

GOOD PRACTICE CASE STUDY

MONGOLIA: CAPACITY DEVELOPMENT IN PUBLIC FINANCIAL MANAGEMENT

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December 2004

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¹ This good practice case study is jointly prepared by EAP PREM and the Financial Management Anchor of the World Bank. Vera Songwe, Sr. Economist, EAP PREM first initiated the work and this was finalized in its current form by M. Mozammel Hoque, Sr. Financial Management Specialist of Financial Management Anchor. Parminder Brar, Ron Points, Saiyed Shabih Ali Mohib, Nancy Chen and Irene G. Verdu reviewed the draft and provided some useful comments. The final version was edited by Sheldon Lippman. The use of this document is restricted to World Bank's internal purpose.

ACRONYMS AND ABBREVIATIONS

FMS	Financial Management Specialist
GFMS	Government Financial Management Information System
IMF	International Monetary Fund
PFM	Public Financial Management

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I. BACKGROUND AND OBJECTIVES

1. This case study reviews the on-going efforts of the Government of Mongolia in moving to a results-focused high performing public sector that delivers quality services to its citizens. Public sector reforms in Mongolia include public financial management (PFM) and public administration reform supported by technical assistance and budget support of development partners. This study provides an overview of the reform program and discusses donor support for its implementation. It also outlines the key hurdles faced in implementing the reform agenda thus far, the main lessons learned, and challenges ahead.
2. Mongolia has a population of 2.5 million people of which 33 percent live below the poverty line. Mongolia has a per capita income of US\$440, making it one of the poorest in the region. With an area of 1.6 million square-kilometers, Mongolia is the least densely populated country in the world. Mongolia is a parliamentary republic governed by a new constitution enacted in 1992 after the fall of Communism. The president is the chief of state while the prime minister is the head of government. The country is administratively divided into 21 provinces and 1 municipality.
3. The PFM reform in Mongolia began in 1993. The main objectives of reform were to maintain aggregate fiscal discipline, allocate public resources in accord with strategic priorities, promote the efficient provision of services, and strengthen financial transparency and accountability. The Government aimed to institute a medium-term budget framework that links policy priorities with budget resources, improves budget comprehensiveness, rationalizes the system of norms procedures, introduces a Treasury Single Account system, and improves the reporting system. The Government intended to align fiscal and tax policies to achieve macroeconomic stabilization, financial sustainability, improved fiscal balance, expanded access to and improved quality of social services, and increased pro-poor orientation of public expenditures. These reform measures were grounded in the technical assistance provided by the World Bank, Asian Development Bank, and other donors. The World Bank is proposing to support PFM reforms under the umbrella of the poverty reduction strategy credit operation that is currently under preparation.

II. REFORM ENVIRONMENT

4. To address growing inadequacies in public sector management, the Government proposed the Public Sector Financial Management Law in 1997 as a major instrument for reasserting budget discipline. The adoption of the Law was the stepping stone to change the way the budget and treasury offices would function in Mongolia. While it was acknowledged that the scope and demands of the Law exceeded the existing capacity and infrastructure of Mongolia, Government's willingness to push this agenda forward was strong. Parliament stalled the law for almost five years largely because of disagreement to proposed intergovernmental arrangements that called for a reconcentration of core activities at the center. However, Parliament approved a new version of the Law that focused on improving financial management practices.² Issues of intergovernmental finance were not treated as exhaustively as in earlier versions.

² The new version of Public Sector Financial Management Law was passed by Parliament in June 2002.

5. **Supporting the Legal Framework.** Acknowledging capacity deficiencies in implementing the Public Sector Financial Management Law, the World Bank worked with the Government in improving current practices that comply with the Law's requirements. The choice to support and work with the Government allowed for easy consultation with the authorities and provided the donors with access to all parts of the Government. The Law became the centerpiece for all donors to engage with the Government and consequently played a strong role in harmonizing donor interventions around a coherent framework. In keeping with the Government's commitment to improve transparency, the Government is preparing a draft law on the use of contingency funds for parliamentary approval.

6. **Performance-based Budgeting.** The main thrust of the PFM reform calls for a gradual shift to performance-based budgeting. Other reforms within the government will require improved mechanisms for strategic priority setting; budget formulation and execution process; financial management systems; and capacity of the civil service. The main tenets of the Public Sector Financial Management Law are summarized in Box 1. To meet the Law's requirements, Mongolia must make fundamental changes in policies, systems, and processes. The ongoing World Bank assistance toward PFM reforms in Mongolia are designed to help the Government in bridging the gap between current practices and the new reform measures.

Box 1. Public Sector Reform in Mongolia: Main Tenets of Public Sector Financial Management Law

- Adoption of output-based budgeting, management and reporting by ministries/agencies,
- Adoption of accrual budgeting and accounting by ministries/agencies,
- Delegation of input management decisions to state secretaries and chief executives,
- Strategic business planning by ministries/agencies,
- Accountability of state secretaries and chief executives at the end of the year,
- Integration of current and capital budgeting,
- Preparation of appropriation estimates and annual reports by portfolio ministers, and
- Preparation of forecast accrual financial statements and annual accrual financial statements.

Source: Project Appraisal Document on a Proposed Credit to Mongolia for a Technical Assistance Project, Report No. 17460-MOG, Annex 11, World Bank, 1998.

7. **Overcoming Hurdles.** Overall assistance to PFM reforms was based on the findings of a 2002 Public Expenditure and Financial Management Review by the World Bank in collaboration and consultation with other donors. Implementation of a more performance-oriented public sector faces many hurdles. The capacity development projects supported by the World Bank and other donors are addressing these hurdles. With this assistance, the Government can identify and implement policies that improve systems and institutions to raise the quality of outcomes over time. Assistance also focuses on modifying institutional arrangements that foster cross-institutional dialogue, and instills a process of strategic resource allocation and disciplined policy choices.

8. **Sequencing an Action Plan.** A sequenced action plan based on recommendations of the Public Expenditure and Financial Management Review was agreed on with the Government. The World Bank also worked with the Government to further identify gaps in PFM capacity. This was done over a two-year period following an incremental approach by the Bank. The program started with focusing on financial management, improving treasury functions and cash management, and moving to the development of broad sector strategies with increasing allocative efficiencies. The Review provided the analytical basis for Bank's assistance to Mongolia. In accordance with the Economic Growth Support Poverty Reduction Strategy, the Bank advanced the reform agenda on two tracks. First, with an adjustment loan and a (Japan) Policy and Health Resource Development (PHRD) grant to prepare the loan, the Government began work on overall legislative and regulatory issues. Second, the Bank in close collaboration with the Government designed a fiscal technical assistance project (1998), followed

by an Economic Capacity-Building Technical Assistance Project (2003) to support the medium-term PFM reform agenda. The reforms initially concentrated in the Ministry of Finance and Economy and the Civil Service Council.

9. **Donors' Coordination.** All PFM reform issues were supported by the technical assistance provided by the coordinated effort of the World Bank, Asian Development Bank, and other donors. Working in concert with the Asian Development Bank, the Government of Mongolia took on an ambitious project to revise all laws governing PFM and adopt an output-based public sector management law. The IMF provided a treasury advisor to assist the Government on cash management issues. The World Bank in consultation with the IMF and the Asian Development Bank designed its first PFM project in 1997 to assist the Government in improving revenue, treasury, and debt management. In parallel the United Nations Development Programme and the Swedish International Development Agency provided assistance to upgrade public administration. The Asian Development Bank provided a governance reform loan, while the IMF put in additional technical assistance. In 2003 the World Bank prepared a follow up economic capacity-building technical assistance for further deepening PFM reforms. Measures related to macroeconomic stability will continue to be supported with assistance from the IMF.

10. **Civil Society Participation.** To improve civil society participation in monitoring and evaluating the budget process, the Government followed a wide consultation process with the civil society. To improve transparency, the Government has published the budget on the website managed by a nongovernmental organization.

III. MAJOR ACHIEVEMENTS

11. Although challenges remain, Mongolia made significant progress in macroeconomic adjustment in the early transition of the 1990s. However, at a later stage there was a general decline in public sector fiscal and policy discipline related to increased government employment and cash transfers and to ineffective state-owned enterprises. The problems were further compounded by inadequacies in public expenditure management, such as fragmentation of the budget and policymaking processes, and negative external conditions. By 1996, reasserting discipline over the budget and the civil service and improving basic financial management practices became crucial for Mongolia's long-term development agenda. The World Bank's program helped to improve the budget execution and reporting and align it more with international good practice.

12. **Strategic Budget Framework.** In keeping with requirements of the Public Sector Financial Management Law, the Ministry of Finance and Economy prepared a fiscal policy statement as a basis for the Cabinet and the Parliament to determine the aggregate 2003 and 2004 budget envelopes. The Government also adopted a medium-term budget framework for facilitating its strategic objectives. There are some weaknesses in the medium-term budget framework. One key issue is that the aggregate fiscal framework is not disaggregated into general governor-level ceilings. The World Bank is providing technical assistance to improve the fiscal policy statement and the medium-term budget framework. At the same time, work is being conducted on improving the internal audit procedures.

13. **Government Financial Management Information System.** The Government implemented a Government Financial Management Information System (GFMIS) in January 2005. The GFMIS links all 21 *aimags* (provinces) to the central treasury and covers all ministries, including the municipality of UlaanBaatar. Opening of treasury offices at the regional level facilitated government financial management and reporting practices and the transfer to the Treasury Single Account system. The Government also assigned dedicated information technology staff to carry out the maintenance and support functions for operating and managing core components of the automated systems. The GFMIS

will facilitate timely preparation of government financial reports from all portfolio ministries. This will ensure that audits can be conducted in a timely manner. As per the Public Sector Financial Management Law, the audit reports will be submitted to Parliament and made available annually to the public. The GFMIS will also facilitate relevant budget data availability to the Cabinet, donors, and other stakeholders. The Government is considering other related uses of GFMIS in improving the budget formulation process.

14. **Accounting Standards.** The Government has adopted the International Public Sector Accounting Standards and a uniform Chart of Accounts for use across government agencies. The new Government Financial Statistics system was also adopted to improve classification. The Government has also approved the International Accounting Standards for public enterprises, already adopted for all state-owned enterprises. Procedures for transferring accounting systems to the new International Accounting Standards have been initiated for improving financial management of entities at the regional levels. In addition, training of accountants is underway in all the local government regional treasury offices.

15. **Strengthened Accounting Functions.** The Government has strengthened the accounting department in the Ministry of Finance and Economy by providing technical assistance and training to staff and has developed a time-bound action plan to train agency-level accountants. Other changes needed to build basic accounting include establishing a new director of accounting in the Ministry of Finance and Economy, as well as line ministry positions for chief accountants, to provide leadership in financial management reforms and develop controllership functions.

16. **Strengthened Audits.** The Government recently adopted the State Audit Law and the State Inspection Law and issued regulations clarifying roles and responsibilities of audit bodies. The Mongolia National Audit Office was created in 2003 and assigned the role of conducting financial and performance audits of government finances. The Professional Control Office, established under the prime minister, will enforce the implementation of the Audit Law, oversee the Mongolia National Audit Office, and adopt systems-based audits as the dominant audit methodology government-wide. The Government has finalized the standardized operational methodology for public sector internal auditing. It is developing a comprehensive training program to upgrade auditing skills. In addition, the Government has committed to make all audit reports on the use of the contingency fund and other state reserve funds available to the public.

17. **Procurement Reforms.** The Government approved the revised Public Procurement Law for submission to Parliament and is implementing a time-bound action plan to streamline and strengthen the procurement processes. The Government has upgraded the status of the Procurement Policy and Coordination Division to that of a Department to strengthen its role in overseeing countrywide procurement through direct reporting to the minister. The procurement reform is being assisted by the World Bank and the Asian Development Bank. In the medium term, the Government is proposing to implement e-procurement and to link the procurement monitoring system with GFMIS.

IV. CHALLENGES AND LESSONS LEARNED

18. Lessons have been learned while challenges still face the Government on the design and implementation of PFM reforms in Mongolia. The summaries following encapsulate some of these lessons and challenges brought about by the Mongolian experience with PFM reform.

19. **Capacity Development and Change Management.** Capacity building has been a challenge on two accounts. First, the Mongolian management structure operated top-down and focused on the input-output approach. There was hardly any discussion of strategic resource allocations, little intra-agency

dialogue, and no focus on medium-term strategic planning. This meant that instituting the medium-term budget framework required significant change in management style and mindsets. The amount of change required of management was significantly underestimated by the donors (including the World Bank) and the Government. Second, staff turnover remains significant. The Mongolian civil service has too few technical staff, and the pay scale is low. Once adequately trained, technical staff tended to move to higher-paying private sector jobs or seek further education abroad. This meant that the trained staff needed were not available when actual operations began. These challenges still remain and pose a risk to the sustainability of on-going reforms. However, the risk is being mitigated (a) by providing more intensive and extended training to staff, and (b) by urging the Government to form teams that would receive capacity-building training. A lesson to learn here is to allocate more than sufficient resources for training.

20. **Long-term Engagement and Technical Assistance Support.** The World Bank and other donors are involved in long-term PFM capacity development in Mongolia. Implementing the policy, PFM reforms, and institutional capacity building will require medium- to long-term effort, points made most apparent when designing the technical assistance project.

21. **Promote Successes.** Government officials went on a field trip to Kazakhstan to see a functioning integrated financial management system. Seeing how a system operated in reality provided the momentum for the Government to push ahead with GFMIS implementation in Mongolia. In most countries, PFM reforms are at the core for improving control environment, accountability, and governance. Serious resistance is always expected from the vested interests that benefit from the current systems. In the case of the treasury single account system, for example, this thwarts the ability of the budget governor and budget managers to manage public funds on a discretionary basis. Accountability for the use of funds is enforced but in addition the notional authority of budget governors is curtailed through the use of the treasury single account. Implementation of such a reform is likely to face serious resistance. This resistance could be managed by showing some early wins. The case for building momentum for improving the PFM reform in Mongolia was demonstrated by implementing successful capacity building in revenue and debt management.

22. **Committed Counterpart with Dedicated Project Execution Responsibilities.** A strong committed counterpart and broad-based ownership of the program is required at all levels. Government commitment remains central to implementation success and especially the participation of major stakeholders. Equally important is the enthusiasm of the executing agency in meeting project objectives. When the agency does not consider the specific advisory service relevant to its perceived needs, implementation is less successful. In Mongolia, the Ministry of Finance and Economy provided a leadership role for improving PFM and took ownership for decisionmaking on project design and implementation. Consultants provided advice and skills transfer in key areas. The commitment by and ownership of the Government was supported by a dedicated project manager recruited by the Government to assist with implementation of GFMIS. This mix of ownership and sound project management came together to ensure the broader decisions were taken in a timely and effective manner. Prior to hiring the project manager, the Government was not aware of the technical and functional aspects of the system design that was being installed by the vendors. This information gap led to many impasses and was mitigated by the arrival of the project manager, who worked for the Government and independent of the vendor and knew the specification and broad system design issues. The relationship between the Government and the vendor improved significantly. The role of the project manager as a bridge between the vendor and Government was crucial.

23. **Functional and Technical Assessment.** As part of project design, functional and technical requirement for capacity building were identified. Headed by the State Secretary for Finance and comprising all concerned directors and vendors, a GFMIS steering committee provided strategic

guidance to the system implementers on requirements of the system changes and technological requirements, mapping of various stakeholders, and change management requirements. This steering committee also had the authority of operationalizing the decisions. Technical analysis provided an evaluation of the merits of different systems given the countries technology gaps and capacity constraints. All these were built into the project. Many problems encountered during implementation were addressed and solved at the very early stages of the project implementation with the findings of these analyses by the steering committee.

24. **Compatibility of Systems.** The PFM reform agenda covers a broad range. This is further complicated by multiple reform efforts progressing at a different pace with support from different donor agencies. As a result there is a danger of incompatible systems supported by different donors. For example, the systems put in the place for the banking sector may not be compatible with the treasury system. This incompatibility undermines the successful and efficient functioning of the systems separately and as whole and compromises and increases the cost of both projects. To help assure compatible systems are shared among all government agencies, an oversight agency of the Government should be made responsible for proper review of all systems before procurement.

25. **Right System Fit.** The Government of Mongolia opted for FreeBalance as its GFMIS software solution. This commercial off-the-shelf software is specifically designed to meet the needs of government and public sector entities but does require a degree of customization to fit the local environment (functional set-up, as well as language entries). There were two options: (a) Fit the packaged solution to the organization's current processes and procedures; or (b) fit the organization's procedures to the packaged solution. Mongolia chose a middle ground by customizing the software slightly and by altering certain organizational practices. The lesson here is that extremes on either side are not possible. Some well-thoughtout mix allows for effective software deployment without completely changing well-established organizational practices. Designing a PFM systems will require some reengineering and some incremental change. The challenge is to decide what mix, when is it necessary to implement, and how should it be done.

26. **Information Systems Capabilities and Technology Infrastructure.** While implementing GFMIS in Mongolia, some problems were identified. These were (a) lack of information technology capacity in Government to develop technical requirements and manage systems implementations; (b) lack of capacity to manage and sustain complex implementation, and maintain operational systems; and (c) lack of capacity to manage change in business processes and align internal business processes with the accepted international practices introduced by integrated systems. These capacity gaps were filled through the use of external consultants who conducted requirements analysis, developed technical specifications, and assisted in procurement. Additional consultants were brought in to manage the overall implementation and manage the change processes during implementation. Steps were also taken to supplement the information technology staffing in the Ministry of Finance and Economy to ensure adequate support for the GFMIS. Government has also agreed to allocate adequate resources and to staff appropriately the information technology function in the Ministry of Finance and Economy.

27. **Procurement Delays.** The GFMIS component of the fiscal technical assistance project went through three procurement tender processes spanning a period of 2 years. This caused major delays in the project and led to substantial government apathy for the project. Familiarity with procurement legislation, processes, and systems is crucial to ensuring success of the project.

28. **Capacity Development as a Process.** The PFM reforms program should be comprehensive in scope. In particular, PFM reform should not be considered as an end in itself but as means for the Government to achieve a broader development agenda, reflected in national policy documents such as the poverty reduction strategy and growth strategies and other development plans. It is important to

embed all PFM reform into a legislative agenda that provides an overall framework for engagement around which all partners can tailor their support. All PFM reform should include, as a necessary subset, reforms on budget formulation and oversight. The PFM agenda remains central to all the work undertaken in the World Bank and will remain so for a long time to come. This has implications for how institutions providing advice on PFM-related issues in order to continue being relevant.

29. **Post-System Deployment.** No matter how much the system hardware and software is tested, one can expect unanticipated problems when the system becomes operational. It is of utmost importance to ensure adequate on-ground support by the vendor and the project team at the time when the end-user gets to 'drive' the system. In this case, the Government is the biggest risk taker in new system deployment. If there is a problem with a system, Government needs to continue functioning and making expenditures. If the problem is not resolved in a timely manner, the old system may be reinstated and the new one labeled a failure. Therefore, problems must be addressed quickly and efficiently.

30. **Role of Financial Management Specialist.** The role of the Financial Management Specialist (FMS) is central for achieving results. With the increased emphasis on results, the potential for FMS work could increase. The Bank should develop subject specialists having cross-country and cross-regional experiences that prepares them to provide high-quality advice to clients.