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## **Fiscal Policy in Mongolia**

**Evaluation of the Current Situation and Suggested Directions of Reforms**

Ulaanbaatar

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## **I. Introduction**

1. This memo was prepared by Marek Dabrowski and Jaroslaw Bauc representing CASE - Center for Social and Economic Research in Warsaw (Poland) working under the Economic Policy Support Project, financed by USAID and implemented by Development Alternatives, Inc. in Bethesda, MD (USA). This memo is a result of our mission to Ulaanbaatar from October 21 to November 12, 1996.

2. Our analyses, conclusions and recommendations based in the first instance on the statistics and information provided by Mongolia's Ministry of Finance (particularly the budget draft for 1997), Bank of Mongolia, and State Statistical Office. We also extensively used information and existing analyses of the IMF, World Bank, Asian Development Bank and results of work done by other experts working under the Economic Policy Support Project. We are very grateful to all persons who provided us with necessary information and helped us to understand the specifics of Mongolian economy. Special acknowledgments are addressed to Bill Bikales and Jargalsaikhan from the EPSP who helped us to organize our work in Ulaanbaatar.

3. This memo is devoted mainly to the fiscal policy issues but obviously it also touches general macroeconomic frameworks, monetary policy and some social policy problems, as well as organization of government and some aspects of reforms in microsphere. The paper is organized in the following way: In Section II we summarize the results of Mongolia's transition and analyze macroeconomic frameworks of the fiscal policy in 1996 and 1997. Section III gives a diagnosis of the fiscal policy situation. Section IV presents recommendations related to fiscal policy changes in 1997 and in the following years. Section V is devoted to some problems of fiscal organization and management. Section VI contains suggestions on the directions of the technical assistance in the future. Appendix 1 contains more detailed analysis of the tax policy and possible variants of the tax reform. Appendix 2 presents key economic variables of Mongolian transition period.

## **II. Recent Economic Development of Mongolia.**

4. During 1990s Mongolia has faced two different stages of economic development. First wave of reforms took place during the period of IV 1990 - V 1996. It was an effect of a general dismantling of the centrally planned economy world. The second stage was brought about by the results of parliamentary election of June 1996.

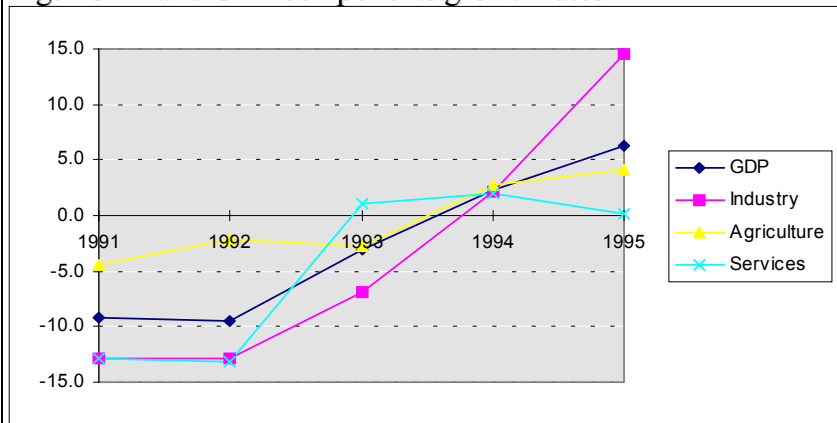
### **A. Mongolia after dismantling CMEA**

5. Despite obvious advantages of the radical transition strategy confirmed by the experience of most Central European and Baltic countries, Mongolia chose in the first half of 1990s gradual, step-by-step approach to economic reform. The results of this policy are very mixed. Some foundations of the market economy were built. Most of basic market institutions were created, limited liberalization likewise the privatization started. Annual inflation decreased from three to two digits level.

#### **Economic growth.**

6. The external shock of the CMEA breakdown like in many other post socialist countries caused a GDP decline in Mongolia. In 1994 the economy started to grow (Fig.1).

Fig.1 GDP and GDP components growth rates



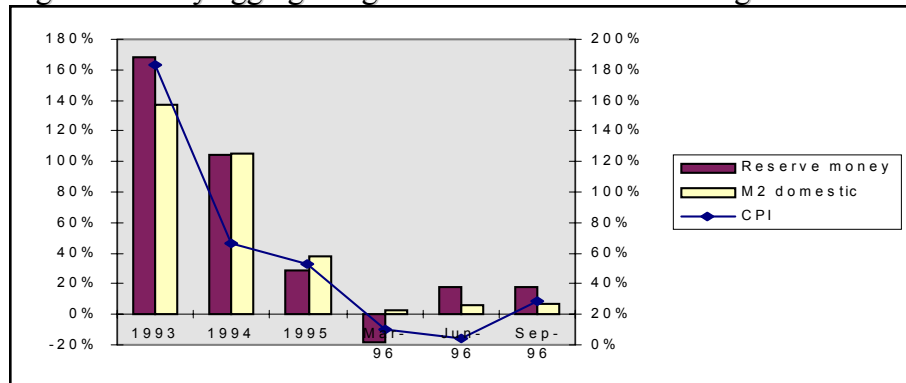
Source: State Statistical Office of Mongolia

The actual scale of growth seems to have been an effect of favourable terms of trade rather than genuine economic reforms. The role of non ferrous metal mainly copper accounted for 55% of total industrial output in 1995. World market price of copper (the main source of export revenue) increased from \$1800 per tonne in 1993 to \$2250 per tonne in 1995. Also the cashmere (the second most important Mongolian product) price increased at that time.

### Inflation

7. One of the most visible result of slow reforms is inflation. Despite 1991-1993 price jump in the following years inflation still exceeded 50% per year (Fig.2).

Fig.2 Monetary aggregates growth rates and CPI in Mongolia



Source: BoM Bulletin

Fig.2 shows distinctly a close relation between money aggregates growth rates and inflation. It is worth mentioning that BoM obligation to buy the domestic production of gold automatically expands the monetary base. This to some extent makes the money supply endogenous under floating exchange rate.

### Privatization

8. Although at the end of April 1996 Mongolia had nearly 40.000 economic entities of which more than 90% were formally private the ownership is, due to the voucher

privatization program, very much diluted (4644 joint stock companies and 4628 corporations). Cash privatization was also undertaken. 49% of government equity of Telecommunications Corporation of Mongolia sold to Korea Telecom was the most transparent result of the capital way in privatization. The privatization process was a subject to hampering in 1994-1996. The same relates to the microeconomic restructuring process. Most of big and medium size enterprises are either state owned or their ownership structure is dispersed<sup>1</sup>. They used to receive soft loans from the commercial banks in the previous years what caused a very serious banking crisis.

### Internal Balance

9. High inflation prevailing during the whole period seems to have helped the government in achieving current surplus from 1993 (Tab.1). Capital expenditure however has made the overall balance be in substantial deficit. This deficit was almost exclusively financed from foreign sources. Despite the backwardness of Mongolian infrastructure and real investment needs in the long run perspective such a kind of development is rather unsustainable.

Tab.1 Government Finance as % of GDP

	1992	1993	1994	1995	VI 1996
Total revenue	27.3	33.3	28.3	33.6	33.3
Current revenue	27.3	33.3	27.2	31.9	32.8
Total expenditures and net lending	8.9	49.4	51.1	44.9	40.3
Current expenditures	28.3	31.2	25.9	27.6	27.7
Capital expenditures and net lending	10.6	18.2	25.2	17.3	12.7
Current balance	-1.0	2.1	1.3	4.3	5.1
Overall balance	-11.6	-16.1	-22.8	-11.3	-7.0
Domestic financing	1.4	-1.1	2.6	-5.2	1.4
Foreign financing	10.2	17.2	20.3	16.6	5.6

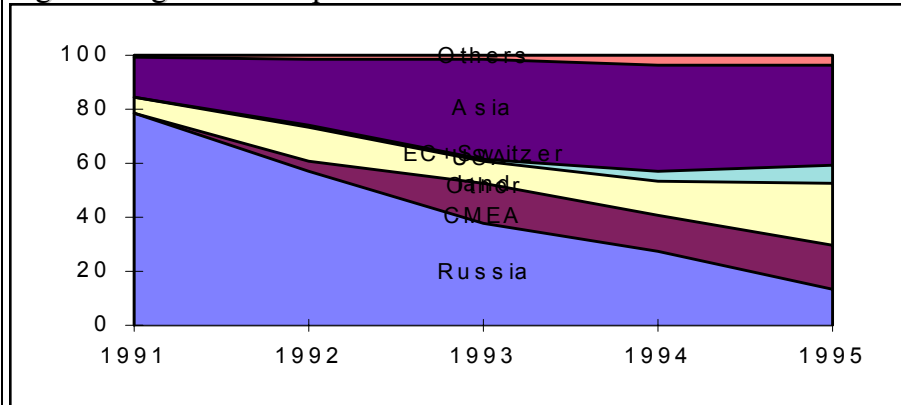
Source: MoF and SSOoM

### External Balance

10. After dismantling the CMEA there was a dramatic reorientation in foreign trade specially with regard to exports. The role of Russia diminished during the period of 1991-1995 from 78.7% to 13.1 % of total exports. This gap was filled by other directions mainly Asian countries.

<sup>1</sup> For instance, the state has more than 51% stake of shares of 20 enterprises out of 75 the biggest companies that form a Stock Exchange Index.

Fig.3 Changes in the export structure



Source: SSOoM

Less dramatic changes took place in imports where Russia still plays the dominant role (drop from 74% to 52% of total imports in the same period).

Tab.2 Balance of payment in million USD

	1991	1992	1993	1994	1995	Jun-96
Trade balance	-140	-62.6	-8.7	-3.5	-18.1	-5.9
Current account	-104.2	-52.8	31.1	37.3	8	19.3
Capital account	106.9	30.7	-9.6	-36.1	1.8	-4.1
Errors and omissions	-94.8	9.5	5.2	-10.7	0	0
Overall balance	-92.1	-12.6	26.7	-9.5	9.8	15.2

Source: SSOoM

After the CMEA breakdown one can observe substantial improvement in the trade balance. Since 1993 this change associated with the flow of transfers the current account has been positive. Except 1994 so has been the overall balance of payment.

## B. Mongolia after last parliamentary election

11. During 1995 the framework of favorable circumstances more or less disappeared. First of all international prices of copper and cashmere declined. Also privatization revenue turned out to be much lower than predicted and finally the critical situation of the banking sector occurred. The overall stability was rescued thanks to tough macroeconomic policy during the second half of 1995. New coalition and government elected in June 1996 faced then challenges to offset the time lost in relatively unfavourable macroeconomic environment of two main constraints i.e. inherited structural backwardness and a deep financial sector crisis.

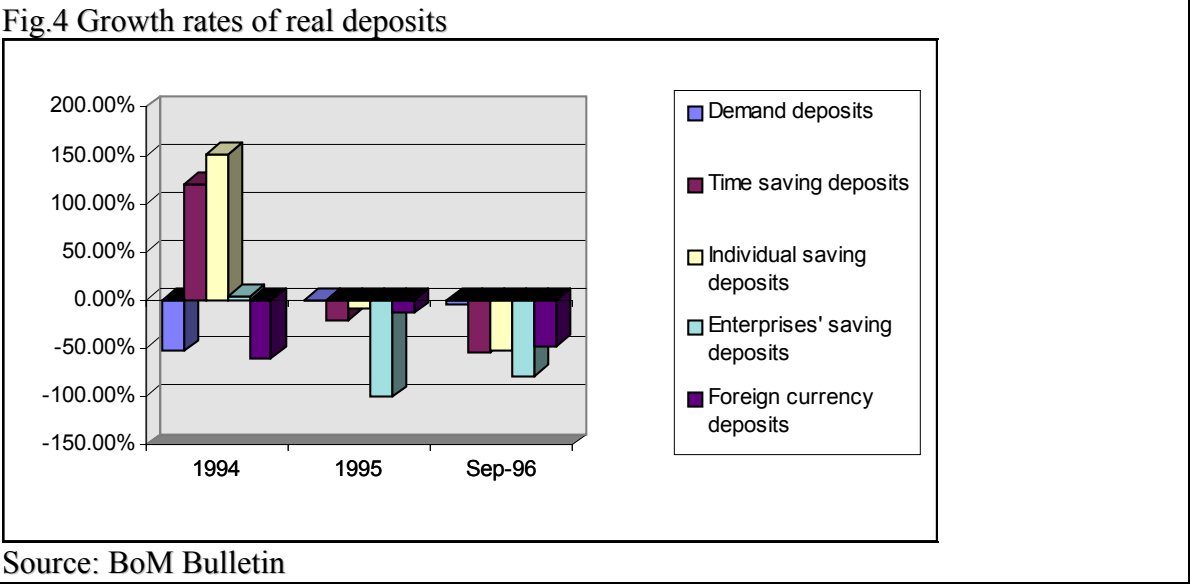
### Structural backwardness

12. Under the socialist system Mongolia's economy was very closely associated with the SU economy. As in any centrally planned economy Mongolia developed during that time production of raw materials, neglected the service sector and monopolized industry. This structure with little changes prevails today. The whole economy relies then very much on several big enterprises whose bad or good faith depends on exogenous variables like world

prices of copper (51% of export revenue), cashmere (12%) or gold (10%) in 1995)<sup>2</sup>. In turn export revenue accounted for 55% of GDP in 1995.

**Banking sector crisis**

13. The basic causes and mechanics of banking sector crisis have already been mentioned. Now the attention will be paid to plausible consequences of this crisis for the macroeconomic stability and the state budget.

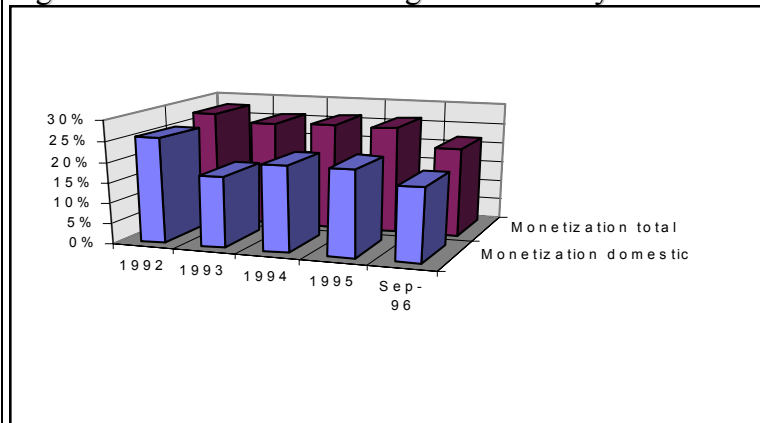


Since the beginning of 1995 every kind of deposit has decreased substantially in real terms<sup>3</sup>. What is important the dollar denominated deposits have also shrunk. It means that not only have the economic units lost the trust in the Mongolian currency but the confidence of the whole banking sector has been undermined as well. Most aware of the current situation are enterprises whose deposits practically have evaporated. In this situation any other widespread bad news might turn out to be the spark of the fire.

<sup>2</sup> See aslo Appendix 1

<sup>3</sup> All of them have also diminished nominally.

Fig.5 Monetization of the Mongolian economy



Source: BoM Bulletin and own calculations

With comparison to some other FSU countries or even Slovenia and Bulgaria Mongolian economy was relatively highly monetized. During this year the situation has worsened quickly. Getting rid of home currency (lowering the demand for home currency) usually speeds up inflationary processes. This is the real danger that can make the Mongolian economy much more difficult and painful.

Apart from inflation current state of banking crisis will have to exhibit budgetary consequences no matter the solution is going to be undertaken. At best it will increase the budget debt and the costs of its servicing.

### III. Diagnosis of the fiscal policy situation

14. Contrary to many transition economies, like many FSU countries or Bulgaria, Mongolia's budget looks quite balanced. It relates both to the expected execution of 1996 budget and to the budget draft of 1997. Starting from 1993 Mongolia has a current fiscal surplus and a negative balance of the capital part of the budget covered mostly from the external concessionaire sources. The direct credit of the Bank of Mongolia to government has been used only temporarily and to a limited extent. Recently Mongolia has not experienced a budget execution crisis when a shortfall of projected revenues (usually an effect of unrealistic budget planning and a reluctance to take the necessary adjustment steps) leads to the necessity of day-to-day sequestration of expenditures, wages and other budgetary payments arrears, collapse of the overall fiscal discipline, etc. undermining the stability of the state. This kind of crisis may be observed in Russia, Ukraine, Belarus, as well as in some Central Asian countries. Revenue base is stronger (at least in aggregate terms) than in the case of Georgia, Armenia, Kazakstan, Kyrgyzstan, Turkmenistan or Moldova. On the expenditure side open direct subsidies are very limited and have a clear downward tendency. Also the social transfers, the most explosive item in the postcommunist consolidated budgets, seems to be moderate and under control in Mongolia.

15. The picture presented above is only a first preliminary impression. Deeper insight reveals the question of quasi-fiscal spending and quasi-fiscal deficit. These phenomena could be observed in many former communist countries both under command economic system and in the first years of transition as well. Mongolia is not an exception in this respect. Although the most obvious forms of the quasi-fiscal financing such as direct,



addressed credit of central bank and negative real interest rate have been already stopped some other hidden forms continue to exist.

- First, only a small part of the Bank of Mongolia (BoM) profit is paid to the budget. The rest is likely to be spent in the form of concessionaire emergency loans to the commercial banks being in troubles. Despite the banking crisis the refinancing credit is still being granted to illiquid banks without any collateral! The outstanding refinancing credit amounted to 4,082 million Tg (31.10.96) and it increased during October by 611 million Tg.
- Second, refinancing facilities help also in supporting non-viable enterprises from non-financial sector. The impression appears that enterprises to some extent are financed through a vicious circle of quasi budgetary funds. The mechanics is following. BoM refines commercial banks that in turn grant loans to enterprises. Enterprises do pay taxes to the budget but do not service the credits. In the short run the fiscal situation does not deteriorate. The monetary system in turn is getting unstable. Eventually any solution will have to involve the budget. In other words part of the budget revenues is collected only due to this soft financing.
- Third, capital expenditure chapter of the state budget does not include all government liabilities comprising the foreign borrowing especially for investment projects (the reason of differences between government and IMF versions of budget projections).
- Fourth, BoM is involved in purchasing all the gold production of the domestic producers. This kind of central bank operations have evidently a quasi-fiscal character.

16. Appendix 1 contains detailed analysis of taxes and tax policy. Here we will only summarize the main findings. First, revenue side of the budget heavily depends on the corporate income tax (CIT) from few biggest enterprises<sup>4</sup>. Strongly progressive scale of CIT (from 15 to 40%; rather a rare phenomenon in the market economy) seems to be specially designed for collecting budget revenues from biggest profit earners, representing producers of the main export commodities. Also most of dividends is paid by the same enterprises which are still predominantly state owned<sup>5</sup>. It also should be stressed that not only are profits taxed by CIT but the fixed assets as well. This is due to the fact that fixed assets have not been subject to revaluation despite high inflation. For instance the market value of 75 biggest enterprises listed on the Stock Exchange estimated to 10,658 bln Tg exceeds the book value of these enterprises more than 800 times!<sup>6</sup>

CIT is expected to give revenues of 5.7% of GDP in the 1997 draft budget while dividends are expected to give the additional 1.3% of GDP. It accounts for 26.4% of the total current revenues.

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<sup>4</sup> According to the World Bank data in 1995 the top five profit earners accounted for 86% of total operating surplus, and the top ten enterprises - for 91%. According to our estimates 96.5% of total CIT revenue would come from 13.3% of enterprises. Firms paying according to current lower rates would provide just 3.5% of total CIT revenue.

<sup>5</sup> In fact it is a continuation of the profit confiscation system that existed in the centrally planned economy.

<sup>6</sup> Liabilities of these enterprises are evaluated on the market basis. Assets are not. Therefore net assets represent an artificially low level.

This situation involves at least three negative consequences.

- First, it makes revenue collection very sensitive to the fluctuation of export prices of few key export commodities such as copper, cashmere or gold<sup>7</sup>.
- Second, it will create a natural bias against privatizing the biggest enterprises from the export sector<sup>8</sup>.
- Third, a progressive CIT will not stimulate the market expansion of small enterprises and their gradual conversion into the medium and large enterprises. Additionally it can create a strong incentive to hide profits.

17. Contrary to CIT, a fiscal role of personal income tax (PIT) is almost negligible. Despite the highest marginal rate of 40% the effective tax rate does not exceed 5% of the potentially taxable personal income. In agriculture this tax is in fact symbolic. One can suspect that in many cases operational costs of PIT collection may exceed revenues received. According to the draft of 1997 budget PIT will give in the next year only 0.8% of GDP. In fact this tax is effectively paid only by the employees with wages and salaries exceeding the national average. Covering of non-wage personal income (the role of which is steadily increasing in the Mongolian economy) by PIT is rather problematic. Not only do the negative consequences of poor PIT collection concern fiscal implications but political and social as well. In fact most of the Mongolian society does not directly participate in financing its government. People do not realize that finally they must cover all expenses of government social programs, government interventionism or basic public goods. It makes easier to press the government to provide new programs and new forms of interventions. It does not help the economic education of the post-communist society and hinders to fight with populist tendencies. Experiences of Central European countries show that despite quite substantial budget revenue (6-9% of GDP) well functioning PIT exerts a positive impact on the political scene (helps to consolidate the lobby against expansion of government expenditure).

18. The sale tax (VAT type tax) with a single moderate rate of 10% might be a main source of budget revenues. A quite narrow tax base is the main obstacle to achieve this goal. Only imports, domestic industrial output (excluding small enterprises) and few services such as hotels and restaurants are actually covered by this tax. According to our knowledge tax refunding does not work well.

19. The 1997 budget draft contains a high revenue from privatization (15 bln Tg, i.e. 2.3% of projected GDP). It means the nominal increase by 443% in comparison with the expected privatization revenue in 1996 (!). Most of transition economies do not collect more than 1% of GDP. Taking into consideration the stagnation of privatization during last two years and the strong political will of the new government to speed up this process a considerable increase of revenue from this source is possible (particularly from the cash privatization of big enterprises). However, government and MoF must be aware that the uncertainty this kind of revenue exhibits is always high.

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<sup>7</sup> The same concerns the fluctuation in GDP and balance of payment. Decreasing the overall dependence of Mongolian economy on the these few commodities should be considered as one of the strategic targets of economic development.

<sup>8</sup> The biggest enterprises like Erdenet (producing copper) were not a subject to even voucher privatization.

20. Social security contributions do not cover all the expenses of the Social Security Fund and its sub-funds. Although the draft of 1997 budget presents a downward trend of government subsidies to the Social Security Fund (nominal decreasing from 11,6 bln Tg in 1996 to 9,8 bln Tg in 1997) the latter still accounts for 1.5% of projected GDP. All the social transfers to households will amount to 37,9 bln Tg, i.e. 5.8% of GDP. It is certainly less than in many other transition countries (especially in the Central Europe) but quite enough if one takes account of younger demographic structure of the Mongolian population and limited revenue capacity of the Mongolian economy. However, most of the social welfare regulations in Mongolia contain possibilities of the fiscal explosion in the future. It relates mainly to the pension entitlements.

Retiring age is low and the same concerns the number of working years which entitles to receive old age pension. Several sectors of the economy, professional or social groups enjoy pension privileges in the form of shorter work period, lower retiring age, preferential formula of calculation of pension benefit. The work period selected for calculation of the individual pension entitlement is rather short what can allow for different type of calculation manipulations. Like in many other transition economies inherited PAYG system offer benefits essentially unrelated to contribution. In this case the political pressure to increase the retirement benefits for the current retirees who typically form a powerful interest is very likely to come up. During 1970s and 1980s such pressures in Western Europe led to large transfers of income to the elderly from the current contributors or even from yet unborn generation. The same phenomenon occurred in much poorer post-communist economies of Central and Eastern Europe during 1990s.

21. Also other than pension social welfare spending may have a rising tendency. First, in 1997 the Unemployment Insurance Fund will start to pay unemployment benefits. The expected acceleration of enterprise restructuring will probably increase at least temporarily the unemployment rate. Additional increase can appear as an effect of starting paying the benefits. This must be reflected in the short and medium term fiscal planning. Second, price liberalization and mentioned acceleration of enterprise restructuring will probably increase the number of people who will seek for social assistance. Third, Mongolia has still many typical of communist origin social provisions such as concessionaire prices for many goods and services for disables, war veterans, pensioners, single mothers, mothers with large families, twins, etc. All this system needs a general careful examination and complex reform which will increase the addressed character of social assistance, its transparency and will take it in line with the real financial capacity of the budget<sup>9</sup>.

22. During few recent years social welfare spending have been kept under the fiscal control mainly due to high inflation and absence of regular formal indexation. It kept all social benefits relatively low in comparison with average wage. Moreover, the nature of ad hoc indexations decisions offering rather a fixed quota for everybody than the proportional valorization according to the initial benefit level has led to elimination of higher benefits (*uravnilovka* effect). In fact most of pensions are now very low and close to the minimum. Of course, such a situation has significantly decreased incentives to use opportunity of

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<sup>9</sup> Before starting the current mission the CASE expert team planned to carry out the complex examination of the existing social welfare system (including pension system) and key sectors of public social services, i.e. health care and education what would allow to present more detailed recommendation related to the expenditure side of the budget. However, because of the lack of approval of Mongolian government for the CASE social policy expert we were not able to provide this part of projected fiscal expertise.

earlier retirement. However, stopping high inflation and increasing restructuring pressure on the labor market (see above) can change this situation very quickly. The natural tendency for real wage increase will also probably create political pressure for the real increase of pension and other social benefits and at least will partially restore the earlier pension differentiation.

23. The biggest expenditure item reflects the so-called budgetary sphere, i.e. general public services, national defense, public order, law enforcement, justice administration, health care, education, culture, sport, etc. In most of postcommunist countries these sectors involve much inefficiency. The service network (schools, hospitals, libraries, houses of cultures, etc.) is usually too big and employment too high. Practically no cost controlling procedures exist. Therefore there are potentially deep reserves of expenditure cuts or at least of their restructuring, e.g. increase of wages and salaries financed out of employment cuts. Significant part of these services can and must be privatized or at least partly commercialized. It relates particularly to sports, recreation, culture, higher education, part of health care.

24. Mongolia has relatively high budget spending for investment programs. Capital spending and net lending will amount in the next year to 5% of GDP (according to the Ministry of Finance draft of the budget) or 11.3% of GDP (according to IMF classification). It is much higher than in most of the transition countries where this item usually does not exceed 3-4% of GDP. It is obvious that Mongolia as a low income developing country needs investment in infrastructure. However, a significant part of infrastructure (apart from free public goods) can be financed from the private sources or be self-financing. It concerns, for example, energy sector, geology research, mining, railways, airport facilities, telecommunication, city bus transportation, highways, etc. This type of investment covers ca. 50% of capital expenditure financed from the own budget sources (mainly from the Privatization Fund) and more than 90% of foreign credits. Existing price control for energy, and transport tariffs appears to be the main obstacle to commercialize this part of infrastructure and lower budget investment grants in future. The infrastructure sector (particularly the energy sector) must be liberalized as quickly as possible. Also some investment projects of obvious non-commercial character do not seem to be of the highest priority (such as border installations on frontiers with Russia).

Another problem for the whole investment process to be rationalized is the evaluation procedure. Currently there are three separate units involved in this process. The Investment Division (ID) within the Ministry of Finance is responsible for assessment projects financed from domestic sources. Foreign Aid Department (FAD) that is subordinated to Prime Minister evaluates projects financed from foreign capital. In addition to that there is FDI Agency also situated in the Ministry of Finance whose main task is to coordinate the foreign direct investments<sup>10</sup>. It seems that ID and FAD duties and responsibilities are not precisely defined. In some aspects they overlap in others - compete. For instance it is entirely unclear who should evaluate, implement and supervise an investment project financed jointly from domestic and foreign sources. Perhaps for this reason there has not been any such a project so far.

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<sup>10</sup> For 1997 there were 220 investment projects submitted by all ministries and local authorities whose total budget exceed 81 bln Tg. 70 projects of total budget 81 bln Tg were accepted.

The evaluation procedures are focused on confronting particular projects with the assumptions of the medium term government policy. In turn the technical aspects of business plan assessment are still quite obsolete.

25. Although the explicit direct subsidies are minimal (0.07% of GDP in the draft 1997 budget; only for city transport) the real picture is far less optimistic. Depicted already quasi-fiscal financing through badly performing commercial banks and their defaulting big clients does not exhaust the problem. Another form of implicit subsidies are tax arrears. World Bank estimations show that public enterprises tax arrears reached 40% of their tax liabilities in 1995. According to information received from the General Department of State Taxation the tax discipline considerably improved during the few recent months. However, the phenomenon of tax arrears must be further carefully investigated. Next form of implicit subsidies are uncounted government liabilities. Apart from domestic soft credits from the banking system non-viable enterprise were granted the government guarantees for foreign credits what has led very often to a default in credit repayments, putting the additional burden on the state budget. Finally, one can observe inter-industry cross-subsidization in some sectors, e.g. in electric power supply, municipal and housing services.

26. The absence of any expenditure related to the expected restructuring of the banking system in the 1997 budget draft seems to be a surprise. The final decision how to deal with a banking crisis has not been made yet. However, any possible approach to the bank restructuring must involve some budget expenses already in 1997.

27. Mongolia accumulated considerable external debt in convertible currencies which oscillates around 60% of GDP. Mostly it is the public debt, representing a future liability of the budget. The debt cumulating process exhibits an increasing trend. Although most of recently acquired loans has a concessionaire character (very long maturity, long grace period, low interest rate) they will have to be paid off sooner or later levying a significant burden on the future generation. This is one more argument in favor of careful monitoring the public investment programs and process of issuing of the government guarantees for enterprises and banks. Additionally, government will have to take responsibilities for the non-performing debts of the banking sector. This will probably increase the public debt by additional 3-4% of GDP. Finally, the unsolved problem of the huge transferable ruble debt to Russia (TR 10.5 billion, amount exceeding several times the Mongolian GDP using any reasonable exchange rate) cannot be simply ignored. One can notice an implicit assumption or a wish among Mongolian politicians and experts that this debt will never be paid off. This does not seem to be a rational approach. In order not to create too dangerous precedent for other difficult Russia's debtors it is very likely that after the year 2000 Russia will try to execute at least a partial repayment of this debt.

28. Looking at the long term fiscal perspective one must notice that Mongolia represents rather a moderate size of government. Total expenditure to GDP ratio for the next year will amount to ca. 34%. This is much higher than in Georgia, Armenia, Kyrgyzstan, Turkmenistan, Moldova or Kazakstan and many developing countries where this ratio generally does not exceed 25% but still lower than in most Central and East European countries, Ukraine, Russia, and Western Europe (40-60%). However, it is necessary to remember that Mongolia belongs to the group of low income countries and it should not be compared with the more developed Western European or even Central European countries. It would be beneficial for the long term growth prospect of Mongolian economy to decrease the expenditure to GDP ratio below the level of 30%.

## IV. Policy recommendations

29. Mongolia's fiscal policy needs several changes. Part of them (such as a revenue decomposition from income tax, cuts in social entitlements) can and should be implemented immediately, i.e. from the beginning of 1997. Others (e.g. an extension of the sales tax base or more generous reform of the social welfare and public social services) need more time. However most of them should be implemented during 1997.

30. Appendix 1 contains detail tax policy recommendations and estimation of the fiscal impact of the proposed changes. Generally, revenue side of the budget must become less dependent on profit from few largest enterprise. Introduction of new CIT and PIT schedules should be considered as the first step. New income tax law ought to be adopted by the end of 1996 (and implemented from January 1, 1997).

31. In the case of CIT it is also necessary to eliminate disincentives for investment and enterprise expansion and in the same time to simplify the tax collection. The proposition is to take a radical step of introducing only one CIT rate of 30% instead of two rates (30% and 40% proposed by the Ministry of Finance). In comparison with MoF variant this proposal means smaller budget revenue of ca. 6.6 bn Tg<sup>11</sup>. This loss will be compensated by higher PIT and sales tax revenue (see - below). Additionally, it is possible to collect higher dividends from some most profitable companies with the significant state stake (which will have higher net profit due to lower CIT rate), and consider to increase rates of taxes for using the natural resources.

32. As far as PIT is concerned two variants of the reform are proposed:

- less radical, i.e. reducing the number of tax brackets to three: 10%, 20%, and 30% with the level of annual income free from taxation equal to 100,000 Tg (for each taxpayer);
- more radical, i.e. introducing one proportional rate of 25%, also with the same level of free tax income i.e. 100,000 Tg (for each taxpayer)<sup>12</sup>.

Both variants approximately double revenues from PIT forecasted for 1997 budget. Apart from obvious fiscal effects they simplify tax collection and make PIT rules more transparent. The second (more radical variant), although politically difficult, has a clear advantage in terms of simplicity, transparency, and counteracting tax avoidance practices. Last but not least, both variants increase the number of actual taxpayers, and mean a shift from enterprise to individual taxation. The reform will help to develop economic and fiscal education of the society as people start understanding that they finance the government expenditure<sup>13</sup>.

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<sup>11</sup> Our estimation has a static, and rather conservative character and relates to 1997. In the following years revenue losses might smaller due to a positive supply response (faster development of new businesses, less interest in hiding profit).

<sup>12</sup> The variant of uniform and equal tax rate of 26% for both enterprises and individuals were successfully adopted in Estonia.

<sup>13</sup> Suggested changes in PIT mean fiftfold higher tax rate for those who previously paid according to 2% tax rate. In reality however this change is not so dramatic. Consider a person who earns 200,000 Tg per year. In a MoF variant she would pay 2% out from 54,000 Tg which equals 1,080 Tg! In our first variant she would have to pay 10% out from 100,000 Tg, i.e. 10,000 Tg per year. Her net income diminishes by less then 9,000 Tg per year!

33. We support the MoF project to increase the tax rate and revenue from livestock. Although still symbolic it will allow to increase participation of the rural population in financing the government programs and partially compensate the loss of revenue from CIT. In the future it would be necessary to replace the current tax rate denominated in tugriks with a rate related rather to a certain proportion of an average wage in the economy.

34. The next step should focus on the extending the tax base of the sales tax (VAT). This tax ought to cover all domestic and imported products (apart from primary agriculture products) and most of services. In comparison with the present situation the sales tax should be extended to such sectors as construction, transport, communication, energy production and supply, wholesale and bigger units of the retail trade, and over other material and non-material services. The tax base can also be broadened by covering more business units through lowering the minimal level of turnover which creates the sales tax obligation.

Broadening the VAT tax base has some other positive side effects. First of all it requires much more precise accounting that can exert a positive impact on the PIT collection. Secondly uniform VAT tax rate levied on all sectors is neutral with respect to the price structure. This makes the whole resource allocation process more efficient.

Extending the sales tax needs some technical preparation. The tax collection inspection has already experience in VAT procedures and so do some economic entities. There is also a law and some knowledge among economic units. It seems then reasonable and plausible to extend the current act as soon as possible. With some time lag of 6 or at most 12 months a modern VAT tax could be implemented. Suggested date is July 1, 1997. If so it would be possible to introduce the uniform CIT tax rate of 30%. Otherwise this tax rate would have to be at least at the level of 33% in 1997.

35. Achieving the ambitious privatization revenue target (see - section 4) needs a serious speeding up all the cash privatization projects including elimination of the existing barriers for foreign investors (domestic investors will not be able to finance this projects at this scale). Working out the detail recommendations in this sphere is beyond the term of reference of our current mission and will be a subject of separate CASE project started at the end of November and financed by the Open Society Institute (George Soros).

36. On the expenditure side the most urgent task is to reform the social welfare system. Taking into consideration a realistic timing two stages of this reform can be proposed. First immediate step (until the end of 1996) should involve 'cleaning up' the existing system of social provisions from solutions which are evidently unsustainable from the point of view of medium and long term fiscal constraints, and may distort the labor market. The period covering 1997 and 1998 should be devoted to more fundamental social reforms particularly in establishing the two tier pension system including a voluntary fully funded pension schedule.

37. Short term pension reform should focus on:

- increasing the retiring age, particularly for women,
- enlarging the number of work years entitled to receive pension, unification of pension rules, i.e. elimination of special branch, professional and other group privileges,

- extending the number of years creating a base for calculation of the individual pension entitlement (what will limit the possibility of calculating manipulations and stimulate the payment discipline),
- suspending pension benefits for working pensioners,
- tightening up the criteria for granting disability pension.

The government should undertake most of this agenda providing people who will lose the pension entitlements with the temporary social assistance. It will also be very important to limit the time of this transitory assistance and make it strictly conditional on active participation in retraining programs (to avoid incentives to stay indefinitely in the welfare system).

38. The proposed 'cleaning up' is intended both to avoid the future financial crisis of the pension system (what most of the transition countries have already experienced) and to create macroeconomic 'space' for introducing an alternative private and fully funded voluntary pension system that could cover most of the society in the future. The idea of compulsory second tier pension system is rather unrealistic in such a country like Mongolia. This is the basic reason we opt for voluntary system with strong financial incentives for participation. In the same time government and parliament should decide the future shape of the existing PAYG system. One of the available options is to convert this system from benefits defined to contribution defined PAYG system<sup>14</sup>.

39. The system of all other non-pension social benefits also needs a very careful revision. Most of the existing social provisions should be translated into the cash form instead of special reduced prices or free access to some goods and services (such as housing rents, transportation fares, energy prices, etc.). In some cases assistance in kind may be still justified but it should be better addressed. It is necessary to concentrate the limited budget resources on precisely defined priorities of social targets.

- Firstly, it needs more extensive research on the sources of poverty in Mongolian society.
- Secondly, eligibility criteria should be clear and transparent and hard to manipulate.
- Thirdly, addressed social assistance cannot create disincentives to legal employment or self-employment and cultural dependence of big group of people on the state social interventionism.

The biggest danger is usually associated with unemployment benefits. Whenever these benefits are too high or easy affordable it stimulates a passive behavior on the labor market or illegal employment.

40. As we mentioned in the section 4 it is necessary to start a general reform of public services, especially in the so-called socio-cultural sphere. The first step should involve a rationalization of the service network aimed at cutting the excessive employment and non-wage current expenditure. Those who will stay should be paid better to create incentives for

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<sup>14</sup> Due to the lack of social expert in our mission we were not able to suggest more detailed recommendations on social policy and social service reform, and estimates on fiscal implications of the proposed measures. However, it is possible to give such an expertise in future.



supplying services of higher quality. In the medium and the long run a privatization and commercialization of at least part of this services must be carried out.

41. The current level of government capital expenditure is not sustainable in the longer term. Some less priority investment projects should be immediately cut to free resources for currently urgent tasks (like the bank restructuring exercise). In the medium term perspective it will be necessary to limit government involvement in the investment programs only to projects connected with providing typical public goods. The rest of infrastructure investment should be financed by the private investors. This obviously requires liberalization, demonopolization and at least partial privatization of such sectors as energy production, transmission and supplying, telecommunication, air transport, etc. In a country like Mongolia the total government capital expenditures (including government guarantees) should not exceed 4-5% of GDP even if they are financed from external credit sources (to avoid uncontrolled increase of the public debt).

Closer look should also be taken at the mechanism and procedures of submitting applications for investment projects, their evaluation, implementation and supervision. In this respect the attention should also be paid to organizing training for the staff working on the investment project assessment.

## **V. Fiscal organization and management**

42. Fiscal organization and management in Mongolia seem to be at the initial stage of transition. It exhibits features that are typical for the centrally planned economy. The attention will now be paid to some crucial problems in this sphere which need to be reformed in future<sup>15</sup>.

43. The radical reorganization of the government and central administration structure decided after the last parliamentary election created very favorable organizational conditions for better fiscal policy planning and implementation.

- First, it significantly strengthened the Minister of Finance position in government eliminating the earlier institutional competition of the National Development Board (the successor of the Mongolian Gosplan) and level of deputy prime ministers. Now MoF is a key person in the government responsible not only for technical aspects of budget process as before but also for the overall macroeconomic strategy of the government. It is definitely in line with the practice of most market economies.
- Second, reducing number of spending ministries and agencies should lower the pressure on the expenditure side of the budget coming from sectoral and branch lobbies inside the government.
- Third, simplified structure of government and parliamentary committees will certainly shorten the procedure of adopting the necessary tax, social, and other institutional reforms. This should exert an important influence on budget, and help in keeping the internal consistency and comprehensives of the reform package.

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<sup>15</sup> Unfortunately, the limited time frameworks of our mission do not allow to present a more comprehensive analysis of the fiscal organization and management. Many interesting and helpful recommendations related to this topic can be found in the report on "Fiscal Policy Making, Planning and Operations" prepared under the Economic Policy Support Project by Mark Gallagher.

44. However, the strengthening and clarification of MoF strategic role has not been accomplished yet.

- First, division of roles and responsibilities between MoF and the Prime Minister Office is not clear. It seems that many strategic functions of macroeconomic policy planning and co-ordination are rather allocated to the latter.
- Second, the coordination of macroeconomic policy planning between MoF and BoM also seems to be far from desired pattern.
- Third, inside the MoF there is not sufficient cooperation and exchange of information between the Budget Department and Macroeconomic Department. More generally, the horizontal coordination (between ministries, and across each ministry) is still a weak point of government organization in Mongolia.

45. Budget planning process for 1997 inside MoF and government is almost finished<sup>16</sup>. After parliament approval of the 1997 budget government and MoF must start to undertake more substantial changes in the budget planning process for 1998.

- First, it is necessary to improve methodological foundations of macroeconomic forecasting and projections which have a crucial importance for the quality of the overall monetary and fiscal planning. This work should be done by MoF together with BoM.
- Second, it would be desirable to extend a time horizon of fiscal planning. It relates particularly to investment programs. It means that budget draft for 1998 should contain also some kind of forecast of the key macroeconomic indicators for 1999 as well as specification of investment and other programs whose fiscal consequences will be carried forward for 1999 and following years. In the future this part of budget projection should be extended to 2-3 years beyond the horizon of each budgetary year.
- Third, budget planning process should be implemented in phases. At the beginning (in spring or early summer of 1997) the basic macroeconomic framework of the 1998 budget should be discussed in government, with the BoM, and with the IMF mission. After being accepted spending ministries should receive very detailed recommendations from MoF how to prepare their budget proposals. Then the preparation of a budget draft inside MoF should be confronted with the expected budget implementation in 1997 and updated macroeconomic projection for 1998. Again, it needs a very close cooperation between MoF and BoM and between Macroeconomic and Budget Departments inside MoF.

46. Treasury Department of the MoF is only at the beginning of its organization. This process must speed up. The consolidation of the budget bank accounts should help in more efficient management of the budget cash flows and decrease total sector borrowing requirements. Even very superficial analysis of the monetary statistics shows that the BoM credit to government (formally of only temporal character) very often coexists with the quite

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<sup>16</sup> We are aware that the draft 1997 budget will need some corrections and updating during its discussion in Parliament. Government will have to submit corrections connected with the new tax laws and changes in social legislation, and probably will have to update the nominal revenue and expenditure for 1997 as a result of higher than anticipated inflation in 1996.

high balances on the bank account of budgetary units in the BoM or commercial banks. It is also strongly advised to keep all the budgetary accounts in BoM instead of in commercial banks. This would help to execute the control over budgetary cash flows and decrease money multiplier. Moreover, keeping a significant budget or quasi-budget balances in these commercial banks which experience liquidity crisis (the case of Pension Fund keeping bank accounts in the Ardiin Bank) may look as a dangerous hazard practice.

47. Treasury Department must also take a full control over the public debt, both domestic and external. Since foreign financing means government liabilities all investment project should be approved by the Ministry of Finance. It also relates to credits granted by the World Bank, IDA, Asian Development Bank etc. The same concerns domestic and external credit guarantees issued by any government agency to enterprises or commercial banks. In the case of credit guarantees MoF must monitor the debtor financial situation to counteract any possible default in advance. We also suggest to move the FAD (foreign aid coordination unit) to the Ministry of Finance.

## **VI. Suggested agenda of the future advisory work**

48. The above analysis gives only a general review of fiscal policy problems in Mongolia. Some problems need further analytical and conceptual work. It relates to the following questions:

1. Pension system and pension reform.
2. Consolidation of the different forms of social support.
3. Review of expenditure on basic public social services such as health care, education, culture, and concepts of their reform.
4. Fiscal and monetary implications of commercial banks' restructuring.
5. Review of government investment expenditure.
6. Improving the tax and custom administration.
7. Preparing the medium term macroeconomic and fiscal scenario for Mongolia (until 2000).
8. Organization of the budget planning process including methodology of macroeconomic forecasting and projection.
9. Development of treasury system.

## **VII. Appendix 1**

### ***Analysis of Tax System in Mongolia***

#### **Findings**

The structure of the real sphere of the economy and the tax system make the budgetary situation of Mongolia very much sensitive on exogenous variables like the copper or cashmere world prices as it has already happened this year. In such a level of uncertainty there is always a threat that the budget will be in troubles or that it unexpectedly will run a surplus. Both possibilities cannot be seen as desirable from the point of view of the effective fiscal policy rules. Unexpected deficit may eventually result in higher inflation. Unexpected surplus stimulates very easy the increase of current spending what may be politically difficult to reverse in the future (what will lead to a higher deficit in less favourable circumstances).

Current tax system in Mongolia provides 74% of total budget revenue that stands for around 22% of GDP. One however should be aware of the following shortcomings of the tax system (see Tab.1):

- relying on few big state owned enterprises which state the basis for collecting considerable share of corporate income tax, sale tax, personal income tax, social security contributions and additionally - dividends.
- extremely low total level (0.81% of GDP) of revenue from personal income tax
- very low share of sales tax (form of VAT) which represents below 15% of tax revenue and just 4.4% of GDP.

Table 1: Structure of Mongolia's tax system

Items	1997 forecast in mln Tug	% of tax revenue	% of total revenue	% of GDP
Tax revenue	143,990	100.00%	74.17%	22.18%
Income tax	42,089	29.23%	21.68%	6.48%
corporate	36,834	25.58%	18.97%	5.67%
individual	5,255	3.65%	2.71%	0.81%
Social security contributions	32,443	22.53%	16.71%	5.00%
Social security contribution	23,679	16.44%	12.20%	3.65%
employees	11,213	7.79%	5.78%	1.73%
employers	5,190	3.60%	2.67%	0.80%
Government (budget units)	7,276	5.05%	3.75%	1.12%
Health insurance contribution	8,764	6.09%	4.51%	1.35%
employees	2,044	1.42%	1.05%	0.31%
employers	2,359	1.64%	1.22%	0.36%
Government (budget units)	4,361	3.03%	2.25%	0.67%
Taxes on goods and services	47,373	32.90%	24.40%	7.30%
Sales tax	28,772	19.98%	14.82%	4.43%
domestic sales tax	15,088	10.48%	7.77%	2.32%
sales tax on imports	13,684	9.50%	7.05%	2.11%
Excise tax	13,176	9.15%	6.79%	2.03%
alcohol	6,774	4.70%	3.49%	1.04%
petroleum	4,716	3.28%	2.43%	0.73%
imported alcohol & tobacco	1,686	1.17%	0.87%	0.26%
Taxes on specific services	5,425	3.77%	2.79%	0.84%
Custom duties	16,215	11.26%	8.35%	2.50%
Other tax	5,870	4.08%	3.02%	0.90%

Source: Ministry of Finance data and authors' estimation

### General recommendations to tax system

In the short run (until the end of 1996) it is necessary to adopt new versions of corporate and personal income tax laws. This should widen the tax base in the case of PIT and make the total system less sensitive on the profit of big enterprises.

In the medium run efforts should be made to introduce modern VAT tax. Starting from July 1997 the current sales tax should be broadened with attempt to cover much wider range of economic activities starting at some minimal level of turnover.

### Corporate Income Tax

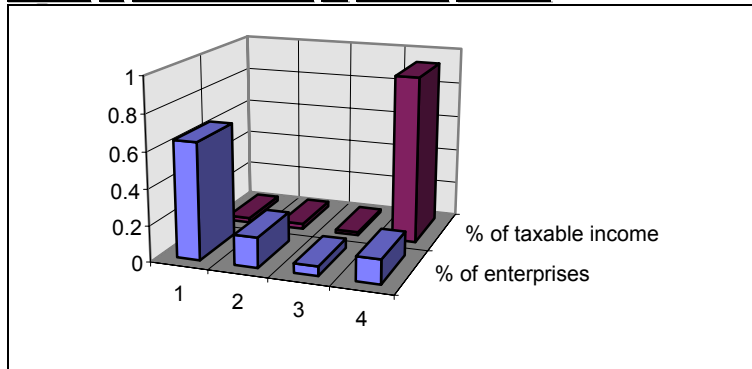
#### *Findings*

Existing schedule of corporate income tax does not seem to meet requirements of simplicity, complexity and efficiency.

Currently there are four rates of CIT, i.e., 15%, 25%, 35% and 40%. Preliminary calculation suggests a very big concentration of enterprises with respect to taxable income that they generate. 96.5% of total enterprise tax revenue would come from 13.3% of enterprises. Firms paying according to current lower rates would provide just 3.5% of total

corporate tax revenue. From such a distribution maintaining the current scheme of corporate tax does not make much sense.

**Figure 1: Concentration of taxable income**



Proposed changes in the CIT law reduce the number of tax rates to two -- 30% and 40% - altering at the same time the taxable income brackets up to or above 100 millions of tugriks. It turns out that even implementing this rather dramatic change leaves the budget relying almost exclusively on 71 enterprises representing just 1% of enterprise population. These 71 firms will provide above 82% of revenues.

The concentration is then even higher than one could expect while taking account of the current tax schedule.

### ***Detailed recommendations***

It seems reasonable to introduce only one uniform CIT rate with purpose to address the following problems:

- necessity to have simple and clear method of tax calculation ,
- stopping the discrimination of the efficiently functioning firms,
- forcing less efficient enterprises to increase profits,
- once the multiple bracket tax schedule is implemented it is hard to withdraw from such a system in the future,
- elimination of the need for periodic adjustment of the tax brackets as result of inflation,
- lowering the uniform tax rate in the future will make all enterprises better off instead of differentiating them.

Table 2 shows the estimation of CIT revenue while using different levels of single, uniform rate.

Table 2: Estimation of fiscal consequences of using single CIT rate

Taxable income	Tax rate	Tax revenue	Planned tax revenue	Change	% change
100,587	40%	40,235	36,834	3,400	9.23%
100,587	39%	39,229	36,834	2,395	6.50%
100,587	38%	38,223	36,834	1,389	3.77%
100,587	37%	37,217	36,834	383	1.04%
100,587	36%	36,211	36,834	-623	-1.69%
100,587	35%	35,205	36,834	-1,629	-4.42%
100,587	34%	34,200	36,834	-2,635	-7.15%
100,587	33%	33,194	36,834	-3,641	-9.88%
100,587	32%	32,188	36,834	-4,646	-12.61%
100,587	31%	31,182	36,834	-5,652	-15.35%
100,587	30%	30,176	36,834	-6,658	-18.08%

Source: Ministry of Finance data and authors' estimation

## Personal income tax

### *Findings*

The personal income tax revenue will amount to only 0.82% of GDP. From the standpoint of budget revenue it is a quite negligible item. Just for the comparison the neighbouring country of Kazakhstan with relatively similar macroeconomic performance collects around 3% of GDP as PIT. This result comes from the following reasons:

- too much limited tax base leaving part of population and some spheres of economic activity out of the PIT system,
- too many and too much diversified tax rates ranging from 2% up to 40% of the taxable income,
- weak tax administration,

Changes in the PIT law proposed by MoF will not be able to provide remedy to above mentioned shortcomings. First of all, changes in the tax rates are rather cosmetic. Replacing 20% by 15% and 30% by 27% while maintaining 40% might alleviate to some extent the burden levied on Mongolian “middle class” but this also depends on the taxable income brackets. This is for income ranging from 576,000 Tg (below \$1,000) per year to 2304,001 Tg (\$3,800) per year.

Substantial broadening of the PIT base by the radical change in PIT law should be one of the most important task to perform in the fiscal sphere. It seems necessary to impose new regulation that would increase budget revenue from PIT at least to 1.5% of GDP in 1997. Further broadening the PIT base as the population becomes richer ought to be at the agenda in the coming years.

### *Assumptions to new PIT system*

1. Citizens whose income comes from livestock production are subject to taxation based on the number of bogs (accountable bogs) as proposed by the MoF (see Table 3). If

one levies tax on one accountable bog of 100 Tg per year, the potential tax revenue reaches almost 4 bln Tg.

**Table 3: Calculation of the income tax from livestock**

<b>Livestock</b>	<b>No</b>	<b>No of bogs</b>	<b>Tax</b>	<b>Tax Revenue</b>
Cattle	3,400,000	10,200,000	100	1,020,000,000
Horses	2,740,000	5,480,000	100	548,000,000
Camels	375,000	750,000	100	75,000,000
Sheeps	14,300,000	14,300,000	100	1,430,000,000
Goats	8,910,000	8,910,000	100	891,000,000
<b>Total</b>	<b>29,725,000</b>	<b>39,640,000</b>	<b>100</b>	<b>3,964,000,000</b>

Source: Statistical Bulletin of the State Statistical Office and authors' own estimation

2. Income structure of the population for the year of 1995 is based on the sample of 1774 families. These families represent 0.34% of Mongolian population which is enough for generalizing (see Tab.4).
3. Reported income brackets were increased by expected CPI during two following years, i.e. 30% for 1996 and 15% for 1997 in order to be comparable with the budget draft for 1997.

**Table 4: Income structure of the Mongolian population**

<b>Min. income per member of family</b>	<b>Max. income per member of family</b>	<b>Average income</b>	<b>No of families</b>	<b>No of family members</b>
0	34,983	17,492	34	173
35,001	84,318	59,659	259	1355
84,336	135,447	109,891	424	2140
133,671	182,988	158,329	396	1801
183,006	232,323	207,664	281	1146
232,341	281,658	256,999	156	613
281,676	330,993	306,334	80	299
331,011	448,500	389,755	144	511
<b>Total</b>			<b>1774</b>	<b>8038</b>

Source: CSO data and authors' own calculation

4. Total employment in 1995 was accounted for 802,200 persons (see Tab.5). Deducting 345,300 people working in agriculture where the majority of people is subject to different PIT regulations there are 456,900 of potential taxpayers.



Table 5: Employment structure in Mongolia

Sector	1995
Total employment	802.2
Agriculture and forestry	345.3
Industry	101.3
Transport and communication	32.0
Construction	27.7
Education	52.9
Health	46.8
Science, R&D	11.1
Other	185.1
Employment without Agriculture	456.9

Source: Statistical Bulletin of CSO

### Scenarios

There are two suggested variants of PIT.

Three tax rates of 10%, 20% and 30% with income of 100,000 Tug free of taxation. The brackets are (0-100,000), (100,001-200,000), (200,001-400,000) and above 400,000 Tug.

There is only one uniform tax rate of 25% with the same tax free income.

### Variant 1

Table 6: Estimation of PIT revenue (variant 1)

Average income	No of taxpayers	Taxable income	Tax rate	Tax revenue
17,492	8,757	153,169,930	0%	0
59,659	66,706	3,979,666,667	0%	0
109,891	109,203	12,000,445,863	10%	108,017,529
158,329	101,991	16,148,213,640	10%	594,909,301
207,664	72,373	15,029,206,805	20%	1,558,390,403
256,999	40,178	10,325,815,684	20%	2,065,163,137
306,334	20,604	6,311,802,451	20%	1,262,360,490
434,605	37,088	16,118,522,238	30%	3,352,048,216
Total	456,900	80,066,843,278	11%	8,940,889,075

Source: COS data and authors' own estimate

Results: The overall tax revenue will amount to 8,941 millions Tug. at the effective tax rate of 11%.

## Variant 2

Table 7: Estimation of PIT revenue (variant 2)

Average income	No of taxpayers	Taxable income	Tax rate	Tax revenue
17,492	8,757	134,094,753	0.00	0
59,659	66,706	3,484,054,721	0.00	0
109,891	109,203	10,505,957,799	0.25	270,030,991
158,329	101,991	14,137,178,983	0.25	1,487,261,268
207,664	72,373	13,157,528,833	0.25	1,947,979,500
256,999	40,178	9,039,879,439	0.25	1,576,990,350
306,334	20,604	5,525,755,538	0.25	1,062,841,089
434,605	37,088	14,111,185,231	0.25	3,102,433,417
Total	456,900	70,095,635,297	0.13	9,447,536,615

Source: COS data and authors' own estimate

Results: uniform tax rate of 25% will give 9,447 millions Tug. of budget revenue. Effective tax rate will equal 13%.

Summing up both sources of PIT (see Tab.8) possible revenue is 12,905 and 13,411 millions of Tug. respectively.

Table 8: Total revenue from PIT

Variant	Tax from livestock	PIT	Total
Variant 1	3,964	8,941	12,905
Variant 2	3,964	9,447	13,411

Source: authors' own calculation

Assuming different kinds of difficulties and obstacles it is quite reasonable to expect total PIT collection around 10 bln Tug. in 1997. This would practically double the planned level of individual income tax revenue that gives around 1.5% of GDP.

## Sale tax

### *Findings*

The current sale tax system is a form of VAT limited to only some economic activities. Now it stands for important source of overall tax revenue, i.e., 19.98% which is roughly equally divided into domestic sale and import. Revenue from this source is also very much dependent on few big enterprises making the whole tax system fragile and uncertain. Many fields of economic activity are not covered by this tax.

### *Recommendations*

It is necessary to broaden the tax base on other sectors of the economy starting from the second half of 1997 but not later than in the beginning of 1998.

It should also be levied on all kinds of energy products.

It is reasonable to maintain uniform 10% tax rate.

### *Preliminary calculations*

Taking into account the current structure of net material product (see Tab.9) it is possible to make a preliminary estimation of fiscal effects of extending the VAT base in the second half of 1997.

**Table 9: Estimation of VAT revenue**

<b>Sector</b>	<b>Structure</b>	<b>1997 NMP forecast</b>	<b>VAT revenue forecast</b>
Net material product	100.00%	509,571	20,774
Industry	34.21%	174,301	14,990
Agriculture	39.40%	200,755	
Construction	2.54%	12,968	558
Transportation	2.97%	15,134	651
Communications	1.00%	5,079	218
Distribution and warehousing	17.19%	87,614	3,767
Other	2.69%	13,721	590

Source: IMF data and authors' own calculation

As we see broadening the VAT base in the second half of 1997 would give additional tax revenue of ca. 5 bln Tug.

### **Structural changes in tax revenue**

Expected increase in PIT revenue of 5 bln Tug plus 5 bln Tug of additional revenues from VAT can compensate losses from reducing the average effective CIT rate. The suggested uniform CIT rate is 30%. All proposed changes would give together about 3.7 bln additional tax revenues.

**Table 10: Summary of the proposed tax changes**

<b>Tax</b>	<b>before changes</b>	<b>% before changes</b>	<b>after changes</b>	<b>% after changes</b>	<b>change in the tax revenue</b>
Total tax revenue	143,989	100.00%	147,761	100.00%	3,772
Income tax	42,089	29.23%	40,176	27.19%	-1,913
Personal income tax	5,255	3.65%	10,000	6.77%	4,745
Corporate income tax	36,834	25.58%	30,176	20.42%	-6,658
Sales tax	28,772	19.98%	34,457	23.32%	5,685
Domestic sales tax	15,088	10.48%	20,774	14.06%	5,686
Sales tax on imports	13,683	9.50%	13,683	9.26%	0

Source: MoF data and authors' own calculation

New structure of tax revenues makes the whole system of budget revenues more stable. However, it should be noted that introducing VAT regulations at the beginning of 1998 requires implementation of higher CIT at the level of 33% in 1997.

## VIII. Appendix 2

**Tab.1 Key economic variables**

	1992	1993	1994	1995
Population (000)	2,215	2,250	2,280	2,318
GDP	47,298	166,219	283,263	391,103
Net factor income from Abroad	-1,599	-11,579	-11,030	-15,891
GNP	45,699	154,640	272,233	375,212
Exchange rate (USD)	40	283	410	449
Per capita income (USD)	534	261	303	376
Inflation (end of period)	326%	183%	66%	53%
Real exchange rate	16.25	6.50	7.46	10.43
Consumption	38,539	122,341	208,637	294,622
Public consumption	8,467	32,233	51,290	76,680
Private consumption	30,072	90,108	157,347	217,942
Current account deficit	-489	-9,594	-16,523	-28,601
Investment	5,322	45,200	62,215	87,847
Domestic saving	4,833	35,606	45,692	59,246
As % of GDP				
Consumption	81.48%	73.60%	73.65%	75.33%
Public consumption	17.90%	19.39%	18.11%	19.61%
Private consumption	63.58%	54.21%	55.55%	55.72%
Current account deficit	-1.03%	-5.77%	-5.83%	-7.31%
Investment	11.25%	27.19%	21.96%	22.46%
Domestic saving	10.22%	21.42%	16.13%	15.15%

**Tab.2 GDP and GDP components growth rates**

	1991	1992	1993	1994	1995
GDP	-9.2	-9.5	-3.0	2.3	6.3
Industry	-12.8	-12.9	-6.9	2.1	14.6
Agriculture	-4.4	-2.1	-2.7	2.7	4.2
Services	-12.9	-13.2	1.0	2.0	0.2

Tab.3 Monetary review

	1992	1993	1994	1995	Mar-96	Jun-96	Sep-96
Reserve money	5.3	14.3	29.1	37.5	30.7	36.0	42.4
Currency in circulation	2.9	10.8	21.8	29.8	28.0	35.1	39.5
Commercial banks	1.1	2.0	3.0	4.2	4.6	4.6	5.7
Outside banks	1.8	8.8	18.8	25.6	23.3	30.5	33.8
Comercial banks	2.4	3.5	7.3	7.8	2.7	0.9	2.9
deposits							
Other deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Money M1	7.6	18.5	29.9	42.6	43.8	49.9	58.3
Demand deposits	5.8	9.8	11.1	17.0	20.4	19.3	24.5
Qasi money	5.4	24.2	43.9	59.4	58.2	57.0	57.0
Time saving deposits	4.4	10.1	28.9	38.5	39.4	38.5	36.2
Individual	3.0	8.0	25.3	36.6	37.7	37.0	34.8
Enterprises	1.4	2.1	3.7	1.9	1.7	1.5	1.3
Foreign currency	1.0	14.1	15.0	20.9	18.9	18.5	20.8
deposits							
Money M2	13.1	42.8	73.8	102.0	102.0	106.8	115.2
Money M2 domestic	12.1	28.7	58.8	81.2	83.2	88.4	94.4
GDP	47.3	166.2	283.3	391.1	0.0	0.0	532.8
M2 domestic/M2total	92.48%	67.00%	79.71%	79.54%	81.51%	82.70%	81.93%
For cur dep/Domestic dep	9.60%	70.91%	37.38%	37.57%	31.55%	31.97%	34.34%
Money multiplier for M1	1.44	1.30	1.03	1.14	1.43	1.38	1.37
Money multiplier for M2 domestic	2.27	2.01	2.02	2.16	2.71	2.45	2.23
Money multiplier for M2 total	2.46	3.00	2.53	2.72	3.33	2.96	2.72
Monetization domestic	0.26	0.17	0.21	0.21	n.a.	n.a.	0.18
Monetization total	0.28	0.26	0.26	0.26	n.a.	n.a.	0.22

**Tab.4 CPI and selected goods and services price growth rates**

	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>Mar-96</b>	<b>Jun-96</b>	<b>Sep-96</b>
CPI	183%	66%	53%	10%	4%	28%
Food	190%	59%	56%	13%	7%	19%
Meat	272%	56%	51%	28%	37%	-36%
Milk, dairy	144%	70%	72%	22%	-12%	-5%
Flour, bakery	197%	43%	60%	8%	11%	55%
Cigarettes	78%	30%	4%	1%	1%	8%
Other	230%	71%	60%	3%	-4%	11%
Clothes & shoes	92%	81%	46%	8%	1%	19%
Men's clothes	87%	94%	15%	14%	-4%	10%
Women clothes	66%	135%	50%	-6%	1%	13%
Wear	87%	31%	62%	-100%	n.a.	n.a.
Children wear	219%	51%	57%	3%	0%	12%
Shoes	85%	89%	35%	3%	1%	23%
Rent & energy	335%	49%	6%	0%	2%	96%
Housing goods	162%	56%	83%	7%	1%	12%
Medicine	883%	0%	0%	15%	2%	1%
Transport & communication	213%	92%	44%	2%	0%	70%
Cultural articles	271%	105%	89%	6%	4%	35%
Other	245%	96%	44%	17%	2%	15%

**Tab. 5 Government budget in % of GDP**

	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995 VI</b>	<b>1996</b>
Total revenue	27.3	33.3	28.3	33.6	33.3
Current revenue	27.3	33.3	27.2	31.9	32.8
Total expenditures and net lending	38.9	49.4	51.1	44.9	40.3
Current expenditures	28.3	31.2	25.9	27.6	27.7
Capital expenditures and net lending	10.6	18.2	25.2	17.3	12.7
Current balance	-1.0	2.1	1.3	4.3	5.1
Overall balance	-11.6	-16.1	-22.8	-11.3	-7.0
Domestic financing	1.4	-1.1	2.6	-5.2	1.4
Foreign financing	10.2	17.2	20.3	16.6	5.6