisis.

- Human Development: Supporting the Mongolian people to address their health, education, and housing needs by allocating funds through the newly established Sovereign Wealth Fund (Box 2), maintaining the Child Money Program, and continuing the subsidized housing mortgage program under a National Housing Corporation.

- Economic Policy: (i) Improving the business environment, implementing tax reforms, ensuring macroeconomic stability and pursuing economic diversification by investing in mineral industrial parks, border ports and transport-related infrastructure, implementing a wide range of energy projects, and liberalizing the energy sector.[b] (ii) Continuing the President's initiatives including, New Cooperative and White Gold movements, Wealthy Herder program, Food Supply and Security, and the Billion Tree national movements.

- Human Rights and Governance: It includes policies in the areas of public sector reform, press freedom, fight against corruption, digital governance (such as automating public services using AI technology), foreign policy (e.g., fostering economic cooperation and free trade agreements with South Korea, China and the Eurasian Economic Committee), among others.

The four-year plan aspires to reach impressive socioeconomic outcomes by 2028. Upon successful completion of the action plan, the government projects GDP per capita to reach US$10,000 (around 80 percent increase from the 2023 level of US$5,956), halving the current poverty rate, maintaining economic growth above 6.0 percent, keeping inflation under 5.0 percent, and achieving a stable sovereign credit rating. Other socioeconomic outcomes cover the areas of human development, business environment, innovation, governance, corruption, privatization, economic freedom, and international competitiveness.

Source: Synthesized from the Government Action Plan 2024-2028 published on www.legalinfo.mn and www.parliament.mn.

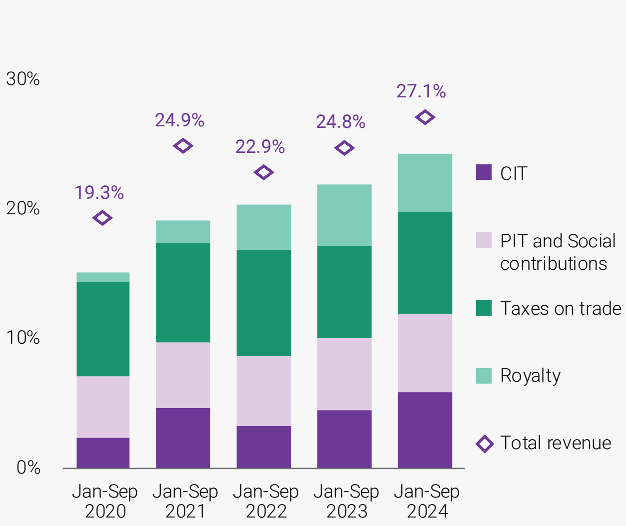
Notes:

a. The action plan includes a total of 620 objectives under these four pillars.

b. The action plan envisages 14 mega-projects in transportation, energy, water, and mining-related heavy industry sectors with an estimated total cost of US$40 billion (180 percent of current GDP). Many of these projects have been under discussion for several years and are currently in the process of securing funding, revising feasibility studies, and/or selecting contractors.

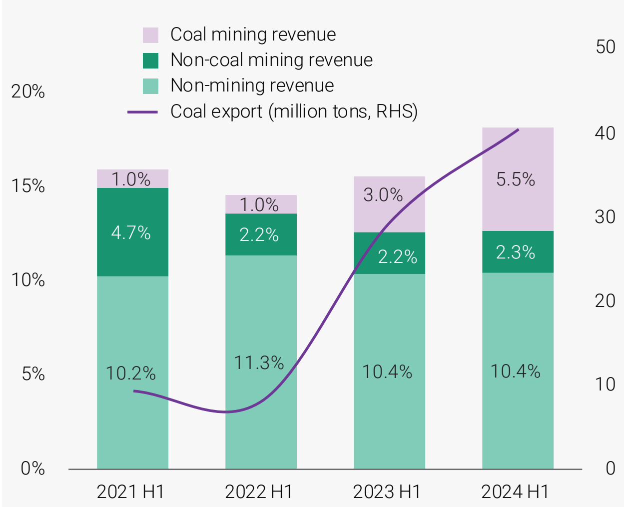
Fiscal revenue saw a significant rise, driven by higher personal and corporate income as well as taxes from trade. In the first nine months of 2024, total fiscal revenue grew by 26.6 percent y-o-y, reaching 27.1 percent of GDP, up from 24.8 percent during the same period in 2023 (Figure 13). Strong growth in both private and public sector wages contributed to a 27.0 percent increase in revenues from personal income tax (PIT) and social security contributions (SSC). Sustained production growth, particularly in the mining sector, led to higher corporate income tax (CIT), value-added tax (VAT), and, to a lesser extent, royalties.[8] CIT and royalties from coal mining firms accounted for 5.5 percent of GDP in the first half of 2024, as coal export volume more than offset the lower prices (Figure 14). Additionally, stronger demand for imported goods further boosted VAT, but also increased excise taxes and customs duties. With improved revenue prospects, in August, it was decided to transfer revenue worth 1.6 percent of GDP to the Sovereign Wealth Fund (SWF) in 2024 and help finance the government's subsidized programs (see Box 2 for details).

Figure 13. Taxes on income and trade were notably high



Sources: MoF; World Bank staff estimates.
Note: Taxes on goods and trade comprise of VAT on domestic and imported goods, excise taxes and customs duties.

Figure 14. Budget revenue remained highly dependent on mining associated revenues, especially on coal exports



Sources: MoF; World Bank staff estimates.

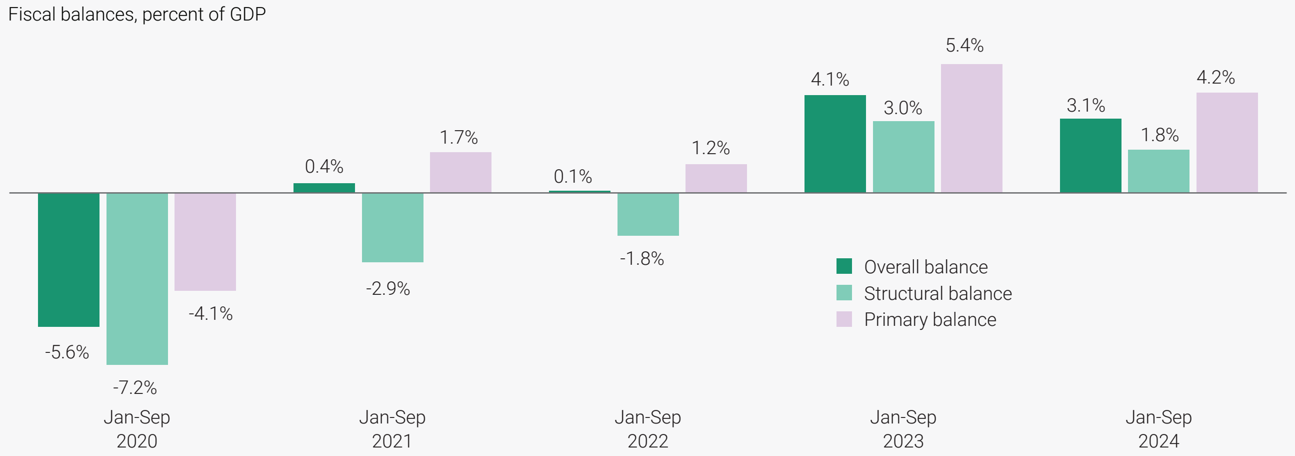
Mongolia's overall fiscal account remains in surplus, contributing to a reduction in public debt. In the first nine months of 2024, the country recorded a budget surplus of 3.1 percent of GDP, as strong revenues outpaced the rise in spending (Figure 15). This improved fiscal position enabled the repayment of US$150 million in public and publicly guaranteed debt. Combined with strong nominal GDP growth, this helped lower the public debt-to-GDP ratio to 38.2 percent by mid-2024,[9] down from 44.4 percent at the end of 2023. However, some public and publicly guaranteed borrowing occurred this year, including borrowing taken by the Development Bank of Mongolia (DBM) and the Municipality of Ulaanbaatar (MUB).[10] Public debt reduction, combined with sustained economic growth, led to an upgrade in Mongolia's credit rating from "B" to "B+" by Fitch and S&P.

8 CIT collected from mining firms constitute about 60 percent of total CIT revenue.

9 The public debt includes publicly guaranteed debt of the DBM but does not include contingent liabilities or the BOM's liability under its swap line with the PBOC (equivalent to an estimated 3.5 percent of GDP in 2024).

10 This includes a US$60 million state-guaranteed loan obtained by the DBM from the China Development Bank in May 2024 to finance a major energy project, a US$150 million domestic bond issued by the MUB in June 2024 for energy and infrastructure projects, and a US$152 million external bond issued by the DBM without an explicit state guarantee.

Figure 15. Government budget is in surplus for the second consecutive year



Sources: MoF; World Bank staff estimates.
Note: Structural balance is defined by the government as the overall fiscal balance net of fiscal saving funds (FSF and FHF).

Box 2. The Newly Established Sovereign Wealth Fund: Structure and Purpose

Mongolia has opted to finance parts of its social and investment expenditures through its newly established sovereign wealth fund (SWF). The Parliament of Mongolia approved the Law on SWF on April 19, 2024. This law, along with subsequent implementing secondary legislation, governs the management of the country's mineral revenues. The newly established SWF incorporates the existing intergenerational Future Heritage Fund (FHF), along with two new funds, the Provident Fund (PF) and the Development Fund (DF), without adding new funding sources. The accumulation rules for these three funds are as follows:

1. The PF will be managed by the Ministry of Family, Labor and Social Protection. It will collect dividends from all existing state-owned mineral projects, limited to dividends on ownership shares of up to 34 percent. The fund's assets will be earmarked to notional individual accounts for Mongolians citizens. Once additional regulations and digital infrastructure are established, the current generation of Mongolians will be able to draw from these accounts to finance certain health, education, and housing expenses. Currently, the fund is set to finance only housing expenses. In 2024, MNT500 billion was saved in this fund (held at the BOM) to support the subsidized Housing Mortgage Program.
2. The DF will receive half of the revenue that would have previously been allocated to the Fiscal Stability Fund (FSF)[a] in years when the structural balance is in surplus. The Ministry of Economy and Development will manage the fund and finance large strategic projects that would support the country's long term economic development and diversification agenda.
3. The FHF will remain as an intergenerational savings fund for future generations. It will continue to save 65 percent of royalties from mineral projects, after allocation to the FSF. However, it will no longer include dividends from existing state-owned mineral projects as these are now collected in the PF. An accompanying law to the SWF law, now allocates only 20 percent of royalties (after the allocations to the FSF) to this fund for 2024 (as opposed to the usual rule of 65 percent).[b]

Source: Synthesized from the general SWF law and accompanying laws.

Notes:

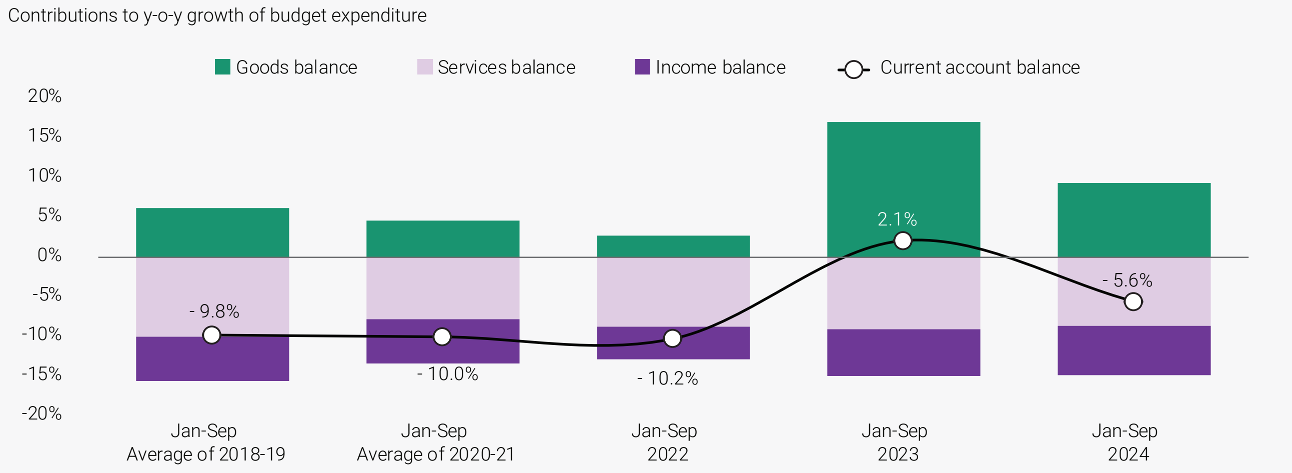
a. The FSF accumulates funds as follows: when revenue from any single mineral (e.g., coal, copper) exceeds 3 percent of total fiscal revenue, the excess amount—calculated as the difference between the market price and a "structural price" (essentially a long-term average price)—is saved in the FSF.

b. The FHF's reserves will remain frozen until they are transferred for investment in international financial markets in 2030.

1.4. Amid soaring imports bill the current account balance shifted to a deficit

A rapid expansion of imports pushed Mongolia's current account back into deficit. In the first nine months of 2024, the current account registered a deficit of 5.6 percent of GDP, compared to a surplus of 2.1 percent during the same period in 2023. This shift was primarily driven by a shrinking trade surplus (Figure 16), as import surged by 27.4 percent y-o-y. The strong growth in imports was fueled by robust domestic demand, which more than offset the effects of declining import prices. In line with strong investment activity (Section 1.1), imports of machinery and equipment for investment projects and mining operations, along with consumer durables like passenger vehicles, grew strongly and collectively contributed 19.3 percentage points to overall import growth (Figure 17).

Figure 16. **The current account deficit re-emerged with a shrinking goods trade balance**



Source: BoM.

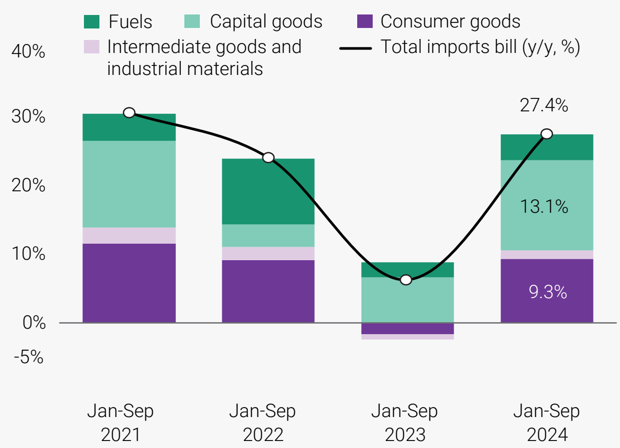
Export revenue growth remained steady, primarily driven by increased coal exports, with higher copper revenues providing additional support. In the first nine months of 2024, export revenue grew by 4.3 percent y-o-y, fueled by coal export revenues, which saw a 3.7 percent increase despite an 18.5 percent decline in coal prices (Figure 18). Copper exports rose by 13.2 percent y-o-y, with both higher volumes and prices (3.0 percent and 9.6 percent, respectively), contributing 2.3 percentage points to overall export growth. During the same period, services export revenue declined by 1.0 percent y-o-y, as lower transportation service exports (due to reduced transport costs) offset a 12.1 percent increase in tourism-related revenue.

11 Average food price at the international market declined by 4.8 percent y-o-y in the first nine months of 2024 (Source: FAO).

12 For instance, the number of imported passenger cars surged by 75.8 percent y-o-y, resulting in a 60.0 percent y-o-y increase in the total import bill for these vehicles.

Figure 17. **The import bill increased strongly, driven by greater imports of capital goods and consumer goods**

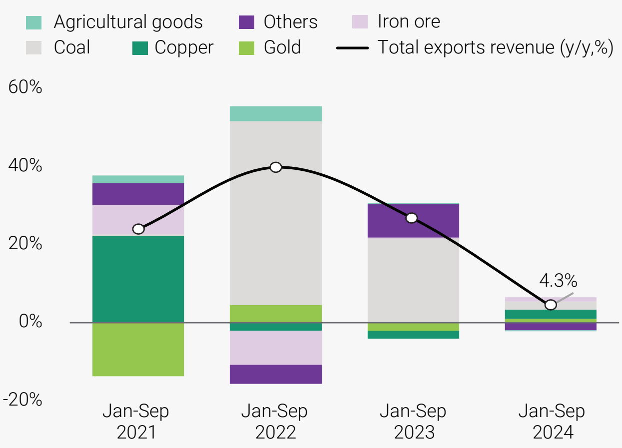
Goods imports bill growth and percentage contributions



Source: BoM.
Note: Stacked bars indicate growth decomposition of total imports bill in percentage points.

Figure 18. **Export earnings growth was modest amid weaker coal price**

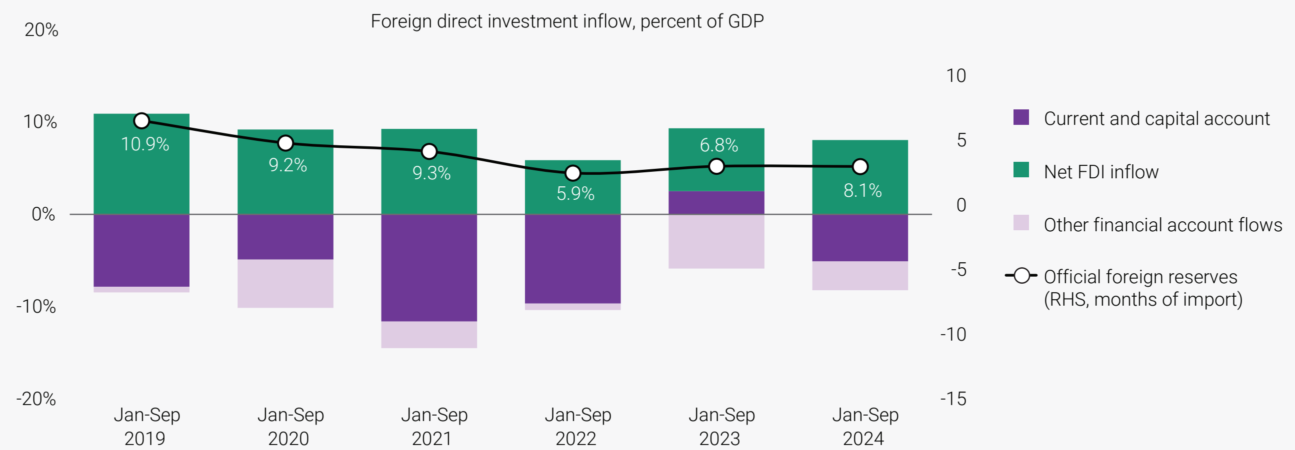
Goods exports growth and percentage contributions



Source: BoM.
Note: Stacked bars indicate growth decomposition of total exports earnings in percentage points.

Despite higher net FDI inflows, weaker current account performance constrained reserve accumulation, further impacted by increased interventions by the BOM to stabilize the nominal exchange rate. Net FDI inflows in the first nine months of 2024 rose to 8.1 percent of GDP, up from 6.8 percent during the same period in 2023, largely driven by greater inflows to the mining sector (Figure 19). However, foreign reserve accumulation was hampered by the current account deficit and the BOM's repayment of US$620 million on its currency swap line with the People's Bank of China in the first half of 2024. Additionally, pressure on the MNT/USD nominal exchange rate prompted further central bank interventions, further limiting reserve accumulation.[13] The BOM supplied US$4.6 billion in foreign exchange to the market during the first nine months of 2024, compared to US$3.0 billion in the same period of 2023.[14] As a result, gross international reserves declined slightly to US$4.7 billion by the end of September 2024, down from US$4.9 billion at the end of 2023. The rapid rise in imports has gradually eroded reserve coverage, which stood at 3.0 months by September.

Figure 19. **FDI inflows improved, partially offseting the weaker current account balance**



Source: BoM.

13 The nominal exchange rate of the MNT experienced a broad-based appreciation against major trading currencies, with an average y-o-y gain of 2.6 percent against the USD during the first nine months of 2024.

14 Reserve accumulation is influenced by net FX interventions, which are calculated as gross FX interventions minus the BOM's direct FX purchases from key mineral exporters. However, data on net interventions is not publicly available.

2. OUTLOOK, RISKS, AND POLICY RECOMMENDATIONS

After steady growth in 2024, Mongolia's economic expansion is expected to accelerate in 2025, driven by increased OT mining production, despite weaker coal output. Growth is projected to maintain its momentum from the first half of the year, reaching 5.3 percent in 2024, supported by strong domestic demand, though tempered by rising imports. In 2025, growth is expected to rise to 6.5 percent (Table 1), with the boost largely stemming from higher production at the OT mine, a modest recovery in agriculture following the 2024 dzud, and despite lower coal production.

On the demand side, sustained consumption, investment, and exports are expected to drive growth, though higher imports are anticipated to weigh against overall growth. Public and private consumption is expected to remain strong, though it is anticipated to moderate slightly in 2025 due to smaller wage and pension increases. Exports—led by increased copper and gold—along with public investments under the government's four-year action plan and private investments supported by expanded bank lending amid a less restrictive monetary policy, are also projected to further support growth. However, their impact may be partially offset by rising imports of investment goods.

Robust domestic demand is expected to drive inflationary pressures. Procyclical fiscal spending, as outlined in the 2024 supplementary budget, combined with rising household incomes, is projected to revive demand-driven inflation in the second half of 2024, elevating average headline inflation to 7.0 percent for the year. Inflation is forecast to rise further to 8.0 percent in 2025, driven by sustained demand pressures from increased public consumption, rising incomes, and robust lending activity, supported by recent monetary easing and ongoing subsidized lending programs.

Expenditures are expected to outpace revenue growth, leading to moderate fiscal deficits. Strong coal revenues are anticipated to raise 2024 revenue to 35.7 percent of GDP, while total expenditure is forecast to be higher at 36.7 percent under the 2024 supplementary budget, resulting in a fiscal deficit of 0.9 percent of GDP. In 2025, government revenues are expected to remain strong at 35.8 percent of GDP, supported by robust revenue from both mining and non-mining activities, though negatively impacted by lower coal prices. Expenditures are projected to outpace revenue growth and remain elevated at 36.5 percent of GDP, resulting in a fiscal deficit of 0.7 percent of GDP. Despite the moderate fiscal deficits, accelerating economic growth is expected to lead to a slight reduction in public debt, projected to fall to 42.2 percent of GDP in 2025.[15]

A current account deficit is expected to reemerge in 2024 and 2025. Declining commodity prices, particularly for coal, coupled with rising imports driven by strong domestic demand, are projected to result in current account deficits of 7.8 percent of GDP in 2024 and 6.2 percent in 2025. The slight improvement in 2025 is attributed to increased gold and copper exports from the OT mine. External debt repayment pressures are anticipated to remain minimal in 2025, with the next major payments—US$600 million in sovereign bonds and US$800 million from the Bank of Mongolia's FX swap with the People's Bank of China—falling due in 2026.

In the medium term, growth is expected to remain strong, though fiscal and current account imbalances are likely to widen. After the 2025 surge in OT's mineral output, mining production is projected to moderate, with non-mining sectors—such as trade and other services, and agriculture—driving economic growth, which is forecast to average 6.0 percent in 2026-2027. On the demand side, increased public consumption and investments under the government's four-year action plan are expected to fuel growth. However, fiscal and current account imbalances

15 The MUB plans to issue a US$500 million external bond in H2 2024 to finance key infrastructure projects.

are expected to widen as public investment continue to expand.

Downside risks persist both domestically and externally. Domestically, greater-than-expected fiscal spending could stimulate economic growth but also elevate inflationary pressures and widen fiscal and current account deficits. Additionally, climate change heightens the risk of more frequent and severe dzuds and flooding, which could have significant economic consequences, especially for poor and vulnerable households, as highlighted in the World Bank's 2024 Mongolia Country Climate and Development Report. Externally, Mongolia faces potential challenges from slower-than-expected global growth, which could weaken external demand and reduce prices for key export commodities (Box 3). Furthermore, escalating geopolitical tensions could drive up fuel prices, leading to higher imported inflation, increased production costs, and a larger import bill.

While Mongolia's ongoing mineral export boom is delivering positive macro-fiscal outcomes for the second consecutive year, sustaining these gains will require sound macroeconomic management. Macroeconomic stability is imperative for promoting sustainable growth and fostering economic resilience, by providing certainty and confidence to businesses and investors, encouraging long-term investments and innovation, and boosting productivity and economic expansion. It also helps ease the severity of economic cycles by minimizing the adverse effects of economic downturns. As recommended in a recent World Bank report,[16] macroeconomic stability requires policies to improve fiscal sustainability and ensure an independent monetary policy to anchor inflation. These reforms should focus on: (i) gradually scaling back pandemic-era social assistance while making it more progressive and responsive; (ii) restructuring subsidies in energy, agriculture, and pensions; and (iii) reducing fiscal risks from contingent liabilities, particularly state-owned enterprises (SOEs). Phasing out quasi-fiscal activities, such as the subsidized mortgage program, and prohibiting such financing under the central bank's mandate will enhance the central bank's independence and credibility in anchoring inflation, while enabling for greater exchange rate flexibility.

Table. 1 Selected macroeconomic indicators

	2022	2023	2024f	2025f	2026f	2027f
Real GDP Growth, at constant market prices	**5.0**	**7.2**	**5.3**	**6.5**	**6.1**	**5.9**
Private Consumption	8.1	9.7	8.4	5.0	6.8	6.4
Government Consumption	6.9	3.2	22.0	4.6	6.8	5.9
Gross Fixed Capital Formation	13.2	5.3	18.0	7.9	6.2	4.1
Exports, Goods and Services	32.3	33.2	5.1	23.9	2.4	5.7
Imports, Goods and Services	29.1	18.9	10.2	15.9	3.9	5.5
Real GDP Growth, at constant factor prices	**4.2**	**7.5**	**5.3**	**6.5**	**6.1**	**5.9**
Agriculture	12.0	-8.9	-23.0	5.0	6.5	4.5
Industry (including mining)	-4.5	12.9	8.3	11.5	6.1	6.2
Services	6.9	9.9	11.0	4.1	6.1	6.0
Inflation (CPI, period average)	**15.2**	**10.4**	**7.0**	**8.0**	**8.5**	**8.5**
Current Account Balance (% of GDP)	**-13.2**	**0.6**	**-7.8**	**-6.2**	**-7.1**	**-10.9**
Net FDI, Inflow (% of GDP)	**13.9**	**7.3**	**8.7**	**6.7**	**6.2**	**8.0**
Fiscal Revenue (% of GDP)	**33.8**	**34.1**	**35.7**	**35.8**	**35.1**	**34.9**
Fiscal Expenditure (% of GDP)	**33.1**	**31.5**	**36.7**	**36.5**	**36.2**	**35.5**
Fiscal Balance (% of GDP)	**0.7**	**2.6**	**-0.9**	**-0.7**	**-1.0**	**-1.1**
Primary Balance (% of GDP)	**2.1**	**4.2**	**0.6**	**0.8**	**0.6**	**0.3**
Debt (% of GDP)	**62.1**	**44.4**	**43.3**	**42.2**	**42.0**	**40.6**

Source: World Bank staff estimates.

Note: Public debt does not include the BoM's liability under the PBOC swap line (3.4 percent of GDP as of Sep 30, 2024).

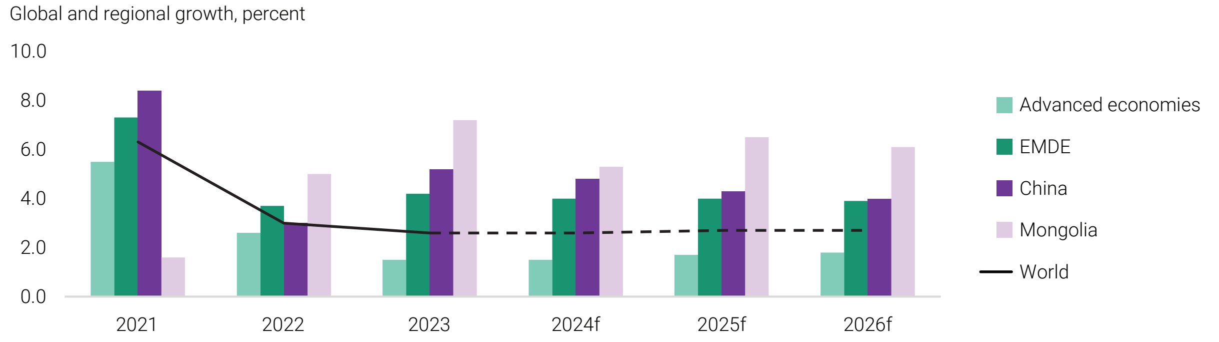
16 World Bank, 2024. "Agenda for Action: Key Policy Recommendations for Mongolia's Sustainable Development Vision".

Box 3. Global and commodity price outlook

Global and regional outlook

The global economic outlook for 2025-2026 is expected to be subdued, with growth in China anticipated to continue slowing. After stabilizing at 2.6 percent in 2024, global growth is projected to edge up slightly to an average of 2.7 percent over 2025-2026, remaining 0.4 percentage points below the pre-pandemic average (2010-2019) (Figure B.1). The slight increase is primarily attributed to modest growth in trade and investment, alongside cautious monetary policy easing in both advanced and emerging market economies. While growth in emerging markets (EMDEs) is projected to decrease slightly from 4.0 percent in 2024 to 3.9 percent over 2025-2026, China's growth is expected to slow more substantially, from 4.8 percent in 2024 to an average of 4.2 percent over 2025-2026. This slowdown is driven by a softening labor market, which curbs household consumption, and a contracting property sector, which weakens investment. Global risks are skewed to the downside and include rising trade fragmentation, prolonged high interest rates due to persistent inflation, policy uncertainty, weaker-than-expected activity in major economies, and climate-related disasters.

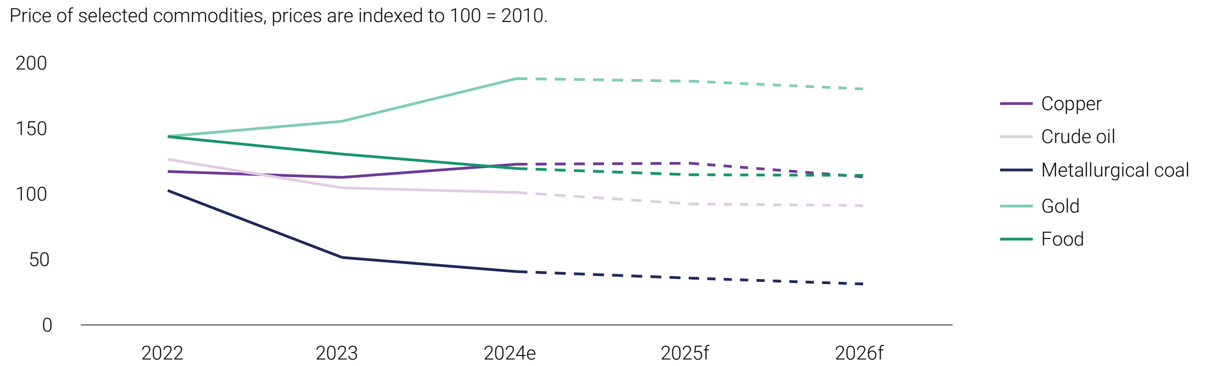
Figure B.1. Global economic growth is projected to stabilize at a moderate level



Source: Macro Poverty Outlook, October 2024 and World Bank Global Economic Prospects, June 2024.

Commodity prices are expected to decline, with larger drops in oil and coal prices anticipated in 2025-2026. Overall, commodity prices are expected to decrease by 5 percent in 2025 and 2 percent in 2026, following a 3 percent softening in 2024. The most significant declines are forecasted for coking coal (metallurgical coal) prices, with projected drops of 12.4 and 12.5 percent over the next two years, driven largely by reduced global coal consumption led by China. Assuming no prolonged geopolitical tension, increased supply from the non-OPEC+ producers is expected to push oil prices down by 8.6 percent in 2026, following price stabilization in 2025. Greater supply of grains and other agricultural commodities, amid favorable growing conditions, is expected to keep food prices low, with a 4.0 percent decline in 2025, followed by stabilization in 2026. A moderate pace of industrial growth in key economies including China, mainly explains the projected 8.6 percent drop in copper prices in 2026, after stagnation in 2025. Meanwhile, gold prices are expected to remain elevated through 2025-2026, buoyed by strong central bank demand following a record-breaking 21.4 percent increase in 2024; however, this effect is likely to taper as the global economy stabilizes.

Figure B.2. Commodity prices are expected to weaken



Source: World Bank Commodities Outlook, October 2024.

Source: This box draws from analysis and projections in the World Bank's Global Economic Prospects (June 2024), the World Bank East Asia and Pacific Economic update (October 2024), and the World Bank Commodities Outlook (October 2024).

DISTRIBUTIONAL IMPACTS OF MONGOLIA'S FISCAL SYSTEM

Fiscal policy plays a crucial role in tackling poverty and inequality by shaping the distribution of resources within a country. Fiscal strategies encompassing taxation, social assistance programs, and public spending on social services and basic infrastructure can significantly influence the income distribution and promote inclusive growth and poverty reduction. To protect the poor and vulnerable, Mongolia's fiscal system has largely relied on expansive, costly, and broad-based social transfer programs. Most recently, in response to the triple shock of the COVID-19 pandemic, trade disruptions, and geopolitical tensions, Mongolia introduced one of the largest stimulus packages in the region. While this package significantly reduced fiscal buffers, some social transfer programs were made permanent. The reduced fiscal space now limits the government's ability to respond to future shocks, underscoring the need for a thorough assessment of the effectiveness and efficiency of Mongolia's fiscal system in addressing poverty and inequality.

In this special chapter of the MEU we examine the distributional effects of the Mongolian fiscal system, notably the impact of taxes and social spending on poverty and inequality.

This chapter summarizes the main findings and recommendations from the World Bank's Commitment to Equity (CEQ) report (forthcoming). By analyzing the equity and poverty impact of the fiscal system (both public spending and taxation, see Table 2), the CEQ report aims to provide policymakers with insights into how different fiscal interventions influence household welfare, and how they can be adjusted to achieve more equitable outcomes while reducing the poverty. The CEQ constructs household income levels before any fiscal interventions (pre-fiscal income) and compares it with actual household income levels. The analysis is based on the 2022 Household Socio-Economic Survey (HSES) complemented with administrative data (e.g., number of taxpayers and beneficiaries of social programs).

Table. 2 Fiscal interventions modeled in the CEQ

	TAXES	TRANSFERS
DIRECT	Personal income tax, Property tax, Non-pension contributions of the SSC[17]	Child Money Program, Social welfare pension, Mother benefits, Food Support (former Food Stamp) Program, Cash subsidies to herders, Other direct social welfare benefits
INDIRECT	Value-added tax Excise taxes	Energy price subsidy, Discounted mortgages under the Housing Mortgage Program

1. DISTRIBUTIONAL ASSESSMENT OF THE FISCAL SYSTEM

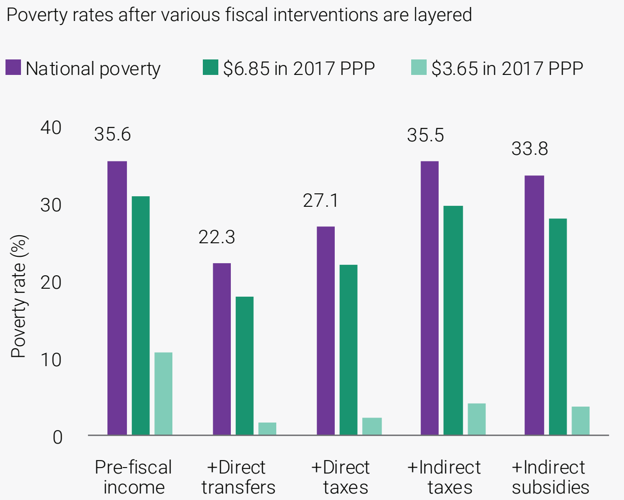
1.1. The fiscal system is effective in reducing poverty and income inequality

Mongolia's fiscal system reduces poverty, as the negative impact of taxes is partially offset by transfer programs. Taxes inherently increase poverty (by 12.4 percentage points), but this impact is largely counteracted by transfers. The national poverty rate, estimated at 35.6 percent based on pre-fiscal income, declines by 1.8 percentage points to 33.8 percent after fiscal interventions are considered (Figure 20). Among these interventions, direct transfers are the most effective, reducing the national poverty rate by 13.3 percentage points and lifting around 40 percent of poor households above the poverty line. Mongolia's fiscal system has a comparatively strong impact on poverty reduction by international standards. At the upper-middle-income country (UMIC) poverty line of US$6.85 per day (in 2017 PPP), fiscal interventions reduce poverty by 2.9 percentage points—well above the UMIC average reduction of 1.0 percentage point. At the lower-middle-income country (LMIC) poverty line of US$3.65 per day (in 2017 PPP), Mongolia's fiscal system achieves an impressive 7.1 percentage-point reduction in poverty, the largest reduction among LMICs.

17 Social security contributions (SSC) for old-age pensions are not treated as taxes in the CEQ, as they represent contributions that individuals make toward their future pension benefits. As such, old-age pension contributions resemble insurance premium payments or deferred income savings rather than a tax.

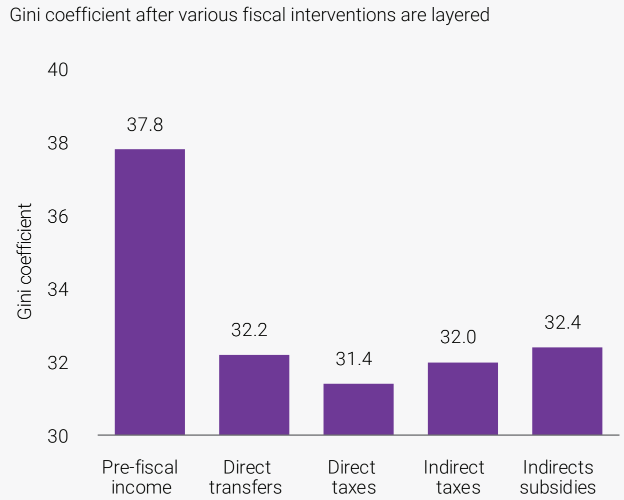
Mongolia's fiscal system is highly redistributive. Fiscal interventions significantly reduce inequality, with the Gini coefficient dropping by 5.4 points from 37.8 (pre-fiscal income) to 32.4 after interventions (Figure 21). Direct transfers play a key role, improving income equality by 5.6 Gini points.[18] This reduction in inequality is larger than the averages for LMICs (2.5 points) and UMICs (3.4 points). The difference is primarily due to Mongolia's generous and extensive direct transfer programs, given the limited redistributive impact of its tax system (see Box 4).

Figure 20. Direct transfers have greater effectiveness in reducing poverty



Source: World Bank 2024, forthcoming analysis on CEQ.
Note: Fiscal interventions are added to the pre-fiscal income one-by-one. Bars on the far-right side indicate poverty levels after cumulative impacts of the fiscal interventions considered in this CEQ.

Figure 21. It also has a strong impact on reducing income inequality



Source: World Bank 2024, forthcoming analysis on CEQ.
Note: Fiscal interventions are added to the pre-fiscal income one-by-one. Bar on the far-right side indicates Gini coefficient after cumulative impacts of all the fiscal interventions considered in this CEQ. Lower Gini coefficient indicate greater income equality.

18 Inclusion of in-kind benefits, particularly education benefits, further reduces the income inequality by 3.0 Gini points (see box 5).

Box 4. Impact of fiscal interventions on households of different income levels

The inequality-reducing effect of Mongolia's fiscal system can be attributed to a greater concentration of generous direct transfers among poorer households. The poorest 40 percent of households in the pre-fiscal income distribution benefits more from the fiscal system in net terms, as they receive more in transfers than they pay in taxes (Figure B.3). Notably, the poorest 10 percent of households receive benefits equivalent to almost 90 percent of their pre-fiscal income, with direct transfers making up the largest benefit. The net benefit declines as income levels rise, with the richest decile contributing, on average, 14.7 percent of their pre-fiscal income to the fiscal system (Figure B.4). In comparison, indirect transfers are relatively small and tend to benefit the richer more due to greater access to and consumption of services with price subsidies such as electricity and heating (see section 1.2 for more details).

Figure B.3. Households in lower income deciles receive greater fiscal benefits, in absolute terms…

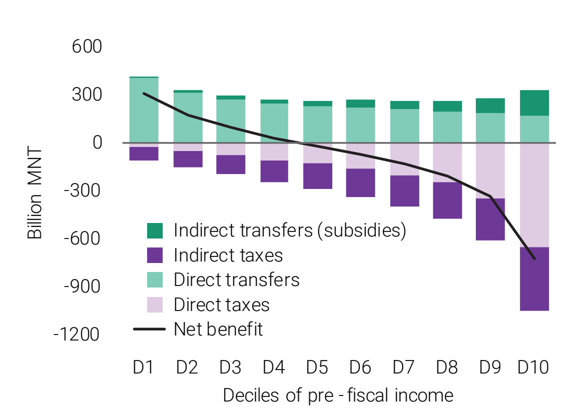
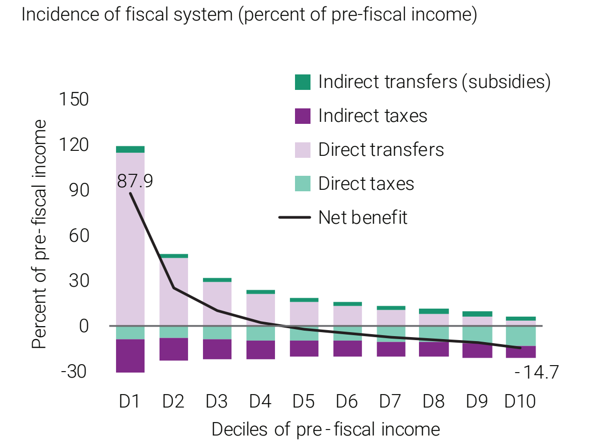


Figure B.4. … and relative to their pre-fiscal income



Source: World Bank 2024, forthcoming analysis on CEQ.
Note: Households are divided into 10 income deciles where D1 reflects the poorest 10 percent, while D10 the richest in terms of pre-fiscal income.

Source: Synthesized from World Bank 2024, forthcoming analysis on CEQ.

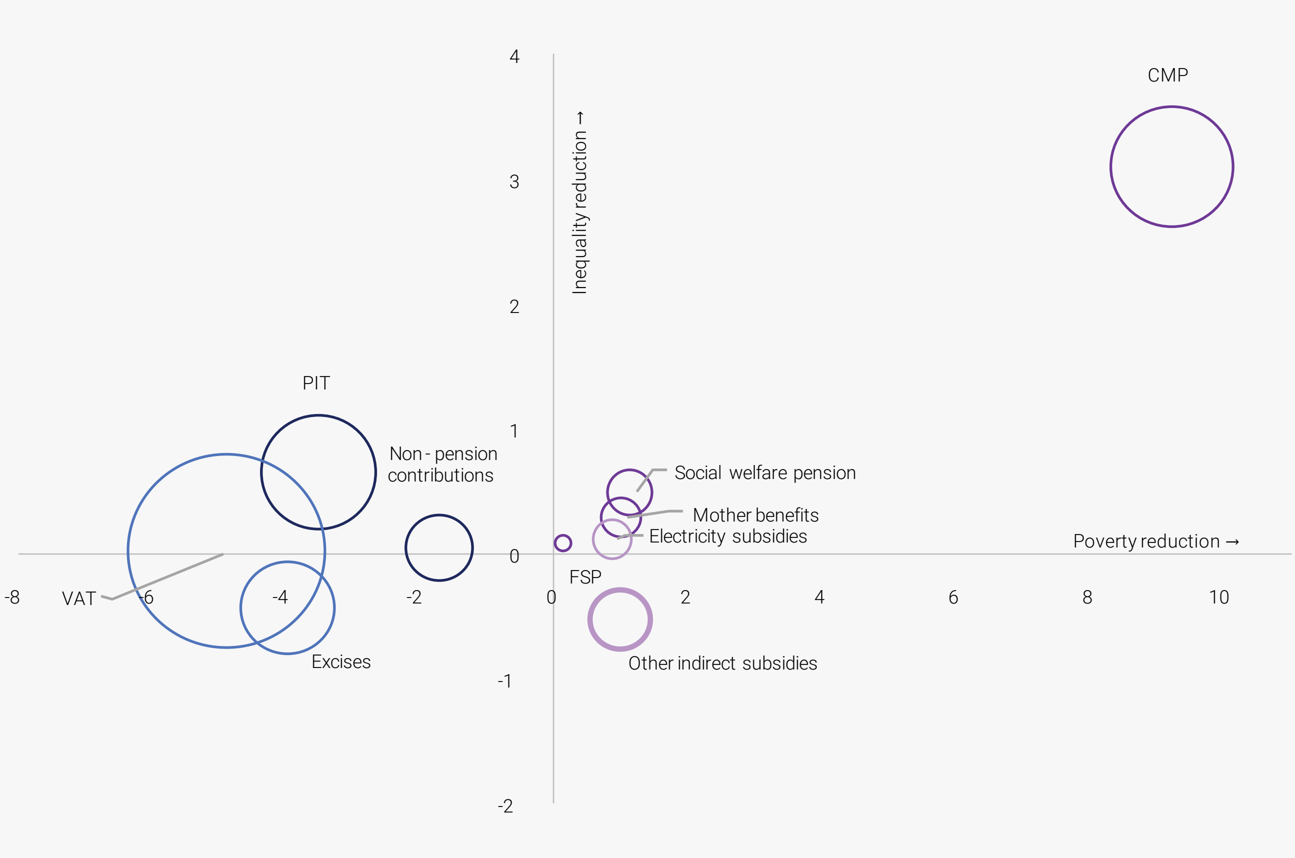
1.2. Direct transfers yield the greatest impact on both poverty and inequality while taxes have marginal redistributive effects

Direct transfer programs are generally pro-poor and redistributive. For instance, households in the bottom income decile by pre-fiscal income receive direct transfers equivalent to 115 percent of their income, and the large size of the direct transfer is sufficient to lift 36 percent of households considered poor by pre-fiscal income, out of poverty. Much of these impacts are due to the generous Child Money Program (CMP, representing 2.6 percent of GDP in 2022 and half of the direct transfers received by the households in bottom decile) and other broad-based direct benefits that target certain demographic categories including benefits to mothers (Figure 22, upper right quadrant). Although a larger share of these direct transfers goes to poorer households, the distribution of these benefits is not as progressive as it could be, as many programs are categorically targeted, instead of an income-based targeting. For instance, the CMP is effectively pro-poor because poorer households have more children, but a significant portion of total transfers (15 percent) still goes to the richest 20 percent of households.[19]

Meanwhile, several programs including the Social Welfare Pension and the Food Support Program (FSP) are more pro-poor, with the latter being the most progressive. More than half of FSP benefits go to the poorest decile.

19 Within the total direct transfer programs, the richest two deciles receive more than 14 percent of benefits, while the poorest two deciles receive 29 percent.

Figure 22. **Direct transfers are more redistributive and poverty reducing, but costly on the budget**



Source: World Bank 2024 (forthcoming CEQ analysis).
Note: Size of the balloon reflects cost of the benefits program and/or revenue generated by taxes, both in percent of GDP. Dark purple circles indicate direct transfers, light purple circles indirect transfers, dark blue circles direct taxes, and light blue circles indirect taxes.

Cost-effectiveness analysis highlights opportunities to reallocate direct transfers spending to enhance its impact. While the FSP's impact on poverty reduction and inequality reduction are the smallest among the social welfare programs, it is mainly due to low coverage and modest benefits.[20] Indeed, the FSP demonstrates the greatest cost-effectiveness in reducing both poverty and inequality, with a 4.1-percentage-point decrease in the poverty gap and a 2.5-point decrease in the Gini coefficient for each percentage point of GDP spent.[21] In contrast, the CMP has lower cost-effectiveness in reducing inequality and poverty, but with significantly high cost at 2.6 percent of GDP. Reallocating spending to more cost-effective (therefore more efficient) and pro-poor programs such as the FSP would enhance the impact of direct transfers at a lower cost on the budget.

Indirect transfers, mostly in the form of price subsidies, have marginal impact on poverty reduction, while exacerbating income inequality, due to disparities in access to and consumption of subsidized services. Indirect subsidies for electricity, heating, water, and mortgages overwhelmingly benefit the richest households, with about 27 percent of total subsidies going to the richest decile and about 2 percent going to the poorest decile (Figure 22, lower right quadrant). This disparity is primarily driven by limited access to subsidized services among poorer households and lower consumption levels among those with

20 With only about 3 percent of households benefitting from the FSP and transfers representing just 6 percent of pre-fiscal income among recipient households, the program is insufficient to yield substantial impacts on poverty or inequality despite being well targeted.

21 The poverty gap measures how far, on average, the incomes of poor people fall below the poverty line.

access. For instance, poorer households who predominantly live in ger districts have limited access to district heating, clean water, hot water, and wastewater services. Meanwhile, electricity price subsidies slightly reduce inequality, though this outcome is atypical; in many middle-income countries, such subsidies tend to increase inequality. The free nighttime electricity policy for ger districts in urban areas is the main driver of this exception, as households in these areas tend to be poorer. However, these subsidies are an inefficient measure, as they provide greater absolute benefits to wealthier households and create price distortions that encourage overconsumption, undermining the financial viability of the energy sector. Finally, housing mortgage subsidies stand out as the most regressive and expensive among the indirect transfers.[22] About 9 percent of the total households benefit from this program with nearly half of total subsidies going to the top decile and less than one percent to the poorest decile. Richer households have greater access because they have higher chances of qualifying for the mortgage loans for apartment purchases.

Direct taxes in Mongolia have a marginal redistributive impact mostly due to flat personal income tax and limited tax expenditures for low-income earners. Direct taxes collectively improve income equality by 0.9 Gini points but increase poverty by 6.4 percentage points, with most impacts attributable to the personal income tax (PIT) (Figure 22, upper left quadrant).[23] While the fiscal system collects majority of its PIT revenue from richer households – consistent with their larger income – the flat income tax burdens are also significant for poorer households due to relatively high formality and limited tax expenditures for low-income earners in Mongolia. In 2022, among the poorest decile about 40 percent of total income came from formal wages subject to PIT, while the share is about 70 percent for the richest decile. Significant exemptions on PIT for agricultural income undoubtedly benefit the poor, but there is a lack of tax exemptions (zero-rate band) and limited deductions for low-income wage earners (mostly in urban areas). In addition, the flat PIT is relatively ineffective when it comes to reducing income inequality. Fiscal revenue equivalent to 1 percent of GDP generated through the PIT results in only a 0.3-point decrease in the Gini coefficient.

Indirect taxes are marginally regressive as poorer households bear a relatively larger burden in relation to their incomes. VAT and excise taxes increase income inequality by 0.4 Gini points (Figure 22, left side). The regressivity is primarily driven by excise taxes (mostly on alcohol and tobacco), as it represents a larger burden for poorer households in relation to their income, resulting in a higher effective tax rate. While richer households contribute more to VAT revenues, for poorer households VAT payments still constitute a significant share of their income. Additionally, the VAT has minimal redistributive impact partly due to the VAT rebate, which disproportionately benefits richer households. In absolute terms, richer households spend more on items subject to the VAT, and therefore benefit more from VAT rebates.[24]

Finally, in-kind transfers strengthen the redistributive impact of the fiscal system. In Mongolia, as highlighted in Box 5, in-kind benefits—especially those related to education, and to a lesser extent health—enhance the equity of the fiscal system.

22 Note that this is technically a quasi-fiscal transfer rather than a fiscal transfer, as the program is financed by the central bank rather than through the budget.

23 Government subsidy for health insurance premiums is also considered a direct tax and it contributes to the overall progressivity. About two-thirds of the population benefit from these subsidies, with a higher concentration among poorer households due to increased vulnerability and lower formal employment rates. Without these subsidies, health insurance coverage may be lower, especially among poorer households, or households would be forced to bear the financial burden themselves.

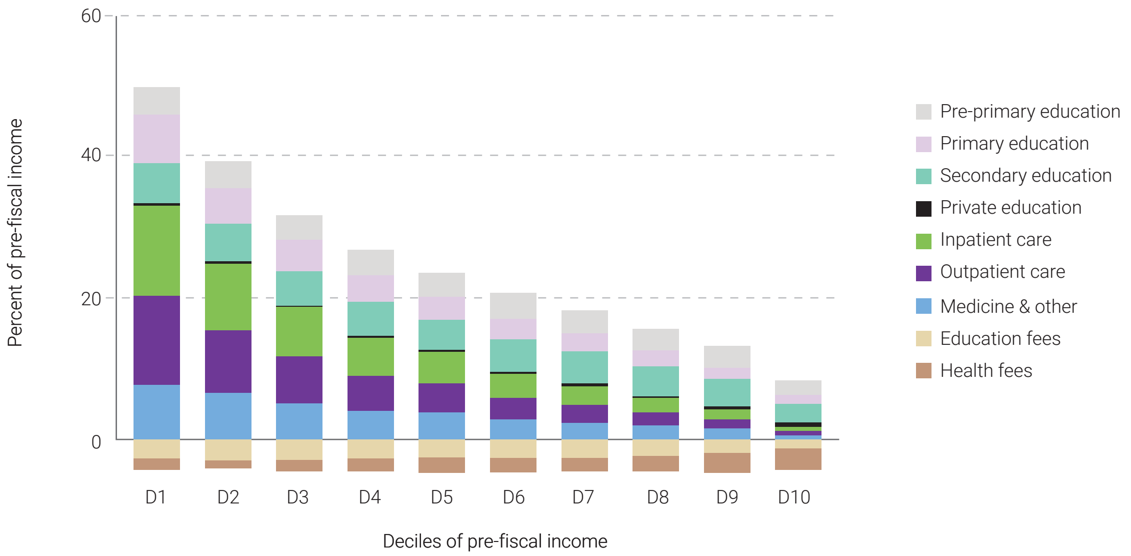
24 In 2016, Mongolia introduced a consumer VAT rebate of up to 20 percent of the VAT paid at registered businesses. Through the e-BARIMT system, consumers can register their purchases on a mobile app by scanning a unique QR code provided on receipts. This reform has led to a sharp increase in the number of firms filing VAT returns, boosting compliance and VAT revenues. However, from an equity perspective, the richest decile receives an estimated 26 percent of total rebates, reflecting their higher consumption levels, reduced informal purchases (or greater access to businesses that provide electronic receipts for the app) and a greater likelihood of reporting purchases.

Box 5. Assessment of the impact of in-kind transfers on income inequality

Public education benefit drives much of the progressive impact of in-kind benefits, reducing the Gini coefficient by 3.0 points. A greater share of education benefits is directed towards poorer households. This is mainly due to greater number of children in poorer households (over 40 percent of the poorest decile have three or more children compared to less than 10 percent of the richest decile). However, access and affordability issues constrict the poorer households from sending their children to pre-primary education, resulting in less progressive distribution of pre-primary benefits (Figure B.5).

Figure B.5. Public education services mostly benefit the poor, while the impact is mixed for health benefits

Incidence of fiscal system, in-kind benefits (percent of pre-fiscal income)



Source: World Bank 2024, forthcoming analysis on CEQ.
Note: Households are divided into 10 income deciles where D1 reflects the poorest 10 percent, while D10 the richest in terms of pre-fiscal income.

Health in-kind benefits reduce income inequality by 0.5 Gini points only, as access to health services vary. The distribution of benefits for outpatient care (i.e., not requiring overnight stay in hospital) tends to be relatively equal across the income distribution, reflecting widespread access and similar utilization rates among households of different income levels. However, benefits related to inpatient care (i.e., requiring overnight stay or longer), medicine and auxiliary healthcare services exhibit regressive patterns due to the richer households' greater access to and utilization.[a] Location of district general hospitals and specialized hospitals pose accessibility challenges to poorer households residing in more remote areas.

A larger portion of health and education user fees and co-payments are borne by richer households, resulting in a reduction in inequality. Health user fees and co-payments have an inequality-reducing effect as richer households are more likely to access medical services that may not be covered by health insurance, such as preventative and diagnostic tests and elective treatments. However, while richer households also pay significant fees for pre-primary and tertiary education, these fees increase inequality as they constitute a larger income share of poorer households. In net terms, education and health fees reduce income inequality as the health fee effect dominates.

Source: World Bank 2024, forthcoming analysis on CEQ.

Note: a. Approximately two-thirds of the benefits related to medicine are allocated to inpatient treatment, which is fully covered by health insurance, while medicine for outpatient care incurs varying rates of co-payments.

2. POLICY RECOMMENDATIONS

Revenue reforms should be pursued to enhance the fiscal system's redistributive impact. Priority should be given to reforms that enhance the progressivity of the PIT system, such as implementing progressive tax rates and increasing taxes on income sources primarily associated with high-income households. Additionally, offering tax deductions and exemptions for low-income earners can further enhance PIT's impact on reducing inequality and mitigating poverty.

The burden of taxes on poor households can be mitigated by allocating funds to more cost-effective programs. Reallocating funds to programs that have greater cost effectiveness in reducing poverty and inequality is an important priority. Poverty-targeted programs should be scaled up while spending on large, broad-based programs such as the CMP should ideally be reduced through targeting or lowering benefits in real terms. In the absence of comprehensive records of individual and household income, improving the efficiency of social spending will require a reliable and well-developed social registry.

Mongolia needs to balance fiscal reforms that achieve short-term poverty and inequality reduction with those that offer longer-term benefits. Broad-based development policies such as investments in infrastructure, human capital, climate adaptation strategies, and public administration are essential for inclusive growth in the longer term, but its immediate impacts on poverty and inequality might be limited. In contrast, short terms measures such as indirect transfers through price subsidies could have immediate redistributive impact but have negative externalities in the medium to long term (e.g., agricultural subsidies resulting in environmental degradation or energy tariff subsidies affecting the financial sustainability of the energy sector).

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