

Chapter 2: ENABLING ENVIRONMENT FOR PRIVATE SECTOR DEVELOPMENT

44. To determine the overall direction of Mongolia's economic reform program and the anticipated role of the private sector, this chapter reviews the core policy statements and positions of the Government. The chapter next (i) reviews the institutional framework to determine the extent to which it accommodates PSD initiatives, (ii) identifies significant challenges to developing a more conducive enabling environment, and (iii) discusses constraints imposed by the limited access to capital, along with significant internal constraints, which might limit the extent to which the private sector responds to improvements in the enabling environment.

A. Policy Framework

45. After the collapse of COMECON and the transition to a democratically elected government, a constitution was adopted to provide for, inter alia, a framework based on the rule of law; and new institutions were created to implement this framework. Successive Mongolian governments undertook important steps to reorient the economy toward a market-based system through liberalization of prices, elimination of market distortions, introduction of private ownership, and facilitation of resource flows.

1. Monetary Policy

46. BOM manages monetary policy and implements the broad guidelines established by the Government. Money supply is managed by a series of measures, including the establishment by BOM of deposit reserve requirements for commercial banks (14% of deposit liabilities in 2002), the issuance of central bank bills,³¹ and, since 2001, entry into repurchase agreements.³² Exchange rates are managed by the sale, through an auction system, of BOM foreign exchange reserves. The BOM keeps the exchange rate stable by intervening periodically in foreign exchange markets.

2. Fiscal Policy

47. To improve fiscal management and accountability, Parliament approved in June of 2002 the Public Sector Management and Finance Law, which was drafted with ADB assistance³³ and began to be implemented gradually in January 2003. This law requires, among other things, that annual expenditure priorities be set forth in strategic business plans and outputs be delivered based on agreements. Planning is based on a 3-year, medium-term fiscal framework. Procedures for budget preparation, approval, and enforcement are set forth in the law.

48. **Revenue.** The Revenue Section of the Fiscal Policy and Coordination Department of the Ministry of Finance and Economy (MOFE) undertakes tax revenue projections. In preparing such projections, MOFE receives information from and consults with GDNT, CGA, and certain large taxpayers. Recent tax forecasting performance has been mixed. But since 1999 the trend has been one of increased conservatism and hence accuracy in forecasts.

³¹ Central bank bills are sold through an auction system, largely to commercial banks, and in May 2003 yielded an effective interest rate of 13.65–14.85%, depending on maturity.

³² During 2001, BOM entered into repurchase agreements to buy/sell local government securities valued at MNT16.5 billion (\$15 million).

³³ ADB. 1997. *Technical Assistance to Mongolia for Program Preparation for Governance Reforms*. Manila.

49. **Expenditure.** The Government's overall strategic development and expenditure priorities are outlined in the Development Vision for 2004–06, the Economic and Social Development Guidelines for 2002, and the Action Plan of the Government of Mongolia for 2000–2004 and are reflected in the annual budget and the medium-term fiscal framework statement. This statement is prepared initially by MOFE, and then is reviewed and finalized by a high-level Public Expenditure Review Committee chaired by the prime minister. Based on priorities determined in the statement, current and capital expenditure ceilings are established for key budget entities for the forthcoming budget year. Forward estimates for 2 additional years also are covered. This rolling document is linked closely to the Medium Term Macroeconomic Policy Framework Statement.

50. Deficit-to-GDP targets have been set for over a decade within annual budgets, but debt-to-GDP ratios have been considered only more recently, after the emergence of potential debt problems. Fiscal deficit levels have been excessively high in Mongolia throughout the past decade, but in general have been budgeted for. Overruns occurred in 1995, 1996, 1998, and 1999 whereas better-than-budgeted performance occurred in 1997, 2000, and 2001. The Government, which covers structural deficits or short-term cash shortages by selling securities, sold MNT21.63 billion (\$18.5 million) worth to banks (99.6% of total security sales) in 2003.

51. **Taxation.** No other subject is of greater concern to the private sector or more important to the functioning of public administration than taxation. It ranked as the principal business constraint in the 2001 USAID-financed Manual for Action in the Private Sector Survey (MAPS Survey),³⁴ with 35% of business respondents ranking it a significant obstacle, and the same percentage ranking it a major obstacle. As will be discussed, the problem is not so much the scope of taxation but the effective rate of corporate tax and the manner of applying tax regulations.³⁵

52. The General Tax Law, Corporate Income Tax Law, Organizations Tax Law, and Customs Tariff Law determine tax regime, which is administered by GDNT and CGA. Principal company taxes include corporate tax, VAT, social security deductions, import tariffs, and excise taxes.

53. **Corporate Tax.** Company income tax is calculated using International Accounting Standards (IAS) and is levied, after the deduction of allowable expenses, on profits of all business entities registered with GDNT. Exemptions and tax holidays are provided for foreign investment in certain sectors and for foreign investors who export more than 50% of production.

54. Before finalization of their accounts and audit, companies are required to submit to GDNT in advance of the tax year a budget indicating expected sales, expenditure, and profit;

³⁴ This survey of 375 businesses was conducted under the USAID Competitiveness Initiative Project, with World Bank and ADB collaboration.

³⁵ Recent independent external reviews of the Taxation Department by IMF (2001) and Korea Institute of Public Finance (2002) suggest that whereas tax rates are generally high in Mongolia there is still considerable scope for raising collection levels by improving tax administration, practices, and efficiency. The Korean study made recommendations in a number of efficiency-related areas, including (i) enhancing computerization; (ii) improving staff recruitment and training practices, including integrity and ethics training; (iii) simplifying the tax system, especially VAT procedures; (iv) enhancing attention to assessing and auditing activities with special attention to compliance; (v) improving coordination with other government regulatory agencies; (vi) preparing manuals to standardize legal interpretations and to decrease discretionary powers of inspectors; and (vii) bringing more small businesses into the tax net through notional assessments and other means.

thus the tax system for corporations is essentially an advanced payment system.³⁶ Estimated taxes are payable every quarter at the rate of 15% of profit up to MNT100 million, and at 30% (recently decreased from 40%) on levels above that. Based on a number of factors, the effective rate of corporate tax in Mongolia may be closer to 60% than 30%. For example, pursuant to specific regulations, business expenses may be offset against corporate income tax whereas losses in 1 year may not be offset against profits for tax purposes in another. Advertising and training expenses are limited to 10% of total taxable income (increased recently from 5%), and any expenditure in excess of budgeted levels is not allowable against tax. The inability to carry forward losses, except where an exemption is made for foreign-invested mining companies, is a major disincentive to business investment, especially at start-up. The tax depreciation schedule allows straight-line depreciation only over 5, 10, or 40 years³⁷ although advanced depreciation schedules are allowable for foreign-invested firms importing export-oriented and scientific equipment. This regulation is extremely limiting and inhibits indigenous investment in both fixed and moveable assets.

55. Although dual rates are found elsewhere (e.g., Canada), the taxation system in Mongolia results in companies' splitting operations among a number of small companies, each with the same business coverage and ownership. Although they complicate company management and decrease efficiency of operation, such registration practices are legal. This system is under active review, and the two rates have been decreased.

56. Given the number of small companies reporting to the tax authorities,³⁸ the company income tax take is particularly low and there is a general perception of large-scale tax evasion. Companies are acknowledged widely to run at least two sets of books: one for the tax authorities and the other for credit and personal purposes. Companies justify evasion by pointing out the onerous regulations concerning qualifying expenses, the dual corporate tax regime, and the allegedly arbitrary assessments and actions of tax collectors.

57. **Value-Added Tax and Duties.** Accounting in 2003 for 25.2% of tax revenues, VAT is an important source of government revenues. VAT at the rate of 15% is charged on company sales when turnover is above the threshold of MNT10 million (\$9,000)/year although exemptions exist for financial services (including insurance and leasing), residential rentals, tourism, and educational and medical services, excluding drug and equipment sales. VAT at the rate of 5% is also charged at the border on imports and is payable within three days of assessment.³⁹ Textile companies reliant on imported raw materials to produce exported goods, oil exploration and production companies, and companies temporarily importing equipment such as drilling rigs can claim exemption, but procedures for doing so are onerous. For most importers, the VAT imposition is essentially an additional import tariff.

³⁶ This requirement reflects the cash needs of the Government and the goal of tax inspectors to deliver expected tax revenues.

³⁷ One audit company interviewed reported that tax officials may allow other depreciation methods.

³⁸ In 2003, 18,078 registered companies submitted tax returns, up from 16,330 in 2002, or an 11% increase. Similarly, the percentage of total tax revenues collected from companies increased from 12.6% in 2002 to 27.3% in 2003.

³⁹ A seasonal import duty (from 1 August–1 April, after the harvesting period) of 15% is imposed on flour and vegetables. Fixed excise duties denominated in US dollars are confined to certain categories, including alcohol, tobacco, and oil and petroleum. *Investment Policy Statement of Mongolia*. Available: www.investmongolia.com.

58. With the exception of certain raw materials including cashmere,⁴⁰ wool, scrap iron, copper, brass, and aluminium, which are taxed based on weight, goods exported from Mongolia are not subject to export duties.

59. Valuation for VAT and duty purposes is carried out by CGA, which has broad powers under the Customs Law.⁴¹ Although tariff nomenclature is based on the Harmonized System, various valuation methods are used because Mongolia is not yet a signatory to the Brussels Definition of Value or the General Agreement on Tariffs and Trade/World Trade Organization (WTO) Valuation Code. Each quarter, typical or guide prices for various categories of imports are circulated to customs offices but are not made available publicly, a situation leading to disputes between customs officers and importers. Guide prices are imposed if agreement cannot be reached with the importer on valuation. The private sector claims that customs procedures are onerous, arbitrary, and delay production whereas CGA claims that importers and exporters are often not equipped with the appropriate paperwork and that goods are held up because of delays in paying duties or VAT.⁴²

3. Trade Policy

60. Because of Mongolia's landlocked position and the limited size and range of products available in its internal market, trade liberalization was essential to the establishment of fully functioning markets. Mongolia acceded to WTO in 1997 and, in connection therewith, adopted, inter alia, a neutral and simple tariff policy, relaxed its border controls, removed restrictions on travel and foreign currency purchases, and abolished export licenses and the gold tax.

61. In 2003, ADB conducted an assessment of the policy, legal, and institutional constraints to trade.⁴³ The report recommended, among other things, that Mongolia consider the benefits of regional trade agreements with the Asian Free Trade Area, the North American Free Trade Agreement, and—bilaterally—with the PRC, already a WTO member, and Russia, which is planning on acceding to WTO in the near future. Specific topics might include decreasing transshipment costs of Mongolian exports through Russia and improving treatment of Mongolian meat exports into the PRC and Russia.

4. Competition

62. Early reforms eliminated central planning of input and output prices, and most price controls were removed by 1996. Evolving markets then were allowed to determine price levels. Currently, a degree of price control remains within publicly owned utilities (telecommunications, electricity and water supply, and internal air travel), but prices are set mainly with a view to allowing state providers to run commercial operations, make a return on capital employed, and prepare for future private sector involvement. An exception is internal airfares, which Mongolian Airlines (MIAT) is required to cross subsidize from foreign flight revenue.

⁴⁰ To avoid payment of export duties, cashmere often is smuggled across the border to the PRC. USAID Competitiveness Initiative. 2002. *Discussion Paper on Fiber Certification Market Promoting Mongolian Cashmere*, April.

⁴¹ For example, customs officials can slow any shipment on the grounds that it needs additional inspection and requires post clearance examination.

⁴² Businesses in the 2001 USAID MAPS Survey rated customs administration as the fourth most important constraint to PSD, 28% of survey participants ranking it a significant obstacle, and 22%, a major obstacle.

⁴³ ADB. 2003. *Final Report on Technical Assistance to Mongolia for Trade Policy Review*. Manila.

63. State production orders were eliminated in 1991 to enable SOEs to set production levels at the economically optimum level. In reality, however, state influence on key SOE decisions remained strong. Directed credits from state-owned commercial banks continued well into the 1990s and were to a great extent responsible for the very high percentage of bad loans and the subsequent liquidation of a number of these banks (Appendix 5). Although the Government undertook wide-scale privatization, SOEs often were sold as complete entities, with no separate sale of constituent parts—despite the fact that many SOEs had effective monopolies.

64. In 1993, Parliament adopted a fair-competition law that (i) prohibits unfair behavior, including central and local government decisions that limit entry, divide markets, or manipulate prices; (ii) regulates pricing and output decisions for natural monopolies; (iii) regulates mergers and takeovers involving dominant businesses; and (iv) provides for the establishment of the Unfair Competition Supervisory and Regulatory Agency.⁴⁴ The agency has not been established yet.⁴⁵

65. There has been progress in promoting private sector competition, especially in the production of consumer items such as bakery products and the award of government contracts.⁴⁶ But partly because the small size of the domestic market makes profitable operation of a significant number of businesses in certain sectors unlikely, the degree of competition remains limited (Box 1).

Box 1: Competition Concerns

Competition concerns arise in a number of areas where the State continues to own key assets. For example, in the telecommunications sector, the Government continues to own 60% of Mongol Telecom along with key network and housing facilities, which it leases to other telecom providers with limited recourse regarding the granting or denial of access rights and tariff charges.

With respect to domestic air transportation, the Government seems to be granting a future monopoly for domestic air transport (respecting profitable routes) to a new private domestic air carrier, Aero Mongolia. The five domestic routes flown by Aero Mongolia are also serviced by Mongolian Airlines, which is government owned but scheduled for privatization. Mongolian Airlines is more restricted in the amount of tariffs it may charge and is required, based on age limitations, to retire all its planes in the next few years.

5. Privatization

66. Privatization in Mongolia, launched in 1991, proceeded more rapidly than in many other former communist countries. In January 1991, the Government created the Privatization

⁴⁴ Law of Mongolia on Prohibiting Unfair Competition, as amended in 2000.

⁴⁵ In May of 2003, USAID assisted in identifying implementation issues under this law and helped develop proposals regarding size, staffing needs, structure, and guidelines for the new regulatory agency.

⁴⁶ The Public Procurement Law of 2000, adopted with ADB assistance (ADB, 1998, *Technical Assistance to Mongolia for Development of Procurement Legislation and Guidelines*, Manila), and related guidelines regulate the procurement of works, goods, and consulting services. ADB also assisted in setting up a procurement monitoring unit in MOFE. Adoption of this law recently enabled 15 Mongolian companies to prequalify and bid for a contract to print schoolbooks. Until late 2002, the practice for schoolbooks was to award a contract to an agent who would then seek to fill the order in the PRC or elsewhere outside Mongolia.

Commission to manage the privatization process. The May 1991 Privatization Law laid down the purpose, forms, principles, and procedures for privatization.

67. Privatization took place in three stages. During the first stage (1991–1995), it was conducted mainly by means of vouchers. Four thousand five hundred entities, mostly SMEs, were privatized in this manner, along with livestock. Employees were given priority in purchasing shares of newly privatized enterprises at discounted prices.

68. During the second stage (1996–2000), 942 enterprises were privatized through sealed-bid auctions that raised approximately MNT58 billion (\$65 million) in revenues.⁴⁷ In 1998, sealed bidding for large-scale enterprises was introduced. From September 1998–December 2000, the Government sold its holdings in 44 large enterprises,⁴⁸ most of which had been majority state-owned. These companies employed 8,743 staff, and share sales raised \$15.4 million in receipts. The purpose of divestiture was not primarily that of raising revenue, however, or even of decreasing state budget transfers to loss-making SOEs, but of introducing private sector management, capital, and risk taking. Only four companies realized more than \$1 million in revenue, two of which were gold mining operations, a fact indicating the low asset levels supporting these business operations and their poor financial performances. Offers reflected the experiences of earlier SOE buyers, who frequently had found that stated assets were overvalued or unrealizable while liabilities were understated.⁴⁹

69. The Government's privatization strategy for 2001–2004 (third stage) focuses on privatization of the country's largest and most valuable enterprises. Table 7 summarizes the status of this stage.

Table 7: Privatization of Most Valuable Enterprises as of December 2003

Company	State Shares Being Privatized	Status
APU Ltd. (alcohol and beverage company)	51% (30% owned by a number of individuals and remaining 19% by employees). Publicly listed on MSE.	Sold to Tuul International, a Mongolian–Russian–German consortium for \$4.5 million at the end of 2001.
Trade and Development Bank	76% (13% is owned by a number of individuals and the remaining 11% owned by employees).	Sold to a US–Swiss consortium in 2002 for \$12.23 along with an agreement by the purchaser to invest a further \$28 million within 2 years of the transaction closing date.

MSE = Mongolian Stock Exchange
Continued on next page

⁴⁷ Background of Privatization Process in Mongolia. Available: www.spc.gov.mn. Barents Group has been engaged as advisor to SPC for the privatization under a contract signed between USAID and the Government.

⁴⁸ USAID–SEGIR Mongolian Privatization Project. Three companies employing fewer than 50 staff have been removed from the list for the purposes of this analysis.

⁴⁹ USAID Competitiveness Initiative, 2001. *Debts and Receivables: Problems of Privatized Companies*.

Table 7—Continued

Company	State Shares Being Privatized	Status
Gobi JSC (Cashmere Production)	74.9%, of which 70% to be privatized through international tender and 4.9% through MSE. (remaining shares owned by a number of individuals and employees).	Original tender in 2001 was unsuccessful based on a high reserve price of \$18.5 million and build-up of company debt. Re-offered in 2003 for a minimum price of \$11.6 million. Expressions of interest received from companies in Mongolia, Australia, Austria, Germany, and Japan. Tender failed due to incomplete bid submission. Possible re-launch in late 2004.
Agricultural Bank	100%.	Sold to a Japanese bidder, HS Securities, in January 2003 for \$6.85 million plus additional committed investments of \$13 million. The closing took place in March 2003. Management team from DAI to remain in place, paid by HS Securities.
Neft Import Concern (Oil and Gas Distribution)	80% (20% owned by a number of individuals and employees).	Sold in July 2003 to a consortium composed of Russian, Cypriot and Mongolian investors for \$7.32 million, but cancelled by the Government in September 2003 based on security concerns. Re-offered on October 1, 2003 for a minimum price of \$6.13 million. Government stake sold to Petrovis for \$8.5 million in April 2004.

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Table 7—Continued

Company	State Shares Being Privatized	Status
Mongol Daatgal Insurance Company	100%.	Tendered in April 2003 with a floor price of \$1.2 million. Seven expressions of interest received by September 2003. Mongol Daatgal Insurance Company successfully privatized on 2 December. Sold to consortium of Angara Insurance CKB, a Russian Insurance Company, and Chinggis Khaan Bank, for \$5.8 million, almost five times the original \$1.2 million asking price.

Source: USAID Mongolia Privatization Program, BearingPoint, Inc.

70. In preparation for the privatization of MIAT in 2004, the Government recently entered into a foreign management contract with Air Consulting International of Ireland, funded by the European Bank for Reconstruction and Development (EBRD). Two of Mongolia's most valuable enterprises, Erdenet,⁵⁰ 51% owned by the Mongolian Government and 49% by the Russian Government, and Mongolia National Railways (MNR), 50% owned by the Mongolian and 50% by the Russian Government, are not expected to be privatized in the near future.⁵¹

71. In 2003, as part of a comprehensive program to improve the performance of public utilities through private sector participation, the Government of Mongolia requested EBRD to provide assistance in preparing government-owned energy sector entities for privatization. A US consulting firm, Applied Technologies International, was selected to implement the EBRD-funded project. In January 2004, the Government of Mongolia made the decision to privatize CHP No. III and Ulaanbaatar Electricity Distribution Network. Because of upcoming parliamentary elections, the project was extended through December 2004.

6. Foreign Direct Investment

72. The Government of Mongolia has placed considerable emphasis on the attraction of FDI and has met with a measure of success (Appendix 4). The principal incentives offered to foreign investors are provided for under the Law on Foreign Investment of 1993 (amended in 2002) and include corporate tax holidays for a given duration (e.g., 10 years for infrastructure investment, 5 years in mining and electronics), followed by a subsequent period at 50% reduction, and selective VAT exemptions on imported equipment.⁵² These incentives are supplemented by ad-hoc incentives such as rollover of year-one losses against future profits and corporate tax in the

⁵⁰ Erdenet employs approximately 9,000 people, spends approximately \$10 million a year on local social infrastructure, and accounts for approximately 25% of foreign exchange earnings. EBRD is providing an external adviser to Erdenet to help it improve performance.

⁵¹ Privatization of these companies would require resolution of Mongolia's outstanding sovereign debt to Russia.

⁵² The VAT exemption previously was provided on all imported materials, but the selective approach attempts to stimulate investments on technology.

mining industry (excluding precious metals).⁵³

73. For investments above \$2 million, FIFTA also may negotiate Stability Agreements written for a period of 10 years for investments of \$2 million–\$10 million and for 15 years on investments greater than \$10 million. A Stability Agreement guarantees the concessions granted, irrespective of future modifications to the law. GDNT has contested Stability Agreements in the past, on the grounds that there was no provision for such Agreements in the Tax Law. This issue was clarified, however, in recent amendments to the Tax Law that specifically allow for the issue of such agreements.

74. FIFTA has the dual and conflicting role of both attracting and regulating foreign investment in Mongolia. Having attracted foreign investment and negotiated tax and other concessions, FIFTA must ensure that the operations of the company and its level of actual investment justify continuation of concessions. Sleeping or phantom foreign investors are clearly beneficial for local companies if they are sufficiently credible to persuade FIFTA to grant concessions. It is rumored that in the manufacturing sector, and especially in the textiles sector, companies with FDI close down after the 3 years of full tax exemption and reregister under a different name, thereby benefiting from another 3 years of full exemption. To enable FIFTA to concentrate on promotion, attraction, and negotiation of FDI, and to monitor the use of such concessions more carefully, it might be beneficial to transfer the role of FDI regulation to a separate organization. World Bank is in discussion with FIFTA and its supervisory ministry, MIT, on this issue.

75. Parliament recently adopted a new Regional Development Strategy that divides the country into five economic zones with two designated cities serving as pillars in each zone. The strategy is largely a central planning approach designed by the Government to direct investors. An ongoing technical assistance (TA) project⁵⁴ has produced a comprehensive analysis of the strategy. In March 2004, the Government of Mongolia announced a tender for strategic investors to establish, develop, and manage the Zamyn-Uud Free Enterprise Zone.

7. Small and Medium Enterprises

76. Although aware of the actual and the potential contributions of SMEs, including micro businesses and informal businesses, to employment creation and growth, the Government has neither adopted an explicit SME policy nor designated a ministry to “champion” small business development. Nevertheless, there are a number of measures under way that might constitute the beginnings of a strategy.

77. First, the formal registration of a business is relatively straightforward and inexpensive and provides no barrier to SME development. Second, very small businesses can operate without registering with GDNT or paying corporate income tax. Instead, such businesses register with local activities and pay a flat-rate levy scaled according to the nature of the business. Third, an attempt has been made to lighten the tax burden for small companies by instituting a two-tiered corporate income tax rate. This means that small companies pay less tax

⁵³ The ad-hoc concessions being offered to foreign investors serve principally to level the playing field at an international level. A review of tax and accounting laws might conclude that carry-over of losses against corporate income tax, more rapid schedules of depreciation, and permission for investment in new enterprises, as a tax-deductible expense, might be appropriate reforms for the economy as a whole.

⁵⁴ ADB. 2002. *Technical Assistance to Mongolia for Capacity Building for Integrated Regional Development Planning*. Manila.

although the side effects of the two-tier policy in terms of the frequent splitting of larger companies have been undesirable.

78. Small-business incentive or support structures that often are available in Western countries largely are absent from Mongolia. Additionally, because the VAT threshold is low, most small businesses are obliged to register and to submit returns, and no legally recognized system for simplifying the accounting of small business statutory returns exists.

B. Institutional Framework

79. There are three main branches of government in Mongolia that adopt and implement the rule of law framework: Parliament (legislative), prime minister (executive), and Judiciary (Table 8).

Table 8: Central Government Bodies That Interface with the Private Sector

Parliament	Prime Minister	Executive Agencies	Judiciary
<ul style="list-style-type: none"> • BOM • MSEC 	<ul style="list-style-type: none"> • SPC • SPIA • State Agency for the Administration of Property Registration • State Professional Supervision Department (Insurance Supervisory Agency is a unit of this department) <p>Cabinet</p> <ul style="list-style-type: none"> • MOFE • MOI • MIT • MOJ • Ministry of Environment • Ministry of Education, Culture and Science • Ministry of Health • Ministry of Food and Agriculture 	<ul style="list-style-type: none"> • GDNT • CGA • Civil Aviation Authority • Coal and Energy Regulatory Authority • Road Authority • Construction, Urban Development, Public Utility Agency • Tourism Board • Transport Authority • Railway Authority • Postal and Telecommunications Authority • FIFTA • Mongolian Resource Authority • Petroleum Authority • Intellectual Property Office • General Authority for Implementing Court Decisions • Nature, Water and Forest Resources • Medical Services Authority • State Veterinary Agency 	<ul style="list-style-type: none"> • Supreme Court • Administrative Courts

BOM = Bank of Mongolia, CGA = Customs General Administration, FIFTA = Foreign Investment and Foreign Trade Agency, GDNT = General Department of National Taxation, MIT = Ministry of Industry and Trade, MOFE = Ministry of Finance and Economy, MOI = Ministry of Infrastructure, MOJ = Ministry of Justice and Home Affairs, MSEC = Mongolian Securities and Exchange Commission, SPC = State Property Committee, SPIA = State Professional Inspection Agency,

Source: ADB research.

80. Policy is formulated largely within Parliament, with input from the executive branch. Parliament writes laws to be implemented by the responsible ministry or implementing agency through guidelines and regulations. In practice, these guidelines and regulations often allow

implementing agencies considerable discretion. Ineffective checks on the powers of such agencies raise the cost of doing business in Mongolia, which lacks an effective forum for dispute resolution.

1. National Government

81. **Parliament and the Prime Minister.** Under the Constitution, the Ikh Hural, the National Parliament, is the highest organ of state power. The 76-seat unicameral Parliament is elected by universal suffrage on a 4-year cycle. The largest political party forms a government with the approval of the president,⁵⁵ electing a prime minister who appoints cabinet ministers, who may be parliament members.⁵⁶ Ministries have the power to develop state policy on issues for which they are responsible and to implement laws, presidential decrees, and government decisions; and are accountable to the prime minister and Parliament. The key ministry as far as the macroeconomic environment is concerned is MOFE whereas MOI, MIT, and a number of other ministries influence the business environment in key sectors.

82. Parliament operates seven standing committees (economy, legal affairs, state structures, social affairs, national security and foreign affairs, national budget, and environment and rural development), which carry out investigations, recommend policies, and prepare legislation. These committees have formed a number of subcommittees and working groups including participants from the executive branch (e.g., a Working Group on Corporate Governance has been convened by the Economic Standing Committee). Under the Law on the State Great Hural, parliamentary sessions are open to the public.

83. As reflected in Table 8 above, Parliament has established a number of subordinate bodies that report directly to it, including BOM and the Mongolian Securities and Exchange Commission (MSEC). Parliament's functions also include defining the Government's monetary policies, developing guidelines for its economic development, and approving its action program and budget.

84. **Judiciary.** The Mongolian Constitution provides for an independent judiciary that includes Courts of General Jurisdiction and other specialized courts that may be created by Parliament. There are three levels of the Court of General Jurisdiction: (i) *soum, inter-soum*, and other district courts, which have first-instance jurisdiction in cases involving matters of less serious and criminal nature and in civil cases with claims of less than MNT10 million; (ii) *aimag* (i.e., provincial), city, and capital city courts, which deal with first-instance cases of more serious crimes and civil matters with claims of more than MNT10 million, in addition to appeals on cases coming from lower courts; and (iii) the Supreme Court, which deals with any first-instance case not covered above and appeals on all cases. An Administrative Court is being established at the *aimag*, city, and capital city level in order to deal with cases involving infringements of citizen's rights by any public-sector agency or official. All courts are presided over by a panel of three judges.

85. To ensure that there is no backlog of cases in Mongolia, civil cases must be concluded within 60 calendar days of filing. The presiding judge is required to issue an opinion within 43

⁵⁵ The president is elected every four years by direct vote, may veto, wholly or partly, laws or other decisions adopted by Parliament, but can be overturned by a two-thirds majority of that body, and upon nomination by it appoints the prime minister and Supreme Court judges.

⁵⁶ Members of Parliament may serve as cabinet ministers.

days of filing and a written decision within three days of issuing an opinion, which triggers the 10-day period within which to bring an appeal.

86. To ensure judicial independence, a General Council of Courts was established under the Constitution and is headed by the chief justice of the Supreme Court and 11 other members (seven judges from different levels, a member of Parliament, the Ministry of Justice and Home Affairs (MOJ), the general prosecutor, and a representative of the president). The General Council of Courts nominates candidates for judicial appointment to the president; formulates and submits proposals to Parliament on the judiciary's budget, judges' salaries, infrastructure, and other requirements; and initiates disciplinary proceedings against erring judges.

87. The Constitution sets out the basic requirements for judicial appointment. Candidates for appointment to the lower courts should be at least 25 years old and have a higher legal education and at least 3 years of legal experience; those to the Supreme Court should be at least 35 years old with a higher level of education and at least 10 years of judicial experience. Although the pay level for judges compares favorably with civil service salaries,⁵⁷ private sector legal positions pay at least two to three times these levels, a situation making it difficult to attract and to retain qualified candidates.

88. The Court Decision Enforcement Agency, under MOJ, oversees enforcement of court orders and arbitration decisions. Bailiffs are offered incentives for executing judgments, based on a percentage of the judgment amount (5%).

2. Local Government

89. Under the Constitution, local governments have the autonomy and flexibility to manage economic matters in their respective jurisdictions though free operation of the local governments is limited by heavy dependence on the central Government for funding.⁵⁸ Local governments in Mongolia have their own legislative and executive branches at the *aimag*, *soum*, and *bag* (subdistrict) levels. *Aimag* and capital city governors are appointed by the Prime Minister after parliamentary nomination. *Soum* governors, appointed by *aimag* governors, appoint *bag* officials.

3. Implementation of the Rule of Law Framework

a. Rule of Law

90. Mongolia has adopted, but has not yet implemented fully, a rule of law framework. As generally understood, the rule of law consists of the promulgation of easily accessible, objective, and clearly understandable laws and regulations, with communication and participation by affected parties; and the fair, reliable, and nondiscriminatory application of both laws and contracts.⁵⁹ The rule of law is expected to usher transparency, predictability, and consistency into the business environment.

⁵⁷ The chief justice of the Supreme Court receives a total salary of \$170 per month while judges at the lower levels receive \$120 per month.

⁵⁸ Local governments are responsible for providing education and health care; developing culture, art, science, and technology; and protecting historical and cultural sites, natural resources, and the environment. Local governments can make policy in relation to the supply of water and electricity and implement such policies in coordination with the relevant central government bodies, protect the genetic sources of livestock, introduce veterinary and sanitary control, and build and maintain roads and bridges.

⁵⁹ American Chamber of Commerce. 2001 White Paper. People's Republic of China.

91. **Legislative and Regulatory Process.** Participation by affected parties in the legislative and regulatory process requires a shift in the perception that legislative and regulatory drafting is an internal government process. Investors in Mongolia cite many cases in which important laws and/or amendments have been adopted without such participation or a clear understanding of negative market effects.

92. No public mechanism currently exists to promote actively or to formalize public involvement in the legislative process. Draft legislation is not published routinely although procedures are in place for consulting the public.⁶⁰ Most NGOs lack the capacity to participate in the legislative process effectively.⁶¹

**Box 2: The Mongolian Minerals Law:
Efforts to Change a “World-Class Law”**

The Minerals Law was enacted in July 1997 and is regarded widely among mining investors as one of the most investor-friendly laws in the mining world. The law simplifies the procedures for mining exploration and decreases license fees. Under the law, the State has the right to grant exploration and mining licenses, and license holders have the exclusive right to obtain a mining license and to mine all minerals discovered within the license area. Mineral licenses in whole or in part can be freely transferred, sold, or used as collateral by license holders. Exploration licenses can be held for 7 years and mining licenses for 100 years. Under this law, processing of exploration license applications takes no more than 10 business days, and mining license applications take no more than 20 business days. An application for a mineral license can be rejected only if the requested area overlaps with a national park, nature reserve, other special needs land, areas already covered by valid mineral licenses, or areas within disputed mineral license titles subject to a court ruling. This world-class law, along with other incentives granted to attract investors to the sector (e.g., tax concessions) has attracted foreign investors to Mongolia in an internationally competitive sector.

In mid-2001, the Ministry of Industry and Trade proposed a series of fundamental amendments to the Minerals Law. Strong objections were raised, and a public seminar was organized to discuss the amendments. The results of the seminar were communicated to the Prime Minister’s office, and in late 2001 the amendments were revoked.

Continued on next page

⁶⁰ USAID has been working with the Government to open up parliamentary hearings to the public. USAID’s “Open Government Initiative” (www.open-government.mn) provides a mechanism for the public to address questions to the prime minister, as well as to the Parliament, and to review draft legislation. Although this mechanism provides a framework for consultation, initiatives to address specific legislative issues seem more effective. For example, the Tax Roundtable, an initiative of the North America–Mongolian Business Group, involves the participation of the Chairman of the Standing Committee of the Economy, representatives of the GDNT, accountants, businesspeople, and lawyers.

⁶¹ In addition to the North America–Mongolian Business Group, a number of other NGOs are lobbying the government on behalf of their members. One of the larger NGOs, the Mongolia Chamber of Commerce and Industry (MCCI), regularly convenes its Public-Private Sector Committee, which includes representatives from MOFE, to discuss business legislation issues affecting the private sector.

Box 2—Continued

However, in January 2002, a Special Licensing Law, which became effective in January 2002, began to require regional governments (*aimags*) to approve the issuance of an exploration or mining license even though the applicant already had obtained approval from the Mineral Resource Authority of Mongolia. Based on the new requirement to obtain local government approval, licensing procedures now may take up to 50 business days. A number of attempts to shorten or to eliminate the power of local governments to approve license applications have failed. In mid-2002, the Ministry of Industry and Trade introduced to the cabinet proposals to amend the Minerals Law and the Licensing Law to require the Mineral Resource Authority to liaise with *aimag* governors with respect to licensing applications. If no response was received within 15 business days, the application was to be deemed granted. These proposals never were presented to Parliament. In June 2003, proposed Licensing Law amendments that would decrease the response period of local governments from 30 to 10 business days for an exploration license were submitted by the Cabinet to Parliament for deliberation. Parliament postponed deliberation in conjunction with other related laws to a later time.

93. New laws and amendments also have been used to implement the policies of successive administrations and have given rise to an increasing level of ambiguity. Laws often are coordinated poorly;⁶² adopted on an ad-hoc basis; and based on laws from more-developed markets,⁶³ some with different legal systems. Some laws may reflect local realities (e.g., a weak judiciary) inadequately and/or may cater to a narrow interest group.

94. **Regulatory Compliance Burden.** The civil law system, which has been adopted by Mongolia, assumes that codified law will regulate all cases.⁶⁴ But Mongolian laws tend to be general, descriptive and vague, with few implementing guidelines or official clarifications published to facilitate an understanding of them,⁶⁵ a situation resulting in a confusing framework that leaves ample room for interpretation by regulated persons and regulators.⁶⁶ Difficulties often surface during government inspections, identified as a significant obstacle and cost to doing business in Mongolia in the 2001 USAID MAPS survey (Box 3). Moreover, judges are not bound by earlier decisions on similar matters.⁶⁷ Thus, it might not be uncommon for courts to reach opposite conclusions in similar cases.

⁶² The Law on the Procedures for Developing and Submitting Draft Laws and Other Decisions of the National Parliament (last amended in 2001) and the Law on Government Service define the process for developing laws and government resolutions. Under these laws, ministries prepare draft laws by first consulting MOJ, with both ministries approving the concept for the proposed law. The draft then is distributed to other ministries for comment. A working group may be set up. Financial implications of the new proposal must be taken into account, as must legal implication of the proposals.

⁶³ An observer states, "Mongolia's legal system consists of a European Constitution, US commercial law, Indonesian Petroleum Law, German Civil Code, Swedish Administrative Law, and Canadian Bankruptcy Law." World Bank. 1999 and 2000. *Mongolia Legal Needs Assessment Report*. Chicago, June 1999/May 2000.

⁶⁴ When the law does not clearly address all issues presented, judges may consider common practices of business (rule by analogy). See Article 198.6 of the Civil Code, which governs contract interpretation.

⁶⁵ No guidance is provided on the power of the Government to issue implementing regulations. In practice, individual ministries and executing agencies administer the laws and regulations for which they are responsible. The Cabinet approves implementing regulations, and related legislative interpretations are submitted to the relevant parliamentary committee for review. See US Department of State, *Country Commerce Guide*, 2000, p. 18.

⁶⁶ For example, in the area of customs and taxation, at least 10 separate laws exist. Exemptions from these laws are found in many separate laws. New amendments to these laws are discussed in almost every legislative session. See ADB. 2002. *Governance: Progress and Challenges in Mongolia*. Manila.

⁶⁷ In contrast, common law systems build upon case law (legal precedents).

Box 3: Government Inspections

As a result of reviewing its inspection function after decreasing the licensing burden from more than 600 to 87 agencies, the Government recently restructured its inspection framework. The number of agencies involved in inspections was decreased from 49 to 41, still a significant number for a small economy. A new regulatory agency under the control of the prime minister, the State Professional Inspection Agency (SPIA), was established by bringing together 11 agencies that had employed 328 people, including employees from border checkpoints.⁶⁸ SPIA is expected to employ approximately 180 persons, including 66 of the former senior and national inspectors from previous agencies.

SPIA's scope remains extensive, and several of its functions affect private sector operations. It is reasonable for private businesses to be inspected to protect employees, customers, and the public interest more broadly; but there is concern that the structure of the Government's inspection framework, which still encompasses overlapping jurisdictions and roles and is accompanied by allegations of corruption, will remain unchanged. Inspections often are viewed as a means of extracting official payments from companies, rather than of enforcing regulations. Regulations may be widely interpreted by inspectors, who impose fines. More commitment to the spirit, rather than the letter, of recent reform efforts is necessary to enable the private sector to benefit from the consolidation of functions.

95. Although laws and regulations, once passed, are accessible in printed form in the state law journal and newspapers, the volume of legislative and regulatory activity that has accompanied transition, combined with ongoing restructuring of the Government, further limits the transparency of regulatory requirements and imposes a significant compliance burden on private businesses.⁶⁹

96. **Enforcement.** Weak and inconsistent enforcement of laws and regulations is an area in which investors have expressed concern. Weak and inconsistent enforcement is based on several factors: (i) inadequate checks and balances on enforcement actions; (ii) ineffective sanctions and penalties to deter violations; and (iii) general weakness of the court system.

97. The Law on Administrative Courts, adopted in 2002, should provide some protection to private enterprises against arbitrary interference by government authorities. Under this law, specialized courts were to begin operation on 1 June 2004 and to be responsible for reviewing, and changing or canceling if necessary, government decisions or actions.

⁶⁸ State Financial Control and Inspection Agency; State Education, Culture and Science Inspection Agency; State Unit for Nature and Environment Protection; State Control Authority for Infrastructure; State Labour and Social Welfare Inspection Agency; State Industry and Trade Inspection Agency; State Food Safety and Agricultural Inspection Agency; State Health Inspection Agency; National Standardization and Measurement Center's Division for Implementation of Government Inspection Function on Standards, Quality and Measures; Defense Management Inspection Unit; Radiation Inspection Unit of the Atomic Energy Commission.

⁶⁹ There is no legal information system or register of laws. ADB originated the idea of a Legal Retraining Center to help train legal professionals in modern commercial law. ADB. 1997. *Technical Assistance to Mongolia for Retraining of Legal Officials in a Market Economy*. Manila. This assistance was followed up by the ongoing World Bank Legal and Judicial Reform project, which is improving access to legal information through the establishment of a center for legal and judicial research and by enhancing the dissemination of legal and judicial information. ADB also provided training under the "DIAL" project, to familiarize lawyers with researching law on the Internet. See ADB. 1998. *Regional Technical Assistance for Development of the Internet for Asian Law*. Manila.

98. **Dispute Resolution.** Disputes between foreign and Mongolian investors are resolved in the Mongolian courts unless otherwise provided for by international treaties to which Mongolia is a signatory, or by a contract between the parties to the dispute.⁷⁰

99. Judicial competence to rule on commercial matters also is a concern. Before the transition to a market economy, judicial work was predominantly criminal; now it is increasingly commercial.

100. Public opinion surveys reflect a widespread perception of corruption in the judiciary.⁷¹ Judgments made in a small number of recent cases involving foreign investors have been regarded with suspicion both at the highest levels of government and within the private sector (Box 4).

101. A number of foreign donors, including ADB, have documented the problems associated with the judiciary. Several TAs already are underway or are planned to address this issue. The largest is the USAID-funded Judicial Reform Project, which is designed to help the Government implement its strategic plan for the justice system, with a focus on criminal cases. Work in the area of managing the courts; training jurists; establishing a qualification system and a code of ethics for Judges; and clarifying the organization, structure, jurisdiction, and responsibilities of court system agencies is entailed. A World Bank Legal and Judicial Reform Project with an emphasis on creation of a new administrative court system will complement this effort.⁷²

102. Until recently, there were few alternatives to the court system in Mongolia: the MCCI Arbitration Tribunal was the only alternative forum for formal resolution of commercial disputes between Mongolian and foreign entities.⁷³ In May 2003, however, a new Law on Arbitration was adopted. This law, modeled after the 1985 Model International Commercial Arbitration Law recommended by the United Nations Committee on International Trade Law, provides for arbitration in private-business disputes, including those involving domestic entities. Under this law, arbitration decisions are final, with no right of judicial review or appeal to the courts. If the losing party fails to execute the arbitration award, the winning party may submit a request for enforcement to the Court Enforcement Authority.

103. For disputes arbitrated overseas, Mongolia has acceded to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Difficulties have arisen in enforcing foreign judgments, however (Box 4).

⁷⁰ World Bank. 2002. *Investors Forum 2002: Mining and Oil Sector Profile*. Chicago. Note that the Law of Judicial Procedure for Business Disputes has not been translated into English. See 1995 Foreign Trade Arbitration Law (Article 15).

⁷¹ UNDP. 1994. *Public Perception of Corruption, Public Opinion Survey, Academy of Public Administration*, supported by the Soros Foundation; MCCI. 2000. *Survey of Corruption in the Business Sector*; USAID. 2001. *Public Perception of Corruption Survey* by Sant-Marcel Foundation and supported by USAID Mongolia Judicial Reform Project.

⁷² Some of the same problems undermining the credibility of the judicial system (salary issues, low public prestige, and difficulty in attracting and retaining qualified candidates) also may affect this new court.

⁷³ On average, the MCCI Tribunal deals with 15 arbitrations a year, using a panel of approximately 15 arbitrators appointed by MCCI, all of whom are lawyers. On average, cases require approximately two months to resolve.

**Box 4: Enforceability of Judgments Issued by Arbitration Tribunals:
The Marubeni Case**

In 1996, Marubeni–Hong Kong and South China Ltd (Marubeni) extended a deferred payment facility in the amount of \$18 million to Buyan Holding Ltd. (Buyan), a Mongolian cashmere processing and knitting enterprise. In issuing the deferred-payment facility, Marubeni relied on a letter of guarantee from the Ministry of Finance and Economy. This letter was issued in 1996 and provided an unconditional guarantee to pay any amount under the deferred payment facility if not paid when due. The validity of the guarantee was warranted by a legal opinion issued by the Ministry of Justice and Home Affairs. In 2000, Buyan defaulted on the loan after having paid some \$6 million of the facility. The succeeding new Government delayed acknowledgement of the guarantee, despite repeated attempts by Marubeni to resolve the matter. Marubeni subsequently initiated a lawsuit in England, pursuant to the jurisdiction clause in the agreement between Marubeni and Buyan. In late 2002, an English court affirmed its jurisdiction in the matter following a jurisdictional challenge from the Government of Mongolia. Notwithstanding, the Government continues to deny the validity of the previous government guarantee, insisting that it was outside the power of the Ministry of Finance and Economy, notwithstanding the legal opinion of the Ministry of Justice and Home Affairs. The case is tentatively scheduled for hearing in Mongolia in February 2004. In the interim, efforts are being made to find an amicable solution.

104. **Legal Professionals.** There is a shortage of qualified lawyers in Mongolia. Most legal professionals are unfamiliar with new legal concepts and requirements and lack the ability to operate in the new system. Although a small number recently received training in Western countries, most lawyers were trained in the former Soviet Union. For lawyers practicing in the commercial area, graduation from law school is the only prerequisite.⁷⁴

105. Legal education has not remedied this problem. Although remedial education for midlevel professionals is widespread, it has not been institutionalized. Because resources are lacking in educational institutions, new professionals often receive inadequate training. To address this gap in education, World Bank is providing assistance to train trainers at law schools in Mongolia and is helping establish new teaching mechanisms and curricula.

106. Notwithstanding, private companies do not cite legal constraints as a major impediment to doing business.⁷⁵ This may be so because most businesses have not been involved in legal proceedings and/or because appreciation is lacking that other, more pressing issues, such as corruption and cronyism, might be removed with a more effective legal system.

b. Commercial Law Framework

107. To enable private-property owners to uphold their rights against third-party claims and to dispose of or pledge such rights in whatever way they choose, an effective legal framework and dispute resolution system is needed. In Mongolia, private-property rights are protected under the Mongolia Civil Code (amended in 2002) and a number of specific laws, discussed below, which generally have been harmonized or are in the process of being harmonized with the Civil Code.

⁷⁴ A newly developed bar examination will test only newly entering prosecutors, judges, and advocates.

⁷⁵ The 2001 USAID MAPS survey reported that 10 constraints facing companies were considered more severe; only business registration, employment, and business service issues ranked below judicial and legal concerns.

108. **Land.** Until promulgation of recent amendments to the Land Law, effective 1 January 2003, and adoption of the new Law on Mongolian Citizens' Ownership of Land, effective 1 May 2003, Mongolians had the right only to use land, but were not permitted to transfer, sell, or pledge such rights.

109. The Land Law provides local governors and mayors with the power to lease small land parcels to Mongolian citizens and companies, with authority given to regional legislatures to grant larger plots. Leases are valid for 15–60 years, with one extension possible of up to 40 years. Parliament alone has the authority to issue leases to foreign entities. The Law on Mongolian Citizens' Ownership of Land allows private ownership of land by Mongolian citizens.⁷⁶ Under these laws, citizens may use, lease, pledge, or sell their right to lease or to own land, subject to registration of their rights with the Administration of Property Registration Agency, which was formed from the recent merger of three government agencies.⁷⁷

110. **Intellectual Property Rights.** In addition to the Civil Code, intellectual property rights (IPRs) are protected under the Patent Law and the Law on Trade Names and Trademarks. Mongolia is a signatory to the Paris Convention on the Protection of Industrial Property and to the Madrid Convention Concerning International Registration of Trademarks and is a member of the World Intellectual Property Organization. IPRs are administered by the Intellectual Property Office of Mongolia, established in 1996 as an implementing agency of MOJ. By 2002, the Intellectual Property Office of Mongolia had issued 577 patents and had registered 162 innovations, 55 new products, 408 local and 1,800 international trademarks, and 140 industrial designs. Because of the small market, IPR infringement is not a major problem in Mongolia.

111. **Investor Protection.** The legal framework for protecting investors is set forth in the Law on Registration of the Right to Own Property and Other Property Rights Related to It, Bankruptcy Law, Company Law, and Securities Law, in addition to the Civil Code.

112. **Creditors.** Under the Law on Registration of the Right to Own Property and Other Property Rights Related to It, adopted in June 2003, creditors can register their security interest in both immovable and movable collateral with the Administration of Property Registration Agency. This agency maintains a central registry to record leases, pledges, and liens on, and transfers of, immovable and movable property. Banks and NBFIs with secured interests in movable collateral can foreclose on such collateral outside the court system, provided that such foreclosure is provided in the agreement with the debtor. Foreclosure of immovable collateral requires a court order and bailiff's action procedure, however, and, with respect to real property, is permitted only during the summer. Judicial procedures are risky due to a weak judiciary, which may tend to be sympathetic where eviction from real property is involved.

⁷⁶ ADB is providing assistance in the carrying out of a cadastral survey and the establishment of a national land information system scheduled to be completed by July 2007. ADB. 2000. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for Cadastral Survey and Land Registration Project*. Manila.

⁷⁷ Cartography Agency under MOI, Land Agency under the Ministry of the Environment, and State Immovable Property Registration Agency under MOJ.

113. With respect to insolvent companies, creditors are provided with limited protection under the 1997 Bankruptcy Law.⁷⁸ Under this law, creditors may petition the court for the involuntary liquidation of an insolvent company and propose a rehabilitation plan before being approved or dismissed by the courts.⁷⁹ By not stipulating how many creditors must vote for a rehabilitation plan, the law seems to raise the possibility of a small group of junior creditors imposing a plan on senior creditors. The law seems, moreover, to provide precedence to debtors' over creditors' plans. The rights of various groups of creditors is not clear, with claims for injury or death against the company having a higher priority than secured claims. To address some of these concerns and to harmonize this law with recent amendments to the Civil Code, MOJ has scheduled the law for revision in the near term with assistance from the German Agency for Technical Cooperation (GTZ).

114. **Shareholder Rights.** Shareholder rights are defined in the 1999 Company Law and Securities Law (amended in 2002) for MSE-listed companies. The Company Law is considered to have been drafted well but to be enforced poorly. Under this law, shareholders have the power to authorize share buy-backs, to exchange debt for equity, and to liquidate, sell, merge or consolidate the company. The Annual General Meeting of shareholders appoints the Board of Directors and approves its financial reports and Board remuneration. Holders of ordinary shares also have preemptive right to purchase additional ordinary shares *pari passu* to their original holding or to sell those rights.

115. Shareholder rights under the Securities Law are based on the provision of full and fair disclosure by listed companies and by companies making a public offering. Compliance with current disclosure requirements, including accounting regulations, is rare to nonexistent, and sanctions are insufficient. For example, most MSE-listed companies (70%) did not hold an annual general meeting of shareholders in 2000. Although the situation improved in 2001 (noncompliance declined to 62%), it became worse in 2002 (72%).⁸⁰ Resistance to holding general meetings of shareholders may reflect the fact that shares often are closely held among relatives or insiders. Higher penalties for noncompliance included in recent Securities Law amendments were rejected by Parliament, and fines for the failure to hold an annual general meeting remain quite low. After both an initial World Bank study on corporate governance and a government review of Organization for Economic Cooperation and Development norms, EBRD is providing assistance to a working group on corporate governance convened by the Economic Standing Committee of Parliament. Areas examined include the service of independent directors on company boards and the strengthening of sanctions for noncompliance.

116. With respect to the banking sector, BOM recently adopted, based on Bank of International Settlements Principles for "Enhancing Corporate Governance for Banking Organizations," Guidelines for Corporate Governance for commercial banks and issued a Governor's Order obliging banks to adopt these principles.

⁷⁸ The BOM regulates bankruptcy of banks under the Banking Law. The decision to liquidate or to restructure a private bank is made by shareholders and requires BOM consent. BOM appoints conservators and receivers, who may be appealed to by shareholders, creditors, and depositors. Upon appointment, conservators and receivers have complete authority over such banks, resulting in the suspension of bank officers' and shareholders' authority.

⁷⁹ Bankruptcy is seldom initiated. In addition to cultural factors and unfamiliarity with related procedures, the Bankruptcy Law is considered by some experts to be onerous and unclear. ADB consultants reviewed this law in detail in connection with ADB. 2000. *Technical Assistance to Mongolia for Strengthening Financial Sector Development*. Manila.

⁸⁰ Interviews with MSEC and MSE Chairs.

C. Labor Laws and Social Safety Nets

117. The business community does not seem to view the Labor Law, adopted in 1999, as a limitation to PSD.⁸¹ This law defines labor rights and imposes labor obligations on all entities operating in Mongolia. Sanctions for violations set forth in the law are low, ranging from MNT5,000 (\$4) for an officer involved in illegal practices, to MNT250,000 (\$228) for a company, depending on type and severity of offence.

118. The Law on Social Insurance, adopted in 1994 and amended in 1996, 1997, and 1999, provides for the payment of benefits to insured persons in the areas of pensions, industrial injury, unemployment, and sickness. Cost of the program is covered by a 19% employer levy on formal sector wages, a 7% contribution by employees, and voluntary contributions from those outside the formal sector. Although the percentage of contributions is relatively high by transition and developing country standards, benefits are modest. Concern persists regarding the number of people who are not covered by the legislation,⁸² whose employers do not comply with the law, and/or whose employers are in arrears.

D. Environmental Laws

119. Environmental pollution is a serious concern in Ulaanbaatar and other locations in which specific industries pollute the environment. In the capital city, carbon monoxide, nitrous oxide, and dust build-ups cause concern, particularly from October to March, when domestic and power station combustion levels increase and when climatic conditions prevent dispersal. River-water quality in Ulaanbaatar is poor, with average contents of mineral nitrogen, phosphorous, and other soluble organic substances exceeding the maximum permissible levels by 2–14 times. The capital also produces 195,000 tons of waste/year, with virtually no recycling or waste processing. In rural areas, pasture and land degradation are especially worrisome (Box 6).

120. A strong legal framework for environmental protection has been adopted. The Environmental Protection Law of 1995, as amended in 1998 and 2002, regulates the pollution of air, water, and land resources by toxins or waste products and covers chemical traces in food and maximum applications of agricultural chemicals. Under this Law, the Ministry of Nature and the Environment is responsible for developing appropriate indicators and maintaining records of environmental measurements. Inspectors from other agencies may be designated environmental inspectors and instructed to carry out specific inspections. Businesses are obliged to keep records of toxins used or discharged into the environment and to rehabilitate damaged areas at their own cost. Licenses are required for the discharge of toxic waste and for the use of natural resources, which are not defined in the law. Fines for noncompliance range from MNT10,000–20,000 (\$9–18) for an individual to MNT150,000–200,000 (\$136–181) for a business.

E. Access to Capital

121. In Mongolia, private sector access to capital, especially among SMEs, is quite limited. Because a diversified financial sector does not exist, private enterprises depend on the banking system as the primary source of capital. Banks have relatively undeveloped credit appraisal

⁸¹ The 2001 USAID MAPS survey placed employment issues next to the bottom of its list of concerns within the business environment.

⁸² Herders are covered as “contracted workers” if formally employed. But because most are individually employed, contributions are voluntary.

systems and rely extensively on collateral, of which SMEs, especially those within the service sector, may have little. What is more, the unit cost of granting credit to small businesses is relatively high and in a high-risk environment may make lending to small businesses unattractive. Banks also prefer lending on a short-term basis. It is very difficult, therefore, for start-up businesses to raise investment loan financing from banks. Moreover, limits are imposed on the amount that can be lent each borrower (20% of share capital).

122. Because of the absence of transparent and reliable financial statements (discussed below—Internal Constraints to PSD) and on the presence of weak corporate governance, equity finance is severely lacking. There have been no initial public offerings on MSE since its creation in 1995, and no formal venture capital funds operate in Mongolia.

F. Internal Constraints to Private Sector Development

123. A number of significant internal constraints to PSD limit the private sector's capacity to respond to business and investment opportunities.

124. **Business Culture.** The business culture in Mongolia has been formed mainly under a command economy even though most businesses have been established post-transition. Business culture is evolving. On the positive side, a "culture of repayment" of bank loans by private businesses is fully evident. Increasing links with other countries and foreign businesses have provided a rich source of business information and creative ideas. Many bright young entrepreneurs have opened new businesses. Certain negative aspects of business culture, however, including fairly low levels of accountancy skills and a lack of familiarity with international currents in marketing, management, and investment analysis, represent significant impediments to business growth and development. Many businesspeople are oriented to production rather than to customer requirements and have a bureaucratic approach to management and business development. Entrepreneurship, at least within the formal sector, thus is limited.⁸³

125. **Financial Control and Accounting.** Although the Accounting Law (1993, amended 2002) requires all companies to adopt IAS and submit audited financial statements to MOFE, and although the Auditing Law (1997) requires adoption of international standards of auditing (ISA),⁸⁴ compliance is quite weak. Most companies employ few if any managerial accounts, i.e., revenues and costs broken down by activity, product, or line of business. Control in the modern business sense is poorly understood, and accounts generally provide insufficient detail or are improperly prepared, irrespective of deliberate obfuscation. As a result, potential investors are unable to evaluate businesses, and commercial lending is carried out on the basis of collateral coverage rather than cash flow.

126. Advances in accountancy, auditing, and control are constrained severely by lack of skilled practitioners. As of 2 September 2003, there were 840 certified public accountants

⁸³ The Dutch-financed Enterprise Restructuring Project, which worked with 10 former-SOE enterprises in its first phase (1999–2002), identified the key factors of company success in Mongolia as (i) an increase in control over internal procedures; i.e., strong management supported by committed shareholders; (ii) an ability to develop a company vision and to drive the company toward it; and (iii) a reorientation of approach away from production control and towards customer satisfaction.

⁸⁴ World Bank is translating ISA standards into Mongolian.

(CPAs), including 320 auditors⁸⁵, but only a few accountants have a reasonable understanding of IAS and of how to apply these standards. CPAs certified before 1997 were only required to pass a general examination. Most CPAs fail to undergo additional training to update their skills, and the number of qualified accounting professors and lecturers are small. Accounting specialists often only verify whether financial reports have been filed in the correct format and do not examine source materials for appropriate treatment.⁸⁶

127. Three organizations currently oversee implementation of accounting standards: MOFE and the two professional accounting bodies known as the Mongolian Institute of Certified Public Accountants (MICPA), which administers the CPA examination and provides ongoing training, and the Mongolian Professional Accounting Council, which is authorized under the Auditing Law to license accounting firms and strengthens and regulates the accounting profession.

128. Implementation of IAS and ISA is a long-term process and, in addition to capacity building, depends on the resolution of outstanding tax issues currently discouraging the appropriate reporting of accounts and encouraging the splitting of businesses. ADB assistance in this area has been ongoing since 1995. An early ADB TA in 1995 supported the drafting of the legal framework and the constitution and bylaws of MICPA (ADB. 1995. *Technical Assistance to Mongolia for Improving Accounting and Auditing Systems*). A second TA was provided in 1997 to help 18 accountants qualify for the CPA examination, to train 200 accountants in IAS generally and 36 in IAS applicable to banks and financial institutions, and to help MICPA develop a new syllabus for CPA examinations (ADB. 1997. *Technical Assistance to Mongolia for Improving Accounting and Auditing Systems 2*). More recently, an ongoing ADB TA approved in 2002 will help 100 private SMEs adopt IAS and will provide assistance to MOFE to develop criteria for monitoring compliance with IAS (ADB. 2002. *Technical Assistance to Mongolia for Capacity Building for Accounting and Auditing Professionals*. Manila).

129. **Human Resources.** Skilled managers, finance professionals, and technologists are in short supply. Although private involvement in the tertiary education sector has led to a large increase in the number of graduates, many have no practical skills.⁸⁷ Foreign investors in the garment industry cite a lack of work ethic among workers, which leads to low productivity. In an employer survey carried out in 2001,⁸⁸ 48% of company respondents said that high school graduates lacked interest in business, and 24% said that graduates of higher education had poor levels of technical knowledge. Inadequate human resources are therefore a significant constraint to PSD.

130. **Technology.** Many businesses, particularly in the manufacturing sector, rely on old, sometimes obsolete, technology and are only able to operate internationally because of a comparative advantage based on natural resources, relatively low labor costs, and/or international trade agreements (e.g., the textile industry). Technological constraints may be overcome to some extent by foreign investment and leasing, but medium-term finance for

⁸⁵ Two international accounting firms operate in Mongolia: Ernst & Young, through a branch of its Malaysian office, and KPMG, through a branch of its Vietnam operation. Arthur Andersen maintained a small practice in Mongolia until its dissolution in 2002.

⁸⁶ Companies using IAS may encounter difficulties with respect to deductions based on lack of understanding of IAS by tax authorities. American-Mongolian Business Group. 2000. *Obstacles to Doing Business in Mongolia*, 9 August.

⁸⁷ For example, the GTZ SME Promotion Project noted a situation in which graduate printing engineers had never seen a printing machine, much less operated one. Interview.

⁸⁸ Survey of 57 businesses in Ulaanbaatar and Darkhan under the ADB CAPE Economic Diversification and Reorientation Case Study, 2002.

upgrading technology is in short supply. Market uncertainty, especially for exporters, also limits the desire to invest. Where investment in technology has taken place, it has not always been appropriate or correctly installed, calibrated, and operated. Obsolete technology, as well as lax quality-assurance procedures, often limits Mongolian producers to semi-finished products.⁸⁹

131. **Business Corruption.** In a 2000 MCCI report on business corruption carried out largely within the SME sector,⁹⁰ 32% of respondents admitted to having evaded income taxes,⁹¹ 31% to having evaded customs' duties, and 26% to having evaded VAT payments. Two thirds of respondents agreed that they "sometimes have to bribe," paying as much as 6–10% of revenue (26% of those making payments). It seems unlikely that the incidence of corruption has decreased since the study was conducted.

Box 5: Company Success Story

Darkhan Nekhii was established in 1973, and in 1990 had the capacity to treat 1.5 million sheepskins/year. It exported skins and garments throughout the former Soviet Union. In 1992, it was privatized through the voucher system, resulting in a diffused base of shareholders and full control by management. The company accrued debt (MNT1.2 billion) at the same time as it was losing production and incurring losses. The CEO was replaced five times in 7 years. In January 1998, production ceased and workers were laid off.

In late 1999, external donor assistance permitted the development of a realistic business plan centered on the export of semi-finished skins and on the production of garments for the local market. In 2000 a new CEO began work and one of the largest shareholders, Gazar Holdings, invested MNT50 million in working capital. Working practices were changed, a market study was carried out, management attended the Hong Kong China Leather Fair, and technical assistance in processing technology was sourced. Gazar Holdings factored bank debt, tax arrears were renegotiated, and the company paid off MNT147 million to suppliers. A strategic partnership was agreed to with a Spanish company.

By the end of 2001, more than 200 workers were employed, debt was nearly eliminated, and the business had become profitable. These changes were achieved without major investment but required commitments to finding and exploiting a market niche, improving quality, controlling costs, and being confident enough to admit deficiencies and to learn.

G. Industry Representative Bodies

132. A number of industry representative bodies, a few of which have been effective in presenting private sector concerns to Parliament (e.g., the mining sector) and/or lobbying for tax concessions (e.g., the tourism sector), exist (Table 9).

⁸⁹ A gradual move from raw material production, to semi-finished, to finished production may, however, be sensible commercially (Box 5).

⁹⁰ MCCI. 2000. *Survey of Corruption in the Business Sector*.

⁹¹ The word "avoid" is used in the report whereas discussions with MCCI researchers indicate that the word "evade" should be used. The first is legal, the second is not.

Table 9: Selection of Industry Representative Bodies

Name	Membership	Background
MCCI	600 large and medium enterprises in all sectors.	Funded through membership fees. Provides information to members, offers commercial market research, established Public-Private Consultative Committee with representatives from MOFE, and produces a Top Mongolian Companies chart, which scores companies on a variety of characteristics. Organizes arbitration forum for disputes between foreign investors and local entities.
North America–Mongolia Business Council	American and Canadian companies and professionals.	Founded in 1991. Advocates members' trade and investment interests, with permanent headquarters in Washington, DC.
Mongolian National Mining Association	Geologists, miners, processing engineers, metallurgists and scientists, mine operators, technical universities and schools, science and research organizations, and other professional associations.	Established in 1994. Actively involved in representing members' interests to Parliament with respect to legislation, provides members with information related to mineral resources, and addresses safety, sanitary and social welfare issues of employees and workers in the mineral sector.
Mongolian Tourism Association	96 members consisting of hotels, tour operators, travel agents, gher (tent) camps, and restaurants and other catering establishments.	Involved in policy development, training, marketing and promotion, market research, provision of information, and training of tourism operators. Received assistance from GTZ and USAID to improve their products and services and to increase staff skills and professionalism. Full-time staff hired in 1997.
Mongolian Wool & Cashmere Association	40 members engaged in wool and cashmere production.	Addresses sector problems and needs, incorporates suggestions and proposals of members and forwards them to the government. Also organizes exhibits and trade fairs for its members. Has four full-time staff.

GTZ = German Agency for Technical Cooperation, MOFE = Ministry of Finance and Economy, USAID = United States Agency for International Development MCCI = Mongolian Chamber of Commerce and Industry.

Source: ADB research.

Table 10: Recommendations to Address Overriding Constraints to Private Sector Development

Constraints to PSD	Recommended Government Action
Legal Environment	<p>Formalize/institutionalize procedures for public consultation on legislation and regulations and promote such participation.</p> <p>Implement a more effective mechanism for publicly disseminating legal and regulatory requirements on an on-going basis. Provide a clear set of rules and guidelines on regulatory requirements for public officials and the business community.</p> <p>Develop an efficient and fair judicial system that disposes of cases in a reasonable, timely, and impartial manner. Make judicial decisions publicly available to ensure transparency. Promote use of alternative dispute resolution forums that are efficient and fair.</p> <p>Ensure enforceability of foreign arbitration awards.</p>
Tax Policy	<p>Review and simplify the tax system and review effective tax rates to meet government revenue requirements and promote private sector development.</p>
Inspection Regime	<p>Clarify requirements (e.g., remove discretion where reasonable) and implement systems (computerization) and procedures to ensure transparency of fee collection.</p> <p>Train regulatory officials who interface with the private sector on legislation and regulations.</p> <p>Require all inspectors (of health, fire, tax, etc.) to present a letter signed by their agency authorizing them to conduct an inspection. Consolidate inspections wherever and whenever possible.</p>
Financial Intermediation	<p>Deepen financial sector reforms and promote an enabling environment to diversify alternative financing options for domestic private firms.</p> <ul style="list-style-type: none"> • Continue reforms in financial sector, • Promote development of sustainable alternative financing vehicles, • Promote development of the land market, • Develop a more effective monitoring and enforcement program to promote higher standards of corporate governance for publicly listed firms, • Review accounting standards applicable to SMEs (cost-burden issue), • Effectively enforce compliance with accounting and auditing requirements,

SME = small and medium enterprise

Continued on next page

Table 10—Continued

Constraints to PSD	Recommended Government Action
	<ul style="list-style-type: none"> • Adopt and implement more effective sanctions to ensure compliance, • Continue to provide training on accounting requirements to companies, accountants, regulators (who supervise), and persons who oversee dispute resolution. Require accountants to undergo continual training (e.g., mandatory continuing education requirement), • Continue with capacity building of local audit firms
Management and Technical Skills	<p>Improve the quality of tertiary institutions by promoting and enforcing higher education-standards.</p> <p>Promote educational programs that address private sector needs.</p>

Source: ADB research.