ADB

Progress Report on Tranche Release

Loan Number: 2010-MON [SF]
November 2005

Mongolia: Second Phase of the Governance Reform Program

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 15 October 2005)

Currency Unit	–	togrog (MNT)
$1.00	=	MNT1,193
MNT1.00	=	$0.0008

ABBREVIATIONS

ADB	–	Asian Development Bank
AG	–	accountant general
BOM	–	Bank of Mongolia
CBGR	–	Capacity Building for Governance Reforms
CGA	–	Customs General Administration
CPA	–	certified public accountant
CS	–	cabinet secretariat
EA	–	Executing Agency
GDNT	–	General Department of National Taxation
GDP	–	gross domestic product
GRP II	–	Second Phase of the Governance Reform Program
GSC	–	Government Service Council
HIA	–	head of internal audit
IAS	–	International Accounting Standards
IAU	–	internal audit unit
IMF	–	International Monetary Fund
IPSAS	–	International Public Sector Accounting Standards
MICPA	–	Mongolian Institute of Certified Public Accountants
MJHA	–	Ministry of Justice and Home Affairs
MOF	–	Ministry of Finance
MOFE	–	Ministry of Finance and Economy
MOSTEC	–	Ministry of Science, Technology, Education, and Culture
MSWL	–	Ministry of Social Welfare and Labor
NAO	–	National Audit Office
NCAC	–	National Council on Anticorruption
PARP	–	Public Sector Administration Reform Program
PSMFL	–	Public Sector Management and Finance Law
SBP	–	strategic business plan
SF	–	Special Funds
SOE	–	state-owned enterprise
SPIA	–	State Professional Inspection Agency
TA	–	technical assistance
UNDP	–	United Nations Development Programme

NOTE

In this report, "$" refers to US dollars.

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I. INTRODUCTION

1. On 14 October 2003, the Asian Development Bank (ADB) approved Loan 2010-MON: Second Phase of the Governance Reform Program (GRP II) to Mongolia for a committed amount of SDR9.699 million ($13.5 million) together with Loan 2011-MON: Capacity Building for Governance Reforms for SDR1.437 million ($2 million) from ADB's Special Funds (SF) resources. The latter was a technical assistance (TA) loan.

2. Support for public sector governance reforms in Mongolia has been a pillar of ADB's country operational strategy for Mongolia since 1995. ADB has previously provided Mongolia with a loan and 10 TAs for this purpose.[1] A milestone achievement of the Governance Reform Program Loan I (footnote 1) was the adoption of the Public Sector Management and Finance Law (PSMFL), which provided a sound legal framework for budget, output performance, and financial management reforms (para. 15). GRP II builds on and complements the effort of GRP I. The goal of GRP II is to enhance the accountability and efficiency of the public sector, measured by fiscal sustainability and tangible improvements in the delivery of key public services. It adopts a three-pronged program that is aimed at (i) enhancing institutional capacity by strengthening financial governance norms in the public sector and carrying out PSMFL-related measures for strategic planning and output budgeting in health, education and social welfare sectors; (ii) improving fiscal sustainability through pension reforms and administrative consolidation; and (iii) mainstreaming governance reforms by improving the quality of the civil service and enhancing confidence in key public institutions.

3. The loan was signed on 9 December 2003 and took effect on 27 January 2004. Its first tranche of SDR3.592 ($5.32 million) was released on 3 February 2004. The release of the second tranche of SDR6.107 million ($8.5 million), originally scheduled for July 2005, is contingent on the compliance by the Government of Mongolia with 10 conditions for the release. The Government must also meet 20 monitoring conditions (not mandatory for the release of the second tranche). All program conditions are listed in the Appendix. The Government has complied fully with all the 10 conditions for tranche release.[2] Of the monitoring conditions, the Government has complied fully with six and partially with eight conditions, and is expected to comply with the remaining six conditions while the loan is in effect.[3]

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[1] These were (i) ADB. 1999. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for Governance Reform Program*. Manila (Loan 1713-MON for $25 million, approved on 2 December 1999); (ii) ADB. 1996. *Technical Assistance to Mongolia for Institutional Support for Local Government and Decentralization (Phase I).* Manila (TA 2549-MON for $100,000, approved on 26 March 1996); (iii) ADB. 1996. *Technical Assistance to Mongolia for Restructuring and Staff Rationalization*. Manila (TA 2659-MON for $100,000, approved on 7 October 1996); (iv) ADB. 1997. *Technical Assistance to Mongolia for Institutional Strengthening of the Local Government and Decentralization (Phase II).* Manila (TA 2769-MON for $580,000, approved on 14 March 1997); (v) ADB. 1997. *Technical Assistance to Mongolia for Initial Phase of Civil Service Reforms*. Manila (TA 2868-MON, approved in September 1997); (vi) ADB. 1996. *Technical Assistance to Mongolia for Strengthening the Taxation System*. Manila (TA 2606-MON for $359,000, approved on 9 July 1996); (vii) ADB. 1997. *Technical Assistance to Mongolia for Program Preparation for Governance Reforms*. Manila (TA 2931-MON for $1,051,300, approved on 10 December 1997); (viii) ADB. 1999. *Technical Assistance to Mongolia for Initial Phase of Public Administration Reform.* Manila (TA 3316-MON for $1,100,000, approved on 2 December 1999); (ix) ADB. 1999. *Technical Assistance to Mongolia for Public Expenditure Management*. Manila (TA 3317-MON for $496,000, approved on 2 December 1999); (x) ADB. 1999. *Technical Assistance to Mongolia for Study of Central-Local Government Aspects of Reform Implementation*. Manila (TA 3318-MON for $235,000, approved on 2 December 1999); and (xi) ADB. 2002. *Technical Assistance to Mongolia for Strengthening Public Sector Administration and Financial Management*. Manila (TA 3920-MON for $650,000, approved on 5 September 2002).

[2] It complied fully with tranche release conditions 4, 14, 17, 22, 25, 26, 28, 30, 33, and 35.

[3] It (i) complied fully with monitoring conditions 7, 10, 15, 16, 19, and 24; (ii) complied partially with conditions 6, 8, 9, 11, 20, 29, 31, and 32; and (iii) is expected to comply with conditions 5, 12, 13, 18, 21, and 34 (Appendix).

4. The Government has made significant progress (given its political constraints of a hung parliament following elections and the consequent difficulties, paras. 17–19) in fulfilling the loan's policy conditions relating to (i) improvements in financial governance and reform of the ministries of health, science technology education and culture, and social welfare and labor, and customs administration; (ii) administrative consolidation between and within provinces to improve public expenditure management and achieve economies of scale in service revenues; (iii) improvements in civil service quality and methods for the recruitment and selection of senior officials and the resolution of grievances; and (iv) provision of social safety nets. The Program has provided an important foundation for sound public financial management, essential for sustainable economic growth (paras. 20–64).

II. RECENT ECONOMIC DEVELOPMENTS

5. Following a sharp decline in gross domestic product (GDP) during the early years of the transition, Mongolia's economic growth turned positive in 1994. Annual GDP growth between 1994 and 1999 averaged 3.9%. This was attributable to favorable international prices for copper and cashmere, as well as efficiency gains. The country's growth, however, remains volatile and susceptible to exogenous shocks. In 2001 the growth rate dropped to 1% because of (i) a sharp drop in international copper prices, and (ii) a decline in agricultural output after two consecutive harsh winters. GDP grew at 10.6% in 2004, boosted by strong growth in the agriculture and mining sectors, which cumulatively account for 30% of GDP. Favorable world commodity prices (notably of copper, gold, and cashmere) helped to catalyze the country's economic growth.

6. From preliminary indicators, the International Monetary Fund (IMF) estimated real GDP growth for the first 5 months of 2005 to be 5%. The IMF forecasts economic growth to average 7% in 2005–2007 and 6% in 2006. This forecast is based on (i) continued upward trends in world commodity prices in 2005, albeit at a slower rate than in 2004; (ii) continued growth of the country's livestock sector after two consecutive years of contraction caused by severe winters and foot and mouth disease; (iii) continued strong domestic investment and consumption demand for the outputs of the country's construction and service sectors; and (iv) increased revenues from transit traffic through Mongolia between the People's Republic of China (PRC) and Russia, given the strong growth of these two economies; and (v) strong prospects for new energy exploration in the Gobi desert. However, sustained growth faces a number of constraints. The country is vulnerable to exogenous shocks because of its narrow economic base and high dependence on commodity production and trade. Fragmented domestic markets and geographic isolation are also important constraints. Manufacturing sector growth is hampered by the prevalent use of old technology and by the limited human resources.

7. The lack of a sound and efficient financial sector is also a major constraint on private sector–led economic growth. The banking sector has stabilized and strengthened since the crises of the 1990s. The Government has also taken the first steps to put in place the basic foundation for the nonbank financial sector. However, legal, regulatory and institutional weaknesses remain, constraining the further development of this sector. The cost of borrowing is high, and financial outreach is limited. The lack of long-term funding sources limits investment and constrains economic growth. There are few savings instruments and insurance products. Further, weak governance and the absence of an effective anti–money laundering system undermine the stability of the financial system and investor protection. The Government must address these weaknesses and develop an efficient, broad-based, and well-governed financial system to promote investment and create employment opportunities.

8. The benefits of economic growth are not evenly distributed, as indicated by income inequality and persistent poverty. Thirty-six percent of Mongolians are poor. High unemployment (14.2%) and underemployment due to a mismatch of skills are main causes of poverty. The services sector is the leading source of employment in Mongolia, followed by agriculture and industry.

9. After averaging 4.6% from 2001 to 2003, Mongolia's inflation rate was 10.6% in 2004 and peaked at 16% in May 2005, higher than the Bank of Mongolia's (BOM's) target rate of 6% for 2005.[4] Mongolia's double-digit inflation is caused by both cost-push and demand-pull factors. The cost-push factors are higher oil import prices, supply and distribution problems in the meat market, and increases in administered prices (though long overdue). The demand-pull factors are loose monetary policies particularly during the first two quarters of 2005 (compared with 2004). Money supply (M2) increased by 19.3% in the second quarter of 2005. Net bank credit grew 30% in January to May 2005, with strong demand for credit from the mining, construction, and trade sectors. BOM's monetary policy in the first two quarters of 2005 was not aggressive enough to neutralize the excess M2 liquidity (beyond BOM's targets). Placements of central bank bills have not changed in volume, and rates on the bills have dropped as a result. A tighter monetary policy, particularly through open market operations and higher reserve requirements for banks by the end of 2005, is expected to cool inflationary pressures.

10. Supported by favorable terms of trade—particularly commodity prices for copper, gold, and cashmere—as well as better-than-expected gold production volumes and strong capital inflows from invisibles,[5] the current account shifted to a small surplus of 2% of GDP in 2004, from a deficit of 7¾% in 2003. The external debt of $1,360 million at the end of 2004 and $1,434 million in May 2005 was 90.9% and 88.6% of GDP, respectively. Since a significant portion of this debt consists of long-term loans contracted on concessional terms, debt levels remain manageable with a debt service ratio of 7.5% in 2004.[6] This augurs positively for the country's balance of payments, which improved in 2004 and remained comfortable up to the second quarter of 2005. Net international reserves were $163.5 million at the end of 2004 and $183.9 million in March 2005. The target of $230 million for the end of 2005 should be attainable provided BOM strengthens its monetary policy (para. 9) and the Government its fiscal policy (para. 11). Mongolia's future balance-of-payments position is still contingent on its terms of trade.

11. Satisfactory revenue collections, coupled with improved controls on expenditure in 2004 and the first 5 months of 2005, helped to keep the fiscal deficit to 2.5% of GDP in 2004 and almost maintain fiscal balance between January and May 2005. This deficit is below the IMF's Poverty Reduction and Growth Facility (PRGF) target of 6%. In the second half of 2005 both expenditure and revenues are likely to exceed budget projections. The 2005 fiscal deficit is therefore expected to be contained at 2004 levels, as is necessary for macroeconomic stability. The fiscal deficit is expected to be 3.5% of GDP in 2006 and is likely to be contained thereafter. The fiscal deficit can be controlled with the help of policy measures outlined in the GRPII loan including: (i) expenditure-saving and efficiency-enhancing financial governance reforms, (ii) civil service reforms comprising employment and compensation reviews to improve efficiency and savings, (iii) pension reforms, (iv) programs improving the targeting efficiency of social benefits, and (v) improvements in publicly funded education and health services.

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[4] Source: IMF's 2005 Article IV Consultation Mission's Concluding Statement. June 2005.

[5] Comprising tourism receipts, remittances from Mongolians employed abroad, foreign direct investments, and loan and grant disbursements from donors.

[6] The country's short-term commercial debt at the end of 2004 was negligible.

12. Mongolia's overall macroeconomic environment appears reasonably stable and conducive to the realization of the goals of GRP II.

III. THE PROGRAM

A. Background

13. Mongolia managed its transition reasonably well until the mid-1990s. By 1995, its real GDP was growing by 6% and the fiscal deficit had been brought down to 7% of GDP. However, these initial gains were not sustained between 1995 and 2000 because of the country's narrow economic base and fiscal indiscipline.

14. The fiscal deficit increased from 8% of GDP in 1996 to 14% in 1998. This fiscal profligacy was attributable to (i) full devolution of expenditure responsibilities to lower tiers of government without adequate accountability and checks and balances at the central and local treasury levels, (ii) poor revenue collection and administration, and (iii) soft budget constraints in its public sector in a pluralistic transitional state. ADB and the Government recognized the need for fiscal governance reform to sustain growth.

15. The Government therefore sought ADB's support through GRP I in strengthening public sector administration and financial management according to ADB's country operational strategy (para. 2). GRP I provided a 10-year governance reform roadmap toward a new sound, transparent, and accountable system of public sector financial management. Its milestone was the enactment of the PSMFL (para. 2), whose provisions were implemented on a pilot basis in five major public service entities.[7] Line ministries and budgetary agencies other than those covered by GRP I could not implement these reforms. Given the success of GRP I and the unfinished agenda (with its adjustment costs), it was decided to implement the PSMFL-related measures on a wider scale, keeping in view the lessons learned. Successful nationwide implementation of the PSMFL was seen to be necessary for the sustainability of governance reforms. GRP II's goal and scope (para. 2) conformed to this broader agenda.

B. Program Implementation

16. The Ministry of Finance (MOF)[8] was the Executing Agency (EA) for GRP II, with specific responsibilities for implementing PSMFL-related measures, public sector financial management reforms, and social security reforms. MOF formed a program implementation unit for this purpose.[9] The cabinet secretariat (CS) was the Implementing Agency for local government and civil service reforms and for the anti-corruption component. Given the complex issues involved and their crosscutting ramifications, the Government created an inter-ministerial steering committee under the chief of CS and comprising the ministers of finance, social welfare, and labor and representatives of the prime minister's office. On 25 February 2004, the Prime Minister signed a resolution creating a working group under the steering committee to advise and support CS and MOF in implementation. The working group was chaired by the deputy chief of MOF and comprised representatives of CS, the heads of the fiscal policy and accounting and auditing departments of MOF, and the head of administration of the National Audit Office (NAO).

[7] These were: (i) General Department of National Taxation, (ii) Customs General Administration, (iii) National Office Audit, (iv) State Service Council, and (v) National Statistics Office.
[8] The Ministry of Finance and Economy (MOFE) became the Ministry of Finance in August 2004.
[9] MOF formed this unit in March 2004 and reorganized it in September 2004 to expedite project implementation.

17. The implementation of GRP II was delayed at the start by coordination problems between MOF and line ministries in the implementation of PFMSL. These initial delays were exacerbated by the June 2004 elections, which resulted in a hung parliament. It took more than 4 months for the new government to be formed. Inevitably, there were changes in the bureaucratic establishment, and these further delayed decisions. However, since January 2005, the Government has been coordinating more closely its actions required under the program to address these problems.

18. The Loan Agreement provided that GRP II would be implemented from October 2003 to December 2005. The 2004 elections and the change of government (para. 17) delayed the appointment of the project coordinator and the recruitment of consultants. The project director was appointed in September 2004 and the consultants were recruited and fielded in November 2004. Implementation has since proceeded expeditiously and all the tranche release conditions are expected to be complied with fully by December 2005, within the Program's original schedule.

19. The Government has made significant efforts to meet the objectives of GRP II of (i) enhancing institutional capacity by strengthening the governance norms for strategic planning and budgeting in the health, education, and welfare sectors; (ii) improving fiscal sustainability through pension reforms and administrative consolidation; and (iii) mainstreaming governance reforms by improving the quality of the civil service and strengthening confidence in key public institutions. The Government has complied fully with all the 10 conditions for tranche release. It has complied fully with six and partially with eight monitoring conditions, and is making efforts to comply with the remaining six. The table below summarizes the status of compliance with the conditions for the second tranche. The detailed status of compliance with all program conditions is given in the Appendix. Paras. 20–64 after the table (below) report on the Government's progress in meeting the objectives of the program loan.

Second Tranche Release Conditions

Policy Matrix Ref. No.	Policy Condition	Status of Compliance	Comments/ Recommendations
4	Strategic business plans (SBPs) for 2004–2006 acceptable to Asian Development Bank (ADB) will be finalized for the Ministry of Health (MOH); Ministry of Science, Technology, Education, and Culture (MOSTEC); and Ministry of Social Welfare and Labor (MSWL).	Complied with.	ADB received the SBPs (in English) in August 2005 and found them satisfactory (para. 21).
14	MOFE (Ministry of Finance and Economy) will (i) design an examination structure and exam review courses, and develop continued professional education requirements to certify Government accountants; and (ii) conduct the first exam.	Complied with.	Under the existing Law on Accounting and Public Sector Management and Finance Law (PSMFL), Ministry of Finance (MOF's)[a] accounting policy and methodology division has designed an examination structure, reviewed the course, and developed continuing professional education requirements for the certification of government accountants. The first examination under the revised course was held on 22 November 2005 (para. 41).
17	National Audit Office (NAO), as part of its work program under PSMFL, will audit financial statements of (i) MOSTEC, MOH, and MSWL; and (ii) one province on a pilot basis.	Complied with.	NAO has audited the 2003 and 2004 financial statements of MOSTEC, MOH, MSWL and selected provinces, and has published its audit summaries in newspapers (para. 44).

Policy Matrix Ref. No.	Policy Condition	Status of Compliance	Comments/ Recommendations
22	MOFE will submit to Parliament amendments to the Law on Auditing to (i) modify the certified public accountant (CPA) certification process in line with the completion of different stages of the CPA examinations, with a title CPA-I given those who complete the first stage of 2 years; CPA-II for the second stage of 5 years; and CPA-III for completing the third and final stage of examinations; and (ii) issue license to audit only for those who have completed CPA-II, upon ensuring that the candidates are examined, and qualified, on their understanding of International Accounting Standards (IAS) and international standards of auditing.	Complied with.	Article 14 part 3 of the revised draft amendment to the Law on Audit covers (i); Article 30 of the same draft covers (ii). These revised draft amendments were submitted to parliament on 28 October 2005 (para. 41).
25	MSWL will disseminate the white paper for stakeholder consultations and finalize the reform measures to ADB's satisfaction.	Complied with.	MSWL disseminated the white paper for stakeholders' consultations in November 2003. The paper's contents were in accordance with ADB's pension reform goals under the Program (para. 51).
26	Cabinet Secretariat (CS) and MOFE will draft a concept paper on administrative consolidation within and between provinces to improve public expenditure management and achieve economies of scale in service delivery. A framework will consolidate (i) contiguous provinces on a selective basis, (ii) selected districts within the same or other provinces, and (iii) selected public sector agencies and institutions in the selected provinces and districts.	Complied with. .	The Government finished drafting the concept paper in April 2005. The paper's framework consolidates contiguous provinces, districts, and selected public sector agencies and institutions (para. 54).
28	NAO, with advisory support from the international advisor to NAO, will undertake performance audits of selected functions and outcomes of Customs General Administration (CGA), General Department of National Taxation (GDNT), MOSTEC, MOH, and MSWL, and publish a summary of the audits in major newspapers.	Complied with.	NAO undertook the performance audits of MOH, MOSTEC, CGA, and GDNT for 2004, and published its audit summaries in newspapers (para. 44).

Policy Matrix Ref. No.	Policy Condition	Status of Compliance	Comments/ Recommendations
30	Government Service Council (GSC) will (i) adopt an enforcement mechanism to implement the rules on selection of candidates for senior civil servant positions, as adopted by Parliament, and the grievance/dispute settlement mechanism for settling civil servants' grievances/disputes; and (ii) submit, as part of GSC's regular annual report from GSC to Parliament, an assessment of the enforcement outcomes.	Complied with.	GSC has adopted an enforcement mechanism to implement the rules for the competitive selection of candidates for senior civil service positions and for grievance settlement. GSC submitted to parliament in June 2005 a report containing an assessment of enforcement outcomes (para. 57).
33	Cabinet Secretariat (CS) and the National Council on Anticorruption (NCAC) subgroup, with support from United Nations Development Programme (UNDP) and ADB, will submit and make publicly available a comprehensive report on the role, performance and efficacy of the CGA, GDNT as well as service delivery mechanisms in the education and health sectors with proposed remedial measures, based on the subgroup's assessment.	Complied with.	The subgroup was established by NCAC and CS in January 2005. It prepared its report in August 2005 and made it available to the public on 31 October 2005 (para. 62).
35	MOFE will allocate a minimum of $500,000 in each annual budget during 2004–2006 for social safety nets to mitigate adverse impacts of GRP-II reform measures.	Complied with.	The Government's 2003, 2004, and 2005 budgets contained these provisions (para. 64).

ADB=Asian Development Bank; CGA=Customs General Administration; CPA=certified public accountant; CS=Cabinet Secretariat; GDNT=General Department of National Taxation; GSC=Government Service Council; IAS=International Accounting Standards; MOF=Ministry of Finance; MOFE=Ministry of Finance and Economy; MOH=Ministry of Health; MOSTEC=Ministry of Science, Technology, Education, and Culture; MSWL=Ministry of Social Welfare and Labor; NAO=National Audit Office; NCAC=National Council on Anticorruption; PSMFL=Public Sector Management and Finance Law; SBP=strategic business plan; UNDP=United Nations Development Programme.

[a] The Ministry of Finance and Economy (MOFE) became the Ministry of Finance in August 2004.

Source: Government of Mongolia.

1. Enhance Institutional Capacity

a. Implement PSMFL-Related Reforms

i. Strategic Planning

20. Mongolia's public administration system faced several challenges. These ranged from logistics and other organizational problems to a lack of transparency, poor accountability, and the multiplicity of agencies, hindering the efficient delivery of public sector output. The PSMFL sought to base sectoral budget appropriations on output. However, poor understanding of outputs among government ministries and provincial administration made it difficult for the Government to (i) define and appropriately cost outputs, and (ii) link sector policies with specific

outputs and outcomes that could be monitored. Hence, output-based budget reforms could not be implemented. ADB's GRP I required selected central ministries to formulate strategic business plans (SBPs). This was before the enactment of PSMFL. With the passage of PSML, the central ministries had to move from policy formulation and coordination to overall sector management, but they had difficulty redefining their post PSMFL roles. GRP II would assist three ministries—the Ministry of Health (MOH); the Ministry of Science, Technology, Education, and Culture (MOSTEC); and the Ministry of Social Welfare and Labor (MSWL)—in preparing new SBPs compatible with PSMFL and based on output costs (and not on line budgets), and of a standard acceptable to ADB. In a related move, MOF was required to convene a working group comprising state secretaries from MOH, MSWL, MOSTEC, the Ministry of Justice and Home Affairs (MJHA), and the Ministry of Infrastructure. The group would assess the implementation of PSMFL, determine how well the three ministries understood output-based budgeting, and submit its findings and recommendations to the cabinet. MJHA was brought into the picture to ensure that PSMFL did not create legal bottlenecks in existing statutes.

21. As required, MOSTEC, MOH, and MSWL prepared 3-year SBPs for 2005–2007. MOSTEC's SBP was completed on 7 February 2005, MOH's on 4 April 2005, and MSWL's on 4 July 2005. The 2004 elections delayed the finalization and approval of these SBPs. The Government has emphasized that the building of capacity within ministries to formulate SBPs is a long-term process, and is using its own resources and donor assistance for this purpose. Nonetheless, ADB found the SBPs (in English), which were submitted to it in August 2005, to be comprehensive and to have provisions for further changes in strategies if circumstances change. Most importantly, the SBPs showed that the three ministries had begun to move to output-based costing.

22. MOF coordinated a working group as required (para. 20). The reports submitted by the working group to the cabinet in March 2004 and March 2005 recommended important improvements in PSMFL implementation. The recommendations of the March 2005 report (in English) were submitted to ADB in July 2005 and were found satisfactory. The March 2005 report showed that the three ministries now understood the PSMFL, and the application of the law posed no legal obstacles.

ii. Output-Based Costing and Budgeting

23. GRP II recognized that output-based costing needed to be strengthened at all levels to enable budgetary bodies to base their portfolio appropriations estimates on output, according to the PSMFL. Output-based budgeting called for a totally new type of thinking. MOF, MOH, MOSTEC, and MSWL had to assess the output costs of their respective portfolios and to agree on quantitative norms for benchmarking the costs. The ministries also had to finalize to ADB's satisfaction (i) methods for specifying output and formatting costs for their reports, and (ii) standards for monitoring budgetary utilization against outputs.

24. The three ministries have responded at a varying pace to the requirements. MOH, which had drafted guidelines for hospital service costing and output-based budgeting in the health sector under ADB's Health Sector Project,[10] was able to test an output-based budgeting system in June 2005 and to finalize it in September. MOH discussed its new budgeting system at an international consultative meeting on health financing and insurance organized by the World Health Organization in Mongolia in July 2005, and used suggestions from the participants to further improve the system. However, MOH's transition to the new system (from line-based

[10] ADB. 2003. *Technical Assistance to Mongolia for Health Sector Reform Project*. Manila.

budgeting) could take 3–5 more years, particularly since some health service providers still do not agree with the ministry's output specification and costing methods. (Sunk costs, variances, and overheads were treated differently under central planning.) MOH also has no system to monitor the use of budgetary allocations against specific outputs. Such a system could take another year (up to the end of 2006) to develop. Meanwhile, MOH will continue to use its line-based budget as a temporary benchmark for monitoring budget use.

25. MOSTEC in contrast has developed (i) output specifications, a costing methodology, and delivery report systems; and (ii) standards for monitoring the use of budgetary allocations against specified outputs. MOSTEC was able to develop such systems faster with the help of consultants under the Public Sector Administration Reform Program (PARP) TA.[11] MOSTEC expects to pilot-test its new system in November 2005 and to implement it fully in 2006.

26. MSWL is now working on output costing methods and reporting formats with the help of ADB's consultants under its TA loan (para.1), and expects to complete this task in early 2006. In 2007, MSWL plans to begin measuring the use of budgetary allocations against specified outputs. MSWL has been hampered by staffing and budgeting problems and by its inability to benefit from technical assistance in the way that MOSTEC and, to a lesser degree, MOH did.

27. Thus far, only MOSTEC has assessed output costs, but it will establish proposed quantitative benchmarking norms only in 2006. MOSTEC, with the help of the PARP TA consultants (footnote 11), has developed output costing for kindergartens and secondary schools, but not all budgetary agencies in the education sector have developed output-based costing, given the newness of the concept to Mongolia. MOH has prepared draft guidelines for the costing of hospital services in Mongolia, and will finalize these after it receives feedback from the hospitals under its administration. Finalization may not begin until well into 2006 because MOH needs to get the health service providers to agree to its new norms (para. 24). The cost data will be used as benchmarks for future output costing and pricing. MSWL is still working on both requirements.

iii. Expenditure Discipline

28. An important objective of GRP II is expenditure control, which was a rationale of output-based costing and budgeting (paras. 23–27). The Government also realizes that it must encourage the ministries to reduce avoidable administrative expenditure and to use the savings for staff incentives and infrastructure upgrading. Accordingly, GRP II required the three ministries under MOF's guidance to jointly assess their administrative expenditures and agree on expenditure ceilings by 1 January 2005.

29. The consultative exercise between MOF and the three line ministries began only in September 2004. MOSTEC and MOH were able to establish internal definitions for administrative cost and to identify administrative expenditures with the use of their output-based budgeting technology, but they could not agree on ceilings. For MOF and MSWL, this process is still ongoing. The three line ministries still define administrative costs differently and could not agree on a common definition. An exercise to assess MOF's and MSWL's administrative expenditure for 2004 was begun earlier this year with the help of the strategic planning expert. The report is now being discussed. MOSTEC is trying to reach internal agreement on ceilings for administrative expenses and expects to do so by 1 January 2006. MOH, meanwhile, will be

[11] ADB. 2002. *Technical Assistance to Mongolia for Strengthening Public Sector Administration and Financial Management*. Manila.

using the output-based costing methodology to assess its administrative expenditure for 2006 and is expected to set a ceiling by 2007.

30. In a move toward fiscal consolidation, the Program also required MOF to report on (i) the impact of the quasi-fiscal and off-budget activities of budgetary bodies, (ii) the contingent liabilities of the Government and guarantees provided to state-owned enterprises and other budgetary bodies, and (iii) tax expenditure arrears in the budget. Resolution 101, which was passed in 2005 facilitated the introduction of a single treasury accounting system, ending the off-budget activities of budgetary bodies. The Law on Unified Budget, according to PSMFL, prohibits government guarantees favoring state-owned enterprises (SOEs) or budgetary bodies. MOF's treasury department prepares monthly, quarterly, and annual reports on budgetary expenditure arrears and submits these to parliament. The general department of national taxation (GDNT), on the other hand, prepares quarterly and annual reports on tax arrears. The Government's budget, however, is still cash-based. Once it has switched over completely to an accrual accounting system, as it is expected to do by 2009 (paras. 33–37), the Government can prepare its report on the past contingent liabilities of various budgetary bodies and SOEs (including government guarantees).

b. Strengthen Financial Governance Norms

i. Sound Oversight for Public Sector Accounting

31. The accounting policy and methodology department (APMD) of MOF is responsible for setting accounting policies and standards. Until recently, however, no department coordinated or supervised public sector financial accounting. To strengthen the financial management system and to facilitate sound financial reporting to the central Government and to Parliament, GRP II deemed it necessary to consolidate government accounts under centralized leadership and control. Accordingly, the Government was required to establish an independent accountant general (AG) position in the MOF and to set up an internal audit function under the AG with links to the positions of chief accountants in the portfolio ministries.

32. Through a cabinet decision in January 2005, the Government established the position of AG, with a certified public accountant (CPA) qualification, in MOF independent of the treasury department and reporting directly to the state secretary. The APMD was placed under the AG to avoid adding staff and increasing budgetary resources. In March 2005, an international accounting adviser to the AG was appointed, and financed from ADB's TA loan (para. 1). The Government is now drafting amendments to PSMFL to establish hierarchical links between the AG and chief accountants in the portfolio ministries, who, together with the internal audit heads of the ministries, will report to the AG. These amendments will be submitted to parliament in November 2005. The Government is also now recruiting the chief accountants. The AG's internal audit functions envisaged under the Program therefore have not yet been implemented. They are expected to be implemented after the chief accountants are appointed.

ii. Transition to Accrual Accounting

33. PSMFL requires all budget entities to generate accrual-based financial statements prepared in line with International Public Sector Accounting Standards (IPSAS), and MOF to consolidate these financial statements and prepare the overall financial statements of the Government also in accordance with IPSAS. This required the creation of IPSAS compatible charts of accounts on a pilot basis for selected ministries and the introduction of sound asset valuation standards (para. 38).

34. GRP II therefore required MOF to (i) finalize and submit to parliament a fiscal framework statement, (ii) formulate a methodology for medium-term expenditure planning on an accrual basis and issue it to all line ministries and budgetary bodies, and (iii) formulate and issue guidelines to all line ministries and budgetary bodies to enable the latter to finalize their portfolio appropriation estimates on an accrual basis, in line with PSMFL provisions.

35. MOF has formulated and submitted to parliament its medium-term fiscal framework for 2005–2007. In accordance with Decree No. 61 of March 2005, the fiscal framework is on an accrual basis. It is formulating the methodology for medium-term expenditure planning on an accrual basis for all line ministries and will issue it once it is completed.

36. The Program also required the Government, with support from ADB's TA Loan (para. 1), to implement a pilot program for the education and health portfolios to (i) develop an initial set of accrual-based accounts that would recognize receivables and payables at the end of each year, and (ii) create asset registers to support validation for costing.

37. With the help of a TA loan from the World Bank, MOF created a chart of accounts for MOSTEC and MOH in 2003. From the chart of accounts, pro forma accrual accounts for the two ministries, together with asset registers, were extracted. However, until the entire Government moves to an accrual accounting system, as it is expected to do in 2009 (para. 30), the two ministries' pro forma accounts cannot be integrated into the Government's overall system.

iii. Sound Asset Valuation Standards

38. Related to the Government's transition to an accrual system (para. 33–37), the Program required MOF's APMD to draft and adopt, with the help of international experts financed under ADB's TA Loan (para. 1), asset valuation standards for movable, immovable, and non-material (intangible) assets. This condition was established to facilitate assigning values to assets, as the basis for their depreciation once the Government moved over to an accrual accounting system. This would facilitate the creation of ministries' balance sheets and income statements according to IPSAS. This condition was complied with satisfactorily with the help of an international asset valuation specialist. The valuation standards, modified to suit Mongolia's circumstances, were valid and internally consistent.

iv. Enhanced Public Accounting Standards

39. ADB recognized that reform of Mongolia's financial governance norms needed an overhaul of its private sector accounting and auditing systems. Accordingly, GRP II (para. 40) required amendments to the country's Law on Audit to transfer the functions of regulation, supervision, and the licensing and training of accountants and auditors from the Government to the Mongolian Institute of Certified Public Accountants (MICPA). To provide for MICPA's independence, GRP II required its separation from MOF. The Program also required amendments to the Law on Audit to enhance entry standards into the auditing profession to improve the quality of audits. The Government separated MICPA from MOF. It did not, however, transfer the powers of supervision, regulation, and licensing of auditors to MICPA (para. 41–42).

40. The Program specifically required the Government to (i) draft amendments to the Law on Audit to strengthen entry qualifications and classification of accountants; (ii) design a new examination structure and conduct its first examination under this structure; (iii) translate International Accounting Standards (IAS) into Mongolian and extend the Law on Accounting to

enforce submission of financial statements; (iv) separate the MICPA from MOF and prevent government officials from serving on MICPA and amending the Law on Audit, to enable MICPA to monitor audit firms and investigate MICPA members; (v) amend the Law on Audit to abolish the Mongolia Professional Accounting Council and transfer from MOF to MICPA its functions of examination, licensing, and supervision of auditors; and (vi) submit to parliament amendments to the Law on Audit modifying the CPA examination process (dividing the course into three parts, issuing titles to candidates who complete each part, and issuing licenses only to those CPAs who have completed at least the second part).

41. To date, the Government has (i) translated IAS into Mongolian, (ii) separated MICPA from MOF, and (iii) designed a new examination structure and developed continuing professional education courses for accountants (under the existing Law on Accounting). The first examination under the revised structure was held on 22 November 2005. The Government submitted to parliament on 28 October 2005 amendments to its Law on Audit relating to (i) modification of CPA examination and certification, and (ii) issuance of audit licenses to qualified CPAs (para. 40).

42. The initial draft amendment to the Law on Audit calling for the transfer from the MOF to MICPA of the powers of supervision, regulation, and licensing of auditors was rejected by the cabinet. MOF argued that MICPA is still new and relatively inexperienced in self-regulation, and that therefore MOF should continue to supervise and license the auditing profession. It must be noted that in a number of developed countries, statutory bodies answerable to the legislature have been constituted to regulate and supervise the accounting and auditing professions. The concept of self-regulation of the accounting and auditing professionals has since ended in the G-8 countries. In the US the Sarbanes-Oxley Act (2002) created the Public Accounting Oversight Board to regulate the accounting and auditing professions (a role previously handled by the American Institute of Certified Public Accountants). Similar legislation for the oversight of the accounting and auditing professions was introduced in the UK and France. In these countries, it was argued that self-regulation could create conflicts of interest. Mongolia's MOF holds the same view for the Mongolian accounting industry, more so as the concepts of propriety and avoidance of conflict of interest are still in their nascent stages in Mongolia's accounting and auditing professions.

v. Enhanced Transparency in Financial Performance Auditing

43. The Program called for increased timeliness and transparency in the financial and performance audit of budgetary bodies. Mongolia's PSMFL mandates the NAO to undertake financial and performance audits of public sector agencies. This is to enhance public sector accountability. The Program required NAO (under PSMFL) to audit the financial statements of MOSTEC, MOH, MSWL, and one province on a pilot basis. The Program also required, with support from the international adviser under ADB's TA loan (para. 1), to undertake performance audits of the Customs General Administration (CGA), GDNT, MOSTEC, MOH, and MSWL and publish a summary of its audit findings in major newspapers.

44. NAO completed in 2004 the financial audit of the 2003 accounts of MOH, MOSTEC, MSWL, and selected provinces and published its findings in major newspapers. It undertook a similar exercise in 2005 for their 2004 accounts. NAO also undertook the performance audit of the 2004 accounts of MSWL, MOH, MOSTEC, CGA, and GDNT. A summary of the audit results was published in newspapers. NAO was able to achieve this deliverable on its own because it had already strengthened its audit capacity under earlier TAs from Deutsche Gesellschaft für Technische Zusammenarbeit of Germany (GTZ).

vi. Forward-Looking Measures to Improve Financial Management

45. The Law on Inspection, which was amended in 2003, established the State Professional Inspection Agency (SPIA) initially under the prime minister's office. SPIA absorbed all the inspection agencies under various line ministries. SPIA's core activities are the financial inspection of government budgetary activities. This is required under the PSMFL. But its track record in the first half of 2003 did not meet the PSMFL requirements.

46. The Program required the Government to undertake forward-looking measures toward financial management reforms. This applied specifically to reviewing the functions of the SPIA, particularly in financial inspection and in restructuring SPIA to ADB's satisfaction. The review objective was to ensure that each budgetary agency's internal control functions are strengthened.

47. SPIA was placed under the administrative control of the CS in 2004 to make it better able to meet its obligations under PSMFL. Restructuring the SPIA required an overhaul of the SPIA Law. Staff turnover in the CS following the elections was high. In July 2005, the Government started drafting a new SPIA Law compatible with PSMFL.

2. Improve Fiscal Sustainability

a. Strengthen Social Security System to Enhance Fiscal Sustainability

48. Mongolia's pay-as-you-go public pension system is a major fiscal burden. Pension payments were 5.1% of GDP in 2001. Mongolia initiated a funded pension scheme in 1999 for persons born after 1960. This scheme will take effect in 2010. The notionally contributed balances were to be converted into notional accounts to be privately managed. In 2003, this system, too, ran a deficit of 1.6% of GDP. Gender inequities in the pension system allowed men to retire at 60 and women at 55. However, many employees chose early retirement (average retirement age was 55 for men and 50 for women) and sought employment outside government while drawing pensions. This created an incentive for early retirement and increased the Government's fiscal burden, with a ratio of pensioners to population over 60 at 2:1. ADB and the Government recognized the need for pension reforms to improve fiscal sustainability.

49. The Program required the Government (with support from ADB's earlier TAs)[12] to undertake critical measures to enhance the fiscal sustainability of the social security system. By July 2004, MSWL was required to draft a white paper on pension system reform, focusing on the need to increase retirement ages, equalizing retirement ages for men and women, and creating inflation-adjusted pension indexes by revamping the notionally defined contribution system. The Program also required MSWL to disseminate by March 2005 a white paper for stakeholder consultations to ADB's satisfaction.

50. These two measures were critical for ensuring that the Mongolia's governance reforms did not create a fiscal imbalance. Further reforming the pension system from the pay-as-you-go model toward a clearly defined contributory system was intended to control future fiscal deficits. Increasing the retirement age for pension benefits was aimed at limiting further fiscal deficit. Equalizing the retirement ages for men and women would facilitate gender equality and (considering the number of women in service) help to reduce the fiscal deficit. At the same time,

[12] ADB. 2000. *Technical Assistance to Mongolia for Strengthening Financial Sector Development*. Manila; and ADB. 1997. *Technical Assistance to Mongolia for Social Safety Net*. Manila.

it was designed to increase investible savings supervised under a prudential regulatory system facilitated by ADB's Financial Sector Program loans.[13]

51. The Government's actions demonstrate its concurrence with the program goal. MSWL completed its first draft of the white paper in November 2003 containing its 10-year social security master plan and published it simultaneously in English and in Mongolian. This paper includes provisions for increasing the retirement age on a gender-neutral basis. In doing so it promotes gender equality and eliminates early retirement benefits, thereby strengthening fiscal prudence. It revamps the current notionally defined contributory system and indexes pensions to the inflation level. While socially desirable, the plan most importantly helps to reduce short-term structural deficits in the pension system. MSWL's white paper was circulated widely among stakeholders in November 2003 and after considerable dialogue with them through 2004 was adopted formally in March 2005. The paper's contents are consistent with ADB's goals for pension reforms under the Program (paras. 48–50).

b. Strengthen Public Resource Management Through Central-Local Consolidation

52. The Government embarked on a plan to develop five regional centers to redress regional imbalances and to distribute the population evenly. While eager for balanced regional development and equity in growth across regions, the Government also wants to avoid the duplication of hierarchic administrative layers that would be fiscally extravagant.

53. The Program supports the Government's intra- and inter-provincial consolidation and shares the Government's concerns about the need to avoid fiscal extravagance. Accordingly, the Program required CS and MOF, as a first step, to draft a concept paper on administrative consolidation within and between provinces to improve public expenditure management and achieve economies of scale in service delivery. The concept paper had to contain a framework that would consolidate (i) selected contiguous provinces, (ii) selected districts within the same or other provinces, and (iii) selected public sector agencies and institutions in the selected provinces and districts. The Program envisaged that such consolidation measures would be undertaken after public consultation among stakeholders of the contents of the concept paper. The consolidation should have public acceptance and should not disrupt the quality of or access to public services. Accordingly, the concept paper had to provide for social safety nets and other mitigating measures.

54. By presidential order dated 29 November 2004, a working group headed by the prime minister and comprising representatives from MOF, CS, and MJHA was established and tasked to develop a proposal to reform administrative and territorial units. By a prime ministerial order dated 18 January 2005, sub–working groups on (i) legal issues, (ii) socioeconomic studies, (iii) publicity and research, and (iv) internal public administration and territorial management were constituted as mandated to assist the working group with specific recommendations in their respective areas. With inputs from the four sub–working groups, the working group prepared a draft concept paper on intra- and inter-provincial measures to improve public expenditure management through increased efficiency and economies of scale in service delivery. Under this concept, as envisaged in the Program, the framework seeks to consolidate

[13] ADB. 1996. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for the Financial Sector Program*. Manila; ADB. 1996. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for Upgrading Skills and Systems of Commercial Banks*. Manila; and ADB. 2000. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for the Second Financial Sector Reform Program*. Manila.

contiguous provinces, contiguous districts within provinces, and selected public sector agencies and institutions. The working group chaired by the prime minister finished the first draft of the concept paper in April 2005 although the working group was formed as late as 29 November 2004, and the sub–working groups in January 2005. The Government is now engaged in consultation with the stakeholders who will be affected by the recommendations of the report.

3. Mainstream Governance Reforms

a. Enhance Civil Service Culture

55. The report and recommendation of the President for this loan noted that capacity constraints on performance and output-based management were exacerbated by fundamental problems faced by Mongolia's civil service. These problems included (i) absence of sound guidelines on recruitment and performance management, (ii) absence of transparency in hiring and firing of civil servants, (iii) lack of merit-based career-track civil service system, and (iv) lack of civil service governance resolution framework. Inevitably, the result was a highly politicized civil service where principles of merit were inconsequential for progression. This led to a high turnover ratio particularly at the senior level. GRPI introduced some basic reforms in the State Service Council. The State Service Council was renamed Government Service Council (GSC) in 2004 and is under the oversight of the prime minister's office. GRP II envisaged supporting measures to strengthen the GSC by establishing a sound information system on civil servants and their working conditions, with supplementing advisory services from the World Bank and ADB's earlier PARP TA (footnote 11).

56. The Program had a twofold approach to the problems faced by Mongolia's civil service. GSC was required to adopt an enforcement mechanism to implement the parliament's rules for the selection of senior civil servants and civil servants' grievance and dispute settlement mechanisms. GSC also had to submit an annual report to parliament assessing its outcomes. GSC was required to develop the criteria for civil servants' recruitment and a code of conduct for civil servants. This condition was intended to establish an objective and rule-based system with clear regulatory parameters, which GSC was required to monitor and enforce. To facilitate the implementation of the above two conditions at the national level, the Program authorized GSC to assess the performance of ministries and provincial administrations in line with GSC's evaluation requirements and to report its findings to parliament. GSC initially had to concentrate on selected ministries and provincial administrations, and later on all of them.

57. The Government has satisfactorily complied with the direction of civil service reforms. The PSMFL and the Law on Government Service (LOGS) provide for open and competitive selection of senior officials. GSC has set a working group to identify required skills for senior positions and procedures for recruiting suitable candidates for these positions. GSC has also developed a government strategy for internal controls and grievance resolution. GSC has adopted a mechanism for the competitive selection and recruitment of civil servants and bureaucratic grievance resolutions consistent with PSMFL and LOGS. GSC submitted to Parliament in June 2005 a report containing its assessment of enforcement outcomes.

58. The GSC, with ADB's technical assistance, has developed a draft of the criteria and code of conduct for civil servants. It submitted the draft to the Government in June 2005. However, the code has not yet been adopted, since GSC is still in consultation with civil servants over its recommendations.

59. Under the PSMFL, the Government has documented the archives of all government ministries and provincial administrations nationwide. As required under the Program, the Government's Resolution No. 42 of 2004 requires GSC to evaluate the performance of selected ministries every 4 years. GSC has so far concerned itself with the ministries' compliance with PSMFL. However, given its human resource constraints, GSC has not been able to cover all ministries and provincial administrations and reported this to parliament in February 2005. GSC will, however, cover different ministries every year to increase its sample for its survey.

b. Improve Public Confidence in Key Public Institutions Through Enhanced Transparency

60. In 2003, public confidence in GDNT and CGA was perceived to be low and public service delivery in the health and education sectors was poor. To address these issues, the Government established the National Council on Anticorruption (NCAC)[14] in 2003 initially under the prime minister's office. After the 2004 elections, it was transferred to the office of the speaker of Parliament.

61. The Program required the implementation of action plans formulated by NCAC to enhance transparency and accountability of public institutions. The Program warrants the constitution of a working group comprising NCAC, CS, and the United Nations Development Programme (UNDP) to assess comprehensively the (i) role, performance, and efficacy of GDNT and CGA; (ii) service delivery mechanisms in the education and health sectors;[15] and (iii) formulate the terms of reference for subgroups to undertake specific performance assessments in (i) and (ii) and design remedial measures. In its endeavor, the working group is required to seek participation from civil society, academe, parliament, and limited representatives from Government. After undertaking the above assessment, CS and NCAC, with UNDP and ADB's support, was required to make publicly available a comprehensive report on issues covered in (i), (ii), and (iii) above.

62. The parliamentary elections and the transfer of NCAC to the office of the speaker of parliament delayed the constitution of the working group. The working group was established on 1 January 2005[16] under a resolution of the speaker of the parliament. It is chaired by the vice speaker and draws its membership from CS, NCAC, and UNDP. It is mandated to strengthen the anti-corruption law. The working group has since reviewed the workings of CGA and GDNT, as well as service delivery mechanisms in the education and health sectors, and proposed remedial measures. A report was prepared by the working group in August 2005 and was made public on 31 October 2005.

4. Formulate Effective Social Safety Net Measures and Allocate Budgetary Resources for Them

63. The Program's forward thrust through fiscal and other consolidation measures sought to conserve the country's public financial resources. However, the Program also sought to ensure that none of its measures would adversely affect the country's poor and vulnerable. Therefore, the Program also required the Government to allocate at least $500,000 annually in its budget

[14] NCAC was set up with assistance from the United Nations Development Programme in 2002 under the Good Governance for Human Security Program and is currently headed by the speaker of parliament.
[15] This was a monitoring condition.
[16] This is because the outcome of the parliamentary elections outcome delayed the appointment of the speaker, under whose jurisdiction NCAC is placed.

from 2003 to 2009 for the creation of social safety nets to mitigate the impacts of reforms on the poor and the vulnerable.

64. The Government allocated $500,000 equivalent in its 2003, 2004, and 2005 budgets for social safety nets to mitigate any adverse impact of GRP II's fiscal reform measures. Pension reform is an important area targeted in the budget for this allocation (para. 51).

IV. CONCLUSION

65. The pace of reforms under GRP II gathered momentum after January 2005. The implementation of GRPII has been delayed by unforeseen political and other developments (paras. 4, 17, and 18). Supported by intensive ADB policy dialogue, the Government kept GRP II reforms on track.

66. The Government has fully complied with the 10 tranche release conditions (footnote 2). Of the 20 monitoring conditions, the Government has fully complied with six and partially complied with eight conditions, and is working toward complying with the other six (footnote 3).

67. While the Government of Mongolia has made significant progress in legal and institutional reform, it still faces challenges in putting in place the necessary political and bureaucratic establishment for its reforms. The Government has, however, assured ADB of its unwavering intent to comply with the remaining monitoring conditions.

V. THE PRESIDENT'S DECISION

68. In view of the substantial progress made by the Government of Mongolia in implementation of the overall program, and in complying fully with each of the 10 tranche release conditions, the President has authorized the release of the second tranche of the Second Phase of the Governance Reform Program Loan to Mongolia. In accordance with established procedure, the release of the second tranche in the amount of SDR6.107 million will be effected not less than 10 woking days after circulation of this Progress Report to the Board for information.

POLICY MATRIX
LOAN NO. 2010-MON: GOVERNANCE REFORM PROGRAM II
PROGRESS ON COMPLIANCE WITH SECOND TRANCHE RELEASE AND MONITORING CONDITIONS

Sub-Objective	Policy Matrix Conditions[i]	Status of Compliance
Enhance Institutional Capacity to Implement Budget, Output, and Financial Management Reforms		
A. Strengthen entity-level strategic planning, in line with PSMFL provisions	4. **Strategic business plans (SBP) for 2004-2006 acceptable to ADB will be finalized for the Ministry of Health (MOH); Ministry of Education, Science, Technology, and Culture (MOSTEC); and Ministry of Social Welfare and Labor (MSWL**).	**Complied with.** ADB received English translations of SBPs in August 2005, which were found to be satisfactory.
B. Improve midterm planning processes to strengthen public expenditure management	5. MOF and the three line ministries listed above will jointly assess their respective public sector administrative expenditures and agree on ceilings on such expenditures, to take effect from 1 January 2005.	To be complied with. MOSTEC and MOH were able to identify administrative expenditures based on their output-based budgeting technology but were unable to agree on ceilings thus far. For MOF and MSWL, this process is still ongoing. This consultative exercise between MOF and the three line ministries began only in September 2004. There are differences in opinions between the three ministries on the definition of administrative costs. The different ministries still use different definitions. MOH and MOSTEC were able to establish internal definitions for administrative cost but not MSWL. An exercise for assessing MOF's and MSWL's administrative expenditure of 2004 was begun in 2005 with the help of the strategic planning expert. The report is now being discussed. MOSTEC is working within the ministry to reach agreement on ceilings for administrative expenses. MOSTEC expects to reach agreement on a ceiling for administrative expenditure by 1 January 2006. MOH meanwhile will be using the output-based costing methodology to assess its administrative expenses for 2006 and is expected to set a ceiling in 2007.
	6. MOF and the three line ministries listed above will assess the output costs of their respective portfolios and agree on quantitative norms against which their outcomes can be benchmarked.	Partly complied with. Steering Committees to organize and monitor the work to be accomplished under ADB's TA Loan (Loan 2011-MON) and working groups to implement them under the guidance of the strategic planning expert were formed by each of the ministries. Output cost assessment was undertaken by MOSTEC. MOF's and MSWL's, output cost assessments have not yet been completed. For MOH, guidelines on costing of hospital service have been drafted. Feedback on the draft from the relevant agencies is awaited.

Sub-Objective	Policy Matrix Conditions[i]	Status of Compliance
	7. MOF will prepare a report on (i) impact of quasi-fiscal and off-budget activities of the budgetary bodies, (ii) contingent liabilities of the Government and guarantees against state-owned enterprises and other budgetary bodies, and (iii) tax and expenditure arrears in the budget.	Complied with. The Government (i) promulgated Resolution 101 passed in 2005 and (ii) enacted the Law on Unified Budget, pursuant to the Public Sector Management and Finance Law (PSMFL). The former facilitated the introduction of a single treasury accounting system under which off-budgetary activities of budgetary bodies have been terminated. The latter law prohibits the Government's provision of guarantees favoring state-owned enterprises (SOEs) or budgetary bodies. Reports on budgetary expenditure arrears are prepared by MOF's treasury department on a monthly, quarterly, and annual basis and submitted to parliament. The general department of national taxation (GDNT) prepares quarterly and annual reports on tax arrears. The Government's budget, however, still operates on a cash-based system.
	8. MOF will (i) finalize and submit to Parliament the fiscal framework statement for 2004-2006, (ii) formulate and issue the methodology for medium-term expenditure planning on accrual basis to all line ministries and budgetary bodies, and (iii) formulate and issue guidelines to all line ministries and budgetary bodies to enable the latter to finalize their respective portfolio appropriation estimates in line with PSMFL provisions.	Partly complied with. (i) MOF's 2005–2007 fiscal framework statement has been completed. and submitted to parliament. (ii) Decree No. 61, of March 2005 of the minister of finance was delivered to ADB. (iii) Decree No. 49, of April 2005 of the minister of finance, which complies with this condition, has been delivered to ADB. MOF is still to formulate the methodology for medium-term expenditure planning on an accrual basis for all line ministries.
C. Mainstream output-based budgeting by setting sound examples in key sectors	9. MOSTEC, MOH, and MSWL will finalize, to ADB's satisfaction, (i) the methodology for output specification and costing, and the formats for reporting the outputs and costs, in the education, health, and social sectors; and (ii) sound standards for monitoring the utilization of budgetary allocations against the specified outputs.	Partly complied with. (i) MOSTEC and MOH have completed the methodology for output specification and costing and format for reporting the output costs. These reports were submitted to ADB. MSWL has not yet completed the work. (ii) MOSTEC has developed the guidelines on indicators of budget allocations. MOH and MSWL are still working on them.
	10. MOF will (i) coordinate and convene a working group of the state secretaries of MOF, MOSTEC, MOH, MSWL, Ministry of Justice and Home Affairs (MJHA), and Ministry of Infrastructure (MOI) to assess the implementation of PSMFL; and (ii) submit lessons learned and recommendations to improve PSMFL implementation for the Cabinet's consideration.	Complied with. MOF coordinated a working group of state secretaries from MOH, MOSTEC, MSWL, MJHA, and MOI to assess PSMFL implementation and submit lessons learned thereon to the cabinet. These reports were submitted to the cabinet in March 2004 and in March 2005. An English translation of the March 2005 report was submitted to ADB in July 2005 and was found satisfactory.

Sub-Objective	Policy Matrix Conditions[i]	Status of Compliance
D. Establish sound institutional structures for effective public financial management	11. The Government, through a cabinet decree, will (i) establish the position of accountant general (AG) position at MOF with certified public accountant (CPA) qualifications, to be responsible for all ex ante financial planning and ex post financial reporting, and overall accounting responsibilities of the Government; (ii) appoint an international senior advisor to the AG with support under the TA loan for Capacity Building for Governance Reforms (CBGR); (iii) ensure that a qualified incumbent staff is nominated as chief accountant in each portfolio ministry and province; and (iv) establish a hierarchical link between the AG and chief accountants of portfolio ministries and provinces.	Partly complied with. (i) Position of AG was established in MOF. Functions to be performed by AG are included in the work plan of the accounting policy and methodology division (APMD). ADB was informed about this through an official letter from the state secretary of MOF dated 11 January 2005. The work plan was delivered to ADB. (ii) The international accounting adviser was recruited in March 2005. (iii) The Government is now recruiting qualified staff for the positions of chief accountants in portfolio ministries to report to the AG. (iv) The hierarchical link between the AG and chief accountants of portfolio ministries and provinces is incorporated in the Financial Statement Consolidation Manual for the Government of Mongolia, which is being developed by the accounting adviser under ADB Loan 2011-MON. These issues are also reflected in the amendments to be made in PSMFL and the Law on Accounting. Amendments to PSMFL will be submitted to parliament in November 2005.

Sub-Objective	Policy Matrix Conditions[i]	Status of Compliance
	12. Government, through a cabinet decree, will (i) establish internal audit functions under the AG's Office, accountable to the AG, led by the head of internal audit (HIA); (ii) coordinate the nomination of a qualified incumbent staff as an internal auditor in the portfolio ministries, including MOF, and provinces, reporting to the respective state secretaries and provincial governors; (iii) set up a hierarchical link between the HIA and internal auditors of portfolio ministries and provinces; (iv) ensure the AG formally defines the terms of references of internal audits in line with the operational standards issued by Institute of Internal Auditor (IIA); (v) ensure that the HIA obtains a government internal audit certificate by meeting all requirements of IIA; and (vi) set up continued professional education requirements for internal auditors.	To be complied with. (i) The AG position was placed under AMPD to avoid increasing staff. While simultaneously placing it outside MOF's treasury department (as was stipulated under the loan), the MOF proposes to amend the structure of HIA in parallel with AG and reporting directly to the state secretary. (ii) To be complied with. If internal auditors will be established in the portfolio ministries and in the provinces, this means increasing the staff in the Government, and thus increasing government expenditure. It would be difficult to establish simultaneously both AG and an internal audit unit. ADB and the MOF agreed to include the internal audit functions under the AG's oversight. (iii) To be complied with. Chief accountants in the portfolio ministries are yet to be appointed. Once appointed, they will report to AG. (iv) To be complied with. The duties of the internal audit unit (IAU) were included in the duties and responsibilities of APMD. Conditions (v) and (vi) are yet to be complied with.
	13. MOF will draft and submit to Parliament amendments to the Law on Accounting to strengthen the entry, qualification criteria, job classifications, and categories for the public accountants at the central and local ministries, governors' offices, and various budgetary bodies	To be complied with. The condition will be complied with when amendments to the Law on Accounting are submitted to parliament.
	14. MOF will (i) design an examination structure and exam review courses, and develop continued professional education requirements to certify Government accountants; and (ii) conduct the first exam.	**Complied with.** Under the existing Law on Accounting and PSMFL, MOFs accounting policy and methodology division has designed an examination structure under a revised course and has developed continuing professional education requirements to certify government accountants. The first examination under the revised course was held on 22 November 2005.
E. Support transition to implement accrual accounting on a pilot basis.	15. Government, with support under CBGR support, will implement a pilot program for education and health portfolios, aimed at developing (i) an initial set of accrual-based accounts that will recognize the receivables and payables at the end of each year; and (ii) registers for assets to support valuation for costing.	Complied with. MOF created a chart of pro forma accrual accounts for MOH and MOSTEC. Asset registers were extracted from the pro forma accrual accounts of the two ministries.

Sub-Objective	Policy Matrix Conditions[i]	Status of Compliance
F. Introduce internationally accepted asset valuation standards.	16. MOF's Accounting Policy and Methodology Department will draft and adopt asset valuation standards on movable, immovable, and nonmaterial assets (e.g., trademarks, copyrights, etc.), with the support of an international advisor under the TA loan for CBGR.	Complied with. MOF submitted the draft asset valuation standards developed by the international valuation expert (under ADB's Loan 2011-MON) to ADB.
G. Strengthen the public sector auditing and financial inspection framework	**17. National Audit Office (NAO), as part of its work program under PSMFL, will audit financial statement of (i) MOSTEC, MOH, and MSWL and (ii) one province on a pilot basis.**	**Complied with.** NAO has audited the 2003 and 2004 financial statements of MOSTEC, MOH, MSWL and selected provinces and has published its audit summaries in newspapers.
	18. The Government will review the functions of the State Professional Inspection Agency (SPIA), particularly in financial inspection, and restructure the agency to ADB's satisfaction.	To be complied with. Government has started drafting in July 2005 a new SPIA Law compatible with PSMFL to restructure SPIA.
H. Strengthen the policy institutional, legal and regulatory frameworks for private sector accounting and auditing.	19. MOF will (i) translate international accounting standards (IAS) into Mongolian to meet IAS guidelines; and (ii) revise the the Law on Accounting to prevent entities from paying penalties rather than submitting financial statements by enforcing submission of financial statements, in addition to penalties, and removing the requirement for quarterly certification of financial statements.	Complied with. (i) IAS have been translated and a copy of the translation was delivered to ADB. (ii) These issues are reflected in the proposed amendments to the Law on Accounting, which have been delivered to the Ministry of Justice and Home Affairs (MJHA).
	20. Government, through MOF, will (i) separate the Mongolian Institute of Certified Public Accountants (MICPA) from MOF and establish the institute as an independent organization from the Government; (ii) prevent government officials from serving as officers and management of MICPA; and (iii) amend the Law on Auditing to enable MICPA to conduct practice monitoring of audit firms and ethics investigation of MICPA members.	Partly complied with. (i) MICPA was separated from MOF; (ii) government officials no longer serve as MICPA officers; (iii) the Cabinet rejected amendments to the Law on Audit transfering the supervision of the auditing profession from MOF to MICPA (see condition 21).

Sub-Objective	Policy Matrix Conditions[i]	Status of Compliance
	21. MOF will submit to Parliament amendments to the Law on Auditing: (i) abolish the Mongolian Professional Accounting Council (MPAC); (ii) assign the CPA examination function to MICPA, including awarding CPA certificates; (iii) transfer licensing of CPAs and audit firms to MOF; and (iv) shift MPAC's training activities to MICPA.	Not complied with. The amendments to the Law on Auditing requiring (ii), (iii), and (iv) of this condition were rejected by the cabinet. MOF argued that MICPA, a nongovernment organization, is still relatively inexperienced in self-regulation. Hence, MOF needs to continue supervising and licensing the auditing profession. In a number of developed countries, statutory bodies answerable to the legislature have been constituted to regulate and supervise the accounting and auditing professions. The self-regulation of accounting and auditing professionals has ended in the G-8 countries. In the US the Sarbanes-Oxley Act (2002) created a Public Accounting Oversight Board to regulate the accounting and auditing professions (a role previously handled by the American Institute of Certified Public Accountants). Similar legislation for oversight of the accounting and auditing professions was introduced in the UK and France. In these countries, it was argued that self-regulation could create conflicts of interest. Mongolia's MOF holds the same view for the Mongolian accounting industry, more so as the concepts of propriety and avoidance of conflict of interest are still in their nascent stages in Mongolia's accounting and auditing professions. The revised draft amendments to the Law on Audit (Article 26) provide that the Government will supervise and license auditors.
	22. MOF will submit to Parliament amendments to the Law on Auditing to (i) modify the CPA certification process in line with the completion of different stages of the CPA examinations, with a title CPA-I given those who complete the first stage of 2 years; CPA-II for the second stage of 5 years; and CPA-III for completing the third and final stage of examinations; and (ii) issue license to audits only for those who have completed CPA-II, upon ensuring that the candidates are examined, and qualified, on their understanding of IAS and international standards of auditing.	**Complied with.** Article 14 part 3 of the revised draft amendment to the Law on Audit covers (i). Article 30 of the same draft covers (ii). These revised draft amendments were submitted to parliament on 28 October 2005.

Sub-Objective	Policy Matrix Conditions[i]	Status of Compliance
I. Reduce the short-term structural deficits in the pension system.	24. Using assessments prepared under ADB TAs to support financial sector development and social security sector reforms, MSWL will draft a white paper on pension system reform, focusing on the need to increase retirement ages (by eliminating early retirement privileges and equalizing the retirement ages of men and women), revamping the current notional defined contributory system, and indexing pensions.	Complied with. The white paper on pension reform was prepared by MSWL.
	25. MSWL will disseminate the white paper for stakeholder consultations and finalize the reform measures to ADB's satisfaction.	**Complied with.** MSWL disseminated the white paper for stakeholder consultations in November 2003. The paper's contents were in accordance with ADB's pension reform goals under the Program.
J. Consolidate intra- and interprovincial administration to achieve economies of scale and efficiency.	**26. CS and MOF will draft a concept paper on administrative consolidation within and between provinces to improve public expenditure management and achieve economies of scale in service delivery. A framework will consolidate (i) contiguous provinces on a selective basis, (ii) selected districts within the same or other provinces, and (iii) selected public sector agencies and institutions in the selected provinces and districts.**	**Complied with.** By presidential order dated 29 November 2004, a working group headed by the prime minister and comprising representatives from MOF, CS, and MJHA was established and tasked to develop a proposal for the reform of administrative and territorial units. By a prime ministerial order dated 18 January 2005, sub–working groups on (i) legal issues, (ii) socioeconomic studies, (iii) publicity and research, and (iv) internal public administration and territorial management were constituted as mandated to assist the working group with specific recommendations in their respective areas. With inputs from the four sub–working groups, the working group prepared a draft concept paper on intra- and inter-provincial measures to improve public expenditure management through increased efficiency and economies of scale in service delivery. Under this concept, as envisaged in the Program, the framework seeks to consolidate contiguous provinces, contiguous districts within provinces, and selected public sector agencies and institutions. The Government finished drafting the concept paper in April 2005.
K. Institute a sound framework to ensure that the public receive good value in return for utilization public sector resources	**28. NAO, with advisory support from the international advisor to NAO, will undertake performance audits of selected functions and outcomes of Customs General Administration (CGA), General Department of National Taxation (GDNT), MOSTEC, MOH, and MSWL, and publish a summary of the audits in major newspapers**	**Complied with.** NAO undertook the performance audit of MOH, MOSTEC, CGA, and GDNT for 2004, and published its audit summaries in newspapers.

Sub-Objective	Policy Matrix Conditions[i]	Status of Compliance
L. Enhance civil service performance	29. Government Service Council (GSC), with advisory support from ADB TA, will develop the criteria and a code of conduct for civil servants, and the Government will adopt the code	Partly complied with. Draft criteria and a code of conduct for civil servants were submitted to the Government in June 2005. The Government has, however, not yet adopted the code.
	30. Government Service Council (GSC) will (i) adopt an enforcement mechanism to implement the rules on selection of candidates for senior civil servant positions, as adopted by Parliament, and the grievance/dispute settlement mechanism for settling civil servants' grievances/disputes; and (ii) submit, as part of GSC's regular annual report from GSC to Parliament, an assessment of the enforcement outcomes.	**Complied with**. GSC has adopted an enforcement mechanism to implement rules for the competitive selection of candidates for senior civil service positions and for grievance settlement. GSC submitted to parliament in June 2005 a report assessing enforcement outcomes.
	31. GSC will assess (i) performance evaluation reports from selected ministries and provincial administrations to see if they are in line with the evaluation requirements established by GSC, and submit and make publicly available an overall performance evaluation report to Parliament; and (ii) the performance of all ministries and provincial administrations, and report the findings to Parliament.	Partially complied with. GSC has evaluated the performance of selected ministries and provincial administrations to determine their compliance with GSC's evaluation requirements as required under PSMFL and the Government's Resolution No. 42 of 2004. These evaluation results (of the selected ministries and provincial administrations) have been submitted to parliament. GSC has, however, not been able to evaluate the performance of all ministries and provincial administrations in the country and report its findings on all of them to parliament.
M. Implement the action plans formulated by the National Council on Anticorruption (NCAC) to enhance transparency and accountability in public institutions.	32. CS, in line with item 2 of the March 2003 action plan of National Council on Anticorruption (NCAC), and with support from the United Nations Development Programme (UNDP) and ADB, will (i) coordinate the establishment of a subgroup within NCAC's program, to comprehensively assess the role, performance, and efficacy of GDNT, CGA, and service delivery mechanisms in the education and health sectors, with participation from civil society, academia, and Parliament, and limited representation from the Government; and (ii) formulate the terms of reference for the subgroup, to undertake the performance assessments and design remedial measures.	Partly complied with. NCAC established in January 2005 the subgroup to assess comprehensively the role, performance, and efficacy of GDNT, CGA, and service delivery mechanisms in the education and health sectors. The subgroup completed its assessment in August 2005 and made public its findings on 31 October 2005. NCAC was not able to involve civil society and the academe in the subgroups.

Sub-Objective	Policy Matrix Conditions[i]	Status of Compliance
	33. CS and the NCAC subgroup, with support from UNDP and ADB, will submit and make publicly available a comprehensive report on the role, performance and efficacy of the CGA, GDNT as well as service delivery mechanisms in the education and health sectors with proposed remedial measures, based on the subgroup's assessment.	**Complied with.** The subgroup was established in January 2005 and its first interaction with UNDP began in February 2005. NCAC is directly under the speaker of parliament, whose appointment was delayed by the outcome of the elections. The subgroup established by NCAC completed its assessment of CGA and GDNT and the service delivery mechanisms in the health and education sectors with proposed remedial measures in August 2005, and made its report public on 31 October 2005.
	34. CS will start implementing the reform measures formulated by the NCAC subgroup.	To be complied with. Implementation of the subgroup's recommendations will begin in 2006.
N. Government to ensure that there are adequate budgetary provisions to support implementation of governance reform measures	**35. MOF will allocate a minimum of $500,000 in each annual budget during 2004-2006 for social safety nets to mitigate adverse impacts of GRP-II reform measures.**	**Complied with.** The Government's 2003, 2004, and 2005 budgets contained these provisions.

[i] Second tranche release conditions appear in bold.