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Mongolia: Establishing Sovereign Wealth Fund Management Institution

Revenue Management in Mongolia

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Abstract

The paper maps out the complex flow-of-funds from the mineral sector in particular to various government entities—including the Fiscal Stability Fund, Future Heritage Fund, sub-national governments and state-owned enterprises—as determined by Mongolian laws and regulations. Based on an examination of the challenges associated with fiscal revenue management in Mongolia, it then offers several recommendations for reform. These are focused on unifying the budget to minimize extra-budgetary spending, smoothing fiscal expenditures, promoting fiscal sustainability and investing in improving the public financial management system.

Introduction

Mongolia is a mineral-dependent economy. In 2017, approximately 24% of fiscal revenues were derived directly from taxes and non-tax revenue collected from the mineral sector.[1] Other major revenue streams for the government are income taxes, social security contributions and VAT, which, in Mongolia, are each correlated to the ups and downs of the mineral sector.[2] In short, Mongolian public finances are tied to temperamental commodities markets.

In response, the Government of Mongolia has enacted a set of policies designed to help mitigate the main challenges associated with mineral dependence, for instance short- to medium-term revenue volatility leading to expenditure volatility, long-term booms and busts, and Dutch disease. These policies have included the establishment of several state-owned enterprises in the mining sector, enacting fiscal rules and creating no less than three extra-budgetary funds to manage mineral revenues (the Fiscal Stability Fund, the Future Heritage Fund and the now defunct Human Development Fund), and establishing a special system of mineral revenue distribution to subnational governments.

Unfortunately, the government's policies have not always proven effective. This was made evident in 2017 when the Mongolian government announced a $5.5 billion bailout agreement with the International Monetary Fund (IMF) and partners the World Bank, the Asian Development Bank, and the governments of Japan and Republic of Korea. The Mongolian government also signed an extension of its central bank swap agreement—essentially a line of credit—with the People's Republic of China's central bank.

In return, Mongolia approved a limited and revenue-focused set of reforms. The reforms included increases in personal income tax rates; increases in fuel, alcohol and tobacco taxes; and a public service wage freeze, though some of those were reversed.

Over the last year, growth has resumed and public finances have stabilized. However, this recovery remains fragile, dependent on higher coal and copper prices and continued support from international donors.

This brief maps out the complex flow-of-funds from the mineral sector in particular to various government entities and identifies the challenges the current system has generated. It then offers several recommendations for reform to stabilize and grow public finances, as well as fix vulnerabilities in the public financial management system.

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[1] Executive Budget Proposal for 2019, Ministry of Finance.

[2] https://www.imf.org/en/Publications/CR/Issues/2018/07/05/Mongolia-Fourth-Review-under-the-Extended-Fund-Facility-Arrangement-and-Request-for-46044

Flow of fiscal revenue in Mongolia

Revenue collection and administration

Revenue collection in Mongolia is dispersed among many government entities, both national and subnational. While the General Department of Taxation collects income tax, value added tax, excise taxes and mineral royalties, other revenue streams are collected by an array of organizations. For example, social security contributions are collected by the Department of Social Insurance. Exploration and mining license fees as well as profit shares and royalties from petroleum production are collected by the Mineral Resources and Petroleum Authority. Some sales of coal and copper are collected by state-owned enterprises such as Erdenes Mongol and Erdenet Mining Corporation. Water and land use fees are collected by the *aimags*. Real estate taxes are collected by the *soums*.

While most of the revenue collected by national government entities make their way into the government treasury, this fractured system makes tracking revenues a complex undertaking. This complexity, along with opacity of some government transactions, enables certain entities to retain a portion of the revenues they collect, especially extra-budgetary entities such as state-owned enterprises. Thus, we must be mindful that any description of the flow-of-funds in Mongolia will inevitably fail to encompass all fiscal revenues.

Fiscal Stability Law

The *Fiscal Stability Law* was adopted in 2010 introducing fiscal rules on expenditure, deficit and debt growth, and saving some of the mining revenue to the Fiscal Stability Fund (FSF) for the purposes of overcoming challenges related to the short-term volatility of the commodity revenue. While 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% of GDP (originally meant to start in 2013, but starting year postponed three times and is now set at 2023). The fiscal deficit target shall be reviewed every four years.

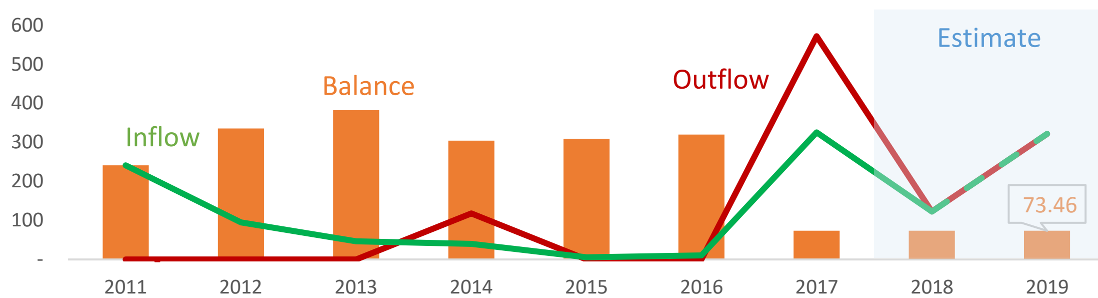
- Debt ceiling: Net present value (NPV) of public debt cannot exceed 60% of Gross Domestic Product (GDP) (originally the target was 40% of GDP, meant to start in 2013, but it was modified and is now applicable as of 2021). For the purposes of this rule, the definition of NPV of public debt does not include 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 non-mineral GDP growth or non-mineral GDP growth over a 12-year period (originally meant to start in 2013, but postponed until 2017).

- Revenue rule: Fiscal revenue projections will be estimated using "structured procedures". According to the Ministry of Finance (MOF), 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% of fiscal revenues, the windfall (calculated using a long-term average price) is saved in the FSF. A shortfall triggers a transfer from stabilization fund under the *Law on Government Special Funds (2006)*. The *Fiscal Stability Law* allows for exceptions in case of recession, natural disaster or national emergency. Suspension of the rules requires State Great Hural (Parliament) approval.

The inflows and outflows, as well as estimated balance of the fund are show in Figure 1 below. These funds are held in commercial banks in Mongolia in non-term deposits with interest rates around 7-9%, 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.

Figure 1. No accumulation to the FSF in 2017-2019



Source: Budget Performance Indicators, Ministry of Finance, www.mof.gov.mn, and author's calculations.

Since the actual sources of revenue and withdrawal rules for the FSF are regulated by *Law on Government Special Funds*, the government can change this law and circumvent the Fiscal Stability Law requirements aimed at accumulating significant amounts in 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 utilize all remaining FSF revenues to finance budget deficits until the end of 2023.[3]

Future Heritage Fund Law

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, the Future Heritage Fund (FHF), to 'park' a portion of mining revenues for the benefit of future generations:

- 50% of additional, new mining revenue;
- 20% of unexpected mineral revenue windfalls (not including state dividends or royalties) (as of 2018);
- 65% of royalties from mineral projects, after distribution to the FSF;
- 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% 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% of mineral revenues might be deposited into the FHF in an average year. In other words, under the current draft, approximately 25-50% of mineral revenues would be saved until 2030, after which 10% of the

[3] Law on Government Special Funds, additional provisions 9(1).3.4 and 34.2, November 2016 and April 2017, www.legalinfo.mn

FHF's net investment income, or approximately 0.2-0.5% of the value of FHF assets would be withdrawn annually.[4]

Unlike most other sovereign wealth funds which are financed out of fiscal surpluses (e.g., Chile, Kazakhstan, Norway, Qatar, Saudi Arabia, Timor-Leste) and/or were established in countries with low or declining public debt levels (e.g., Botswana, Russian Federation), the FHF is being established in a context of significant budget deficits and a large and growing debt-to-GDP ratio. This could lead to a situation whereby mineral revenues are deposited into the fund and being invested in foreign assets at 2-4% 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 5-8% real interest (the current rate in Mongolia).

We have witnessed this situation in other countries, most recently in Argentina, Ghana and 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.

One provision in the FHF legislation states that the it can only start accumulating positive balances once the debts of the now defunct Human Development Fund (HDF) are paid off. The HDF accumulated large debts, mainly to pay for social transfers including child money and universal cash handouts to citizens. These were mostly borrowed from other government entities. Today, the HDF's debts have nearly been paid, meaning that the FHF is likely to begin accumulating funds in 2019.

Implementation of fiscal rules and macroeconomic management

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 raised by the Great State Hural. If the Great State 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 2012-2016, and this resulted in the 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 mortgage program and fuel and wheat price stabilization efforts.

The government attempted to do away with off-budget spending and quasi-fiscal activities as part of the IMF program. For instance, the Development Bank of Mongolia law was revised to allow greater operational and financial independence, and price stabilization programs by Mongolbank were essentially halted. However, risks associated with off-budget institutions destabilizing fiscal sustainability remain. For instance, recently, the Development Bank of Mongolia raised funds on international capital markets by issuing a 5-year, $500 million bond with coupon of 7.25% without

[4] https://resourcegovernance.org/sites/default/files/documents/nrgi_mongoliafutureheritagefund1.pdf

any government guarantee. Yet markets have assumed an implicit government guarantee on this debt.

Similarly, state-owned enterprises (SOEs) such as Erdenes Mongol and its subsidiaries, which manage equity in several large mines, have invested in the development of mining and mining-related infrastructure projects. For instance, Erdenes Mongol maintains the key coal hauling road, and started different projects on geological exploration, downstream activities, processing of minerals, and asset management. For some of these projects, the company and its subsidiaries rely on government loans and guarantees while for others they invest using retained company earnings. The viability of these investments is tied to commodity prices. Thus a negative shock to copper or coal prices would require further government bailouts of SOEs. Erdenes Mongol's recent proposal to create a new investment fund to channel mineral revenues may pose additional risks to the efficacy and accountability of the public financial management framework, especially if scarce resources are diverted away from healthcare, education and production infrastructure, or the fund acts as a parallel budget or development bank.[5]

Another way of circumventing the fiscal rules has been the amendment to the rules by 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 12 times since its approval on 24 June 2010. For example, the requirement to amend this law by absolute majority of the State Great Hural was eliminated in April 2015.

Finally, revenue projections from some big mining projects, notably for the Oyu Tolgoi copper-gold deposit and Tavan Tolgoi coal deposit, have proven wildly over-optimistic. These unwarranted expectations have undoubtedly contributed the government's over-spending.

Sub-national distribution

Aimags and *soums* collect some taxes and fees such as immovable property taxes, land use fees, vehicle taxes, water use fees and royalties on common minerals (gravel and sand). In addition to directly collecting some revenues, subnational governments are allocated a portion of the national budget. Currently, 10% of domestic value added tax payments, 5% of mining royalties, 30% of petroleum royalties, and local government budget surpluses are distributed to local governments. These funds are pooled into the General Local Development Fund and then redistributed to Local Development Funds (LDFs) controlled by *aimags* and the capital city according to a formula. The formula gives equal weight to the following indicators:[6]

- Local Development Index, which consists of 65 indicators, though in practice much of the data needed to calculate the index is unavailable
- Population
- Geographical characteristics—population density, remoteness and size
- Tax generating capacity

Aimags and Ulaanbaatar then redistribute at least 60% of the fund to the lower level *soums* or *khoroo* (Ulaanbaatar subdivisions) on the basis of a similar formula.

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[5] Andrew Bauer and N. Dorjdari, New fund plans could divert Mongolia's focus from mining sector reforms, https://resourcegovernance.org/blog/new-fund-plans-could-divert-mongolias-focus-mining-sector-reforms

[6] Andrew Bauer, Uyanga Gankhuyag, Sofi Halling, David Manley and Varsha Venugopal (2016) *Natural Resource Revenue Sharing*. Natural Resource Governance Institute-United Nations Development Program (UNDP).

Due to the decline in mining revenues, LDF revenues almost halved in 2015. This decline was a significant source of complaint from mining regions. As of 2016, parliament has decided to allocate an additional 30% of mineral royalties (excluding royalties from 'strategic', or large mining projects) directly to mining *aimags*, of which one third would be reallocated to mineral-producing *soums*. But this decision was frozen as part of the IMF EFF program, and now only 10% of royalties would go to LDFs as of 2020. The government has also decided to allocate 100% of mineral exploration license fees as well as 30% of petroleum license fees and 50% of air pollution fees by coal miners to LDFs, effective in 2020.

Challenges and recommendations

Unifying the budget / re-examining the role of extra-budgetary entities

Over-optimistic revenue projections, complex revenue collection mechanisms and off-budget spending, especially by the Development Bank of Mongolia and other state-owned enterprises, have enabled government to over-spend. They also impede controls on government activities by oversight bodies such as parliament and the media. Independent budget projections and bringing all spending on-budget can help control government spending. So can simplifying the country's complex revenue management system, for instance by limiting the number of extra-budgetary institutions to the minimum needed to generate confidence in public financial management. The Government of Mongolia and State Great Hural may wish to consider bringing some of these institutions under the budget framework—essentially de-corporatizing some—or adopting new legislation increasing the transparency and oversight of extra-budgetary institutions so that their performance improves and they pay dividends to the government.

Managing volatility

Despite the establishment of the Fiscal Stability Fund 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 expenditures, as Chile, another copper-dependent country has done, has contributed to Mongolia's fiscal crisis and poor public investment decisions.

We recommend a reexamination and simplification of Mongolia's fiscal rules. The existing rules are generally pro-cyclical and are regularly circumvented. Replacing this complex series of rules with a simple expenditure rule with a mineral-revenue based savings rule to mitigate Dutch disease effects and smooth expenditures over the long-term may be more effective and improve compliance. For example, in Peru, real current expenditure is only permitted to increase by 4% per year, though an exception can be made if Congress declares an emergency. Similarly, Grenada's rule is that real primary spending growth of the central government and covered parastatal entities cannot exceed 2% per year. In Paraguay, real primary spending growth is capped at 4% per annum. In each of these three cases, the expenditure rule is complemented by a balanced budget rule. For example, in Paraguay, the headline budget deficit should not exceed 1.5% of GDP but can rise to 3% of GDP in cases of national emergency or economic crisis.[7] Greater compliance would require consensus among all political parties on the rules, as Brazil, Colombia and Norway have done.

[7] https://www.imf.org/external/datamapper/fiscalrules/Fiscal%20Rules%20at%20a%20Glance%20-%20Background%20Paper.pdf

Fiscal sustainability

Mongolia's public debt-to-GDP ratio is nearly 85 percent, leading to some of the highest interest rates paid by any government in the world.[8] Service payments on public debt alone were greater than MNT1.1 trillion in 2017. In 2018, debt servicing was expected to cost MNT1.15 trillion, 50% more than the healthcare budget and 70% of the education budget for the whole country.

Thanks in part to a plan that effectively restructures Mongolian sovereign debt, the IMF-led program has reduced Mongolia's debt burden such that debt servicing is expected to cost 25% less in 2019 than the year before. The IMF-led program has 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% decrease in commodity prices from June 2017 levels (the equivalent today of an approximately 30% drop in the price of coal and a 15% drop in the price of copper) pushes Mongolia back into a debt crisis, even with implementation of the planned reform measures.[9] Furthermore, absolute debt levels continue to rise, though 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.

Unsustainably high debt levels do not just matter for government expenditures, they also threaten investor confidence, lowering growth rates and employment. High debt levels are also unfair to future generations, as they are the ones who will have to repay it one day.

Achieving debt sustainability requires full implementation of the reform program, at a minimum. This would include greater excise taxes on alcohol and tobacco, implementation of a progressive income tax, increases in social security contributions, a reduction in the government wage bill, and ending the central bank practice of financing off-budget programs such as the mortgage loan program.

The government may also wish to reprioritize government spending by cutting politically motivated local infrastructure projects and reallocating money according to a new national development plan. The new Fiscal Stability Council (FSC), established in response to the condition in the government's bailout plan by IMF, could provide an impetus to reform, but potential for political interference and limited mandate could undermine this institution.[10]

Government foreign savings make sense when the long-run real return on foreign assets is greater than the interest paid on public foreign 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. 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 Fiscal Stability Fund, which, if working well should allow Mongolia to manage economic

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[8] https://www.imf.org/en/Publications/CR/Issues/2018/07/05/Mongolia-Fourth-Review-under-the-Extended-Fund-Facility-Arrangement-and-Request-for-46044

[9] https://resourcegovernance.org/analysis-tools/tools/mongolia-macro-fiscal-model

[10] Munkhsoyol B., Can Mongolia's Fiscal Stability Council Improve Fiscal Discipline?, Natural Resource Governance Institute, https://resourcegovernance.org/analysis-tools/publications/mongolias-fiscal-stability-council

cycles without raiding the Future Heritage Fund. The Fiscal Stability Fund is essential for the credibility of the Future Heritage Fund.

Investing in public investment

Given the country's geography and capital-scarcity, sustainable growth in Mongolia requires public investments, particularly in infrastructure. In recent years, politicians, academics, government officials and the private sector have placed a major accent on so-called 'mega projects', projects valued more than USD 1 billion. Examples include strategic mining deposits such as the Oyu Tolgoi copper and gold mine, the Tavan Tolgoi coking coal projects, commodity transportation and border crossing facilities, power stations and railway projects to support large mining projects, and specific projects on improving exports of agriculture products and reduce dependency on imported agricultural products.

Large infrastructure projects are meant to be driven by the Sustainable Development Concept of Mongolia 2030, a vision statement made more concrete through the associated 2016-2020 government action plan. Separately, the *Law on Development Policy and Planning* (2015) specifies which short and long terms policies the government adopts, and how they link to government's spending policies through annual budgets and other means, including Public Investment Programs and other large projects. The Public Investment Program, which covers projects valued over 30 billion MNT, lists 113 projects in its 2018 iteration. These planning processes have often resulted in a focus on smaller projects scattered around the country, rather than encouraging the government to focus on infrastructure projects that will unlock Mongolia's growth potential, such as a new power plant in Ulaanbaatar or a railway to border with the People's Republic of China which have been discussed for decades.

In contrast, Colombia, Norway, Malaysia and Timor-Leste have each developed procedures for selecting capital projects where selection is based on an evaluation of the bottlenecks to economic growth, recognition of the importance of economic 'clustering', and a value-for-money assessment of each project. National plans have clear costs, timelines and financing information associated with each project. While costs and timelines are available for many capital projects in Mongolia, the government could draw on these experiences to improve its project selection criteria and ensure that feasibility studies are conducted in each case.

Once infrastructure projects are selected, public investments have sometimes generated low returns due to poor project appraisal, improper implementation, or weaknesses in monitoring and *ex post* evaluation of projects.[11] Mongolia's 2015 Public Expenditure and Financial Accountability (PEFA) assessment suggests several reforms that would support project appraisal, implementation and monitoring, such as: ensuring that all government entities, including the Development Bank of Mongolia and other state-owned enterprises, follow budgetary procurement procedures; and improving the reliability of monthly expenditure allocations to ministries and agencies.[12]

The 2017 Open Budget Index confirms the findings in the PEFA assessment concerning budget transparency and oversight, ranking Mongolia 56th out of 115 countries. While budget documents are publicly available and the Office of the Audit General provides essential oversight, there is room for improvement. For instance, there is little public participation in budget decision-making except at the local level and year-end reports are not published.[13] The government could improve

[11] https://www.imf.org/external/pubs/ft/wp/2011/wp1137.pdf
[12] https://pefa.org/sites/default/files/assements/comments/MN-Apr15-PFMPR-Public.pdf
[13] https://www.internationalbudget.org/wp-content/uploads/mongolia-open-budget-survey-2017-summary-english.pdf

public dissemination of information on budget execution, hold public fora on public spending plans, and strengthen the role of the FSC, through increased independence, capacity, transparency, and accountability. The FSC could become responsible for commissioning the consensus economic growth and inflation forecasts to the think-tanks that should be used for fiscal revenue estimation purposes by the MOF.