CHAPTER 2. PUBLIC SECTOR FINANCIAL MANAGEMENT

PROGRESS AND CHALLENGES

Budget planning and execution

- The Public Sector Financial Management Law (PSFML) has been a major positive milestone for Mongolia’s public finances. It is a robust and internally consistent legislative framework, and contains all the key elements of a good public finance management system.
- Budget planning is underpinned by a clearly-defined legal framework, including the medium-term fiscal framework. It could also benefit from fuller integration of sectoral priorities, ODA, and local preferences. The PIP does not include foreign-financed projects, and does not provide the rationale for investment selectivity, thereby weakening the link between stated policy priorities at the sectoral and local level and realized expenditures.
- Mongolia has made significant headway in improving the budget execution system. Since the PSMFL was enacted, a functional Treasury Single Account has been established, a unified and consistent chart of account was implemented, an integrated debt management information system and an integrated government financial management information system were deployed, a country-wide electronic payment settlement system at the Bank of Mongolia was put in place, and a performance contracting framework has been operationalized across the government.
- Key internal controls surrounding the Government Financial Management Information System (GFMIS) are adequate, but they still need improvements. Additionally, these key internal controls should be reviewed periodically, at least yearly, to ensure that they are still functioning as designed.

Procurement

- The new Procurement Law enacted in February 2006 was a commendable improvement over previous legislation. However, a February 2007 amendment significantly altered the spirit of the law by allowing direct contracting and largely restricting international competition by significantly increasing the threshold for international competitive bids.

Audit

- The overall legislative framework is adequate for the Mongolia National Audit Office to effectively audit the Government. The biggest challenge is ensuring that the agency has the capacity to conduct robust financial audits.

Transparency

- In 2006, the Government made significant progress in disseminating some key budget documents and information. However, the PSMFL remains silent on disclosure of budget information.
**KEY FUTURE PRIORITIES**

**Budget planning and execution**

- Rationalize high level strategies and strengthen the links among different sectoral strategies, Official Development Assistance (ODA), Public Investment Program (PIP) and the Medium-Term Budget Framework (MTBF) by making the Public Investment Program the sole entry point for capital projects.

  - **Suggested “how to”:** The key government policy documents should be: (i) the Government Action Plan (GAP); (ii) the Socio-Economic Guidelines that translate the GAP into annual and rolling action plan; (iii) the MTBF which essentially sets the corresponding medium term (N+3) budget framework; and (iv) focus on developing medium term expenditure frameworks for sector ministries that take into account the GAP, Socio-Economic Guidelines, medium term budget framework, and then translates them into detailed sector expenditure plans. Currently sectoral medium-term expenditure frameworks are missing.

- Prepare a robust Public Investment Program with clarified selection criteria.

  - **Suggested “how to”:** Constitute an inter-ministerial working group led by the Directorate General for fiscal policy department to: (i) determine the medium fiscal space taking into account the budget momentum (i.e. medium-long term committed expenditures); (ii) investment needs across the sectors; and (iii) the government action plan.

- Review the efficacy of performance contracts at the Department levels as well as the use of strategic business plans at the Budget Entity Levels.

  - **Suggested “how to”:** Commission a review of the progress and challenges with implementation of performance contracts under PSMFL, with a focus on efficacy of each level of contracting. There is need for such a review to do a cost of compliance versus benefit from performance contracting for each level and present its findings to the Government for review and action. From the PER analysis it seems that there is limited real value of performance contracting at the department-staff level because it is difficult (if not impossible) to assign individual staff contribution to collective departmental outputs. This is similar for budget entity level strategic business plans, as it is most times difficult to separate budget entity strategic plans from the parent ministry action plans.

- Strengthen local horizontal accountability—between local government and service delivery units—while maintaining the existing centralized budget execution framework.

  - **Suggested “how to”:** Amend the PSMFL to include: (i) annual assessment reports of service delivery units from the provincial government to the parent ministries; (ii) mandate publication of performance reports of budget entities at the provincial level; and (iii) mandate publication at the local level total budget allocations and disbursements to service delivery units from central governments.

- Develop a Government-Development Partner action plan with steps and timelines for integrating ODA into country systems, and move towards more sector-wide approaches learning lessons from the successful donor coordination in the education sector.

  - **Suggested “how to”:** Constitute the MoF team by order of the Minister responsible for working with Development Partners to develop a phased plan for closing all special project accounts held outside the TSA and to migrate them to GFMIS. This MoF team should be led by the Treasury Department with representation of all concerned departments. The government should pre-announce this intention to all development partners and determine specific dated milestones for this migration plan.

- GFMIS controls around budgetary, system integrity, payment security, and system management should be improved upon and key internal controls should be reviewed, at least annually, to ensure they are still functioning as designed.

  - **Suggested “how to”:** Review the systems audit report from the recent Mongolia National Audit Office
of GFMIS and to develop respective regulations and system-fixes to address those concerns.

**Procurement**

- Withdraw the February PPLM amendment.
- Improve the integration of public procurement activities with the Government FM system.
  
  **Suggested “how to”:** Implement the Procurement Management, Monitoring and Information System and integrate it with the Government Financial Management and Information System.

- Develop professional standards for public procurement officers and design appropriate capacity building programs for those that do not meet them.

**Audit**

- Strengthen the capacity of Mongolia National Audit Office (MNAO) to conduct robust financial audits of GFMIS.
  
  **Suggested “how to”:** Parliament to provide sufficient annual budget for various training of MNAO staff and for MNAO to continue working on systems audit capabilities. MNAO could consider (i) having dedicated system audit teams to receive necessary continued training to perform this task and, (ii) instilling periodic internal examination of MNAO staff for consideration of promotions or demotions to improve the overall quality of MNAO.

**Transparency**

- Propose clauses for relevant laws for public release of budget information.
  
  **Suggested “how to”:** The Ministry of Finance has established a dynamic portal website. Now the Minister for Finance should issue a Ministerial Instruction not all concerned departments reporting to the Ministry of Finance to: (i) list all laws, decrees, regulations, and guidelines that determine respective departmental operations and to publish them on this MOF dynamic portal; and (ii) require departments to submit compliance reports on the same.

- Establish a regular forum during which the Government will present MBTF policies and proposed State Budgets to media and civil society organizations, around the same time that the policies are presented to Parliament.
  
  **Suggested “how to”:** As part of the budget preparation and approval process, the Minister for Finance should plan and pre-announce a timetable for discussing the executive budget proposal with media and civil society 2-3 weeks before this proposal is submitted to the Parliament. This is to ensure that there is appropriate time for modifying the budget proposal as necessary based on these consultations.
INTRODUCTION

2.1 This chapter highlights key developments in the public financial management (PFM) of public finances in Mongolia since 2003, along with the current challenges. The chapter analyzes issues faced by authorities and recommends ways of addressing issues that would improve the PFM of public finances.

2.2 This chapter covers four elements of public financial management: (i) the legislative framework, (ii) public finance planning and execution, (iii) oversight and adequacy of audit functions, and (iv) disclosure and transparency in public finances. These elements relate to the entire work-flow of the budget system at the aggregate level. This chapter examines these elements at the macro level. Sector-specific issues are covered in subsequent chapters of this report.

THE LEGISLATIVE FRAMEWORK

2.3 The legislative underpinning of public finance is the Public Sector Management and Finance Law (PSMFL, 2003) and the annual Budget Law. This Law applies to all levels of organizations and to fully and partly (with government ownership of 51 percent and more) centrally- and locally-owned legal bodies. The PSMFL was promulgated on January 1, 2003 and mandated the following key provisions:

2.4 Centralization of the intergovernmental fiscal management framework. Budget planning and execution authority was shifted away from provincial authorities. Responsibility for policy planning was vested with sectoral ministries and responsibility for overall budget planning and execution, as well as revenue policy and administration, with the Ministry of Finance. Provincial authorities were tasked with performing general administration. The PSMFL vested the authority to borrow (domestically and internationally) with the Ministry of Finance and clearly set out a centralized cash management framework.

a. Institutionalization of a medium term framework for budgeting. The PSMFL mandates the development of a medium term (three year) fiscal framework (MTFF) along with a deadline for submission of the fiscal framework to the Parliament (May 1). This MTFF should guide the formulation of the socio-economic guidelines and the State Budget. The Law also mandates that budget entities send multi-year budget requests to their respective sector ministries, and sets a clear timetable for preparation and submission of budget estimates to the Parliament. At the time of the submission of budget estimates, the Law also requires the government to submit a statement of fiscal risks, including risks which could result from decisions already taken by the Government, and any contingent liabilities.

b. Clarification of the roles and responsibilities of each level of Government, consistent with the intergovernmental fiscal relations framework. PSMFL is very clear on the roles and responsibilities of the Parliament, portfolio ministries, and state administrative bodies responsible for finance and budget. This includes the administration of bank accounts into which receipts are deposited and from which payments are made. The Law also lays down prohibitions for state budget entities, consistent with the overall financial responsibilities that are laid out in the Law (Article 14). PSMFL mandates a vertical accountability structure at all levels in the financial management framework.

c. Introduction of a comprehensive performance management framework across the public sector, at all levels. There is a vertical system of performance contracts mandated by the Law—individual staff with the division/department director, departmental director with
the state secretary, state secretary with the minister, and the portfolio minister to the Parliament. This accountability network is emphasized throughout the performance contracts. The Law mandates that the performance agreement needs to be concluded within one month of the approval of the State Budget by the Parliament. Further, the Law mandates the preparation of Strategic Business Plans for executing the Budget. The description of the strategic business plans in the Law (Article 26) is quite detailed, as are the timelines for submission of these plans to respective ministers (July 1) and to the Ministry of Finance (August 15). A similar framework is laid out for State Owned Enterprises (SOE), which submit their respective plans to the State Property Committee. At the same time, the Law requires Parliamentary bodies to provide advice to ministers on policy matters including regulations. Box 2.1 shows how performance management is practiced in Mongolia.

d. **Full accrual accounting mandate, with financial reporting to the Parliament**: The Law mandates extensive internal reporting on budget execution to the Parliament including: (i) operating statement; (ii) balance sheet; (iii) statement of cash flows; (iv) statement of changes in net assets; (v) statement of commitments and contingent liabilities; (vi) statement of accounting policies; and (vii) budget execution reports compared with appropriations. The Law also mandates that Government submit the financial statements for the entire government to the MNAO by March 20 (fiscal year runs from January – December) each year. The Law also requires the MNAO to submit the audit opinion to the Parliament within one month of receiving the financial accounts from the Government. Article 40 stipulates that all state budget entities must prepare financial statement on a semi-annual and annual basis, including balance sheets conforming to international accounting standards.

**A review of the PSFML implementation progress**

2.5 **The promulgation of the PSMFL has been a major positive milestone for Mongolia.** The Law has established a robust legislative framework for managing public finances. Overall, the legislative framework for public finance management in Mongolia is similar to that in New Zealand and Australia.

2.6 **Implementation of the PSMFL has been steady, with the Government making significant progress toward centralizing the intergovernmental fiscal framework and implementing a functional centralized cash management system**, with the provincial Treasury offices reporting vertically to the Ministry of Finance. Before 2003, the Mongolian public finance management system was fragmented and lacked operational fiduciary controls in budget execution. The Government was borrowing overnight to meet expenditure needs as there was no consolidated single account, and budget reporting was negligible. By 2007, the authorities had managed to implement a fully functional integrated budget execution system, addressed the problem of arrears, consolidated the government finances into a Treasury Single Account framework, and significantly increased budget reporting. The medium-term fiscal framework has also been established, and the Parliament uses this tool to approve aggregate macro-fiscal ceilings. The government has also instituted the performance management framework across the public sector (discussed in Box 2.1).
Box 2.1: Performance-based Management – Theory and Practice in Mongolia

A performance-based management framework is a systematic approach to improving service delivery effectiveness. This is achieved by establishing strategic performance metrics for agencies and departments; measuring performance by collecting, analyzing, reviewing and reporting performance data; and using this information to drive and reward performance improvement.

Within a performance-based management system, all levels of a Departmental work together to define requirements, establish desired results, and agree on management methods for measuring and evaluating outcomes. To this end, performance-based management encourages innovation and drives long-term performance improvement, must be able to respond to unique situations, and should establish appropriate accountability mechanisms. Performance-based management also prompts partnership, trust, and transparency which in-turn encourages innovation and creativity at all organization levels.

Performance management systems have been used successfully in the private sector for many years. In the manufacturing and service sectors, where it is possible to identify the quality and quantity of outputs, performance management has meant that individuals and units are provided resources to then deliver certain units of outputs of a certain quality. Indicators transparently monitor the performance of individuals and units. At the end of the performance assessment period, results are measured against the agreed targets, and individuals who perform well get bonuses while those who underperformed are penalized. As outcomes are easily verifiable in these situations, such performance agreements have helped improve the effectiveness of staff and processes.

In Mongolia, the government has instituted the performance-based management across the public sector since 2004. Strategic business plans and performance contracts are conducted from low-level management and staff to higher levels—Minister to Cabinet, State Secretary to Minister, Departmental Directors to State Secretary, Department Director to respective Division Directors and staff.

At the beginning of each year, personnel sign performance agreements with their supervisors. At the end of the year, supervisors discuss and appraise individual staff based their performance. It is good practice to have such a performance management system operational at the levels of Departmental Directors and State Secretary, and above. However, it is unclear what the benefit is of performance agreements between Departmental Directors and staff. This is because: (i) It is generally difficult to distinguish individual staff responsibilities in departmental tasks. For example, if there is a team of 4 staff tasked with developing the Debt Management Strategy, it is often difficult to enter into performance agreements with each of the staff for their part of the strategy. (ii) Financial incentives to reward good performance are often too small, and due to lack of staff HR control at the departmental level, it is not possible to take action against under-performers. (iii) During the year, staff is assigned tasks that were not originally envisaged, and therefore it is not possible to measure performance against pre-set targets. (iv) Developing performance contracts takes a significant amount of time and effort, especially at the lowest level, because most of the tasks are inter-dependent, so it is not possible to accurately isolate the sub-tasks that are assigned to specific personnel.

Therefore, it is recommended that the Government revisit the practice of performance agreements at the department-staff level and determine whether benefits of such performance agreements out weigh the costs. A review of the progress and challenges with implementation of performance contracts under PSMFL could be commissioned, with a focus on efficacy of each level of contracting. There is need for such a review to do a cost of compliance versus benefit from performance contracting for each level and present its findings to the Government for review and action. From this analysis, it seems that there is limited real value of performance contracting at the department-staff level because it is difficult (if not impossible) to assign individual staff contribution to collective departmental outputs. This is similar for budget entity level strategic business plans, as it is most times difficult to separate budget entity strategic plans from the parent ministry action plans.

Source: World Bank Staff

2.7 The Government has managed to implement a functional modified accrual system (commitment accounting without accounting for fixed assets). With regards to full accrual accounting (commitment and fixed asset accounting), the government has passed regulations governing fixed asset accounting, but there has been little progress in developing fixed asset
valuation accounting, depreciation procedures and recording of tangible and non-tangible assets. This is the reason that Mongolia has not been able to develop a government-wide balance sheet, as stipulated in the PSMFL. Clearly, valuation of assets is a skill-intensive task and it is understandable that Mongolia has not been able to make significant headway in this area because of human capital scarcity on asset valuation. However, the Government has recently started piloting fixed asset valuation.

2.8 **Two sets of amendments to the PSMFL are broadly contemplated.** The first set of amendments aims to increase the budget for local government community expenditures. The measure aims to provide resources for the provincial Governors’ offices to meet emerging needs of constituents. For example, an amendment passed in mid 2008 gives local government authority to retain revenues from personal income tax. The 2009 proposed budget provides new funding to local government for infrastructure maintenance. A second set of amendments aims to: (i) drop provisions relating to output based budgeting and service delivery reporting; (ii) drop performance contracting.

2.9 In the next sections, this chapter considers progress on budget planning, execution, reporting and transparency, and related issues. These sections will highlight issues pertaining to PSMFL and will lead to recommendations for aligning some provisions of the Law with: (i) implementation capacity; and (ii) cost-benefit analysis.

### Box 2.2: A Summary of the Public Sector Management and Finance Law Key Provisions

<table>
<thead>
<tr>
<th>Key Provisions</th>
<th>Status of Implementation</th>
<th>Recommendations</th>
</tr>
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<tbody>
<tr>
<td>A. Centralization of Intergovernmental fiscal management framework</td>
<td>Implemented. Ministry of Finance is fully responsible for Treasury functions and revenue policy and administration.</td>
<td>Ensure transparency in the budget planning process so that local government level is aware of the resource plans and flows.</td>
</tr>
<tr>
<td>B. Medium Term Fiscal Framework (MTFF) adopted to guide budget planning</td>
<td>Instituted. Government submits the MTFF to Parliament in May. Parliament discusses and approves aggregate macro-fiscal ceilings. Government prepares annual budget based on these approved ceilings</td>
<td>Develop robust medium term sectoral strategies to inform sectoral allocations as per the MTFF.</td>
</tr>
<tr>
<td>C. Centralization of policy formulation</td>
<td>Sectoral policy-making is now under the jurisdiction of respective sector ministries. However, formal roles for local government in policy making are not clear.</td>
<td>Enhance horizontal accountability within vertical control structure.</td>
</tr>
<tr>
<td>D. Performance management introduced across the public sector</td>
<td>The Government has implemented a performance contract system along with Strategic Business Plans for each budget entity.</td>
<td>Roll-out strategic business plans along functional lines, as recommended in Box 2.1.</td>
</tr>
<tr>
<td>E. Full accrual accounting mandated</td>
<td>The Government has implemented modified accrual accounting – commitment accounting, but no fixed asset valuation is in place.</td>
<td>Consider the efficacy of budget entity-level balance sheets, in view of limited capacity.</td>
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</tbody>
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**PUBLIC FINANCE PLANNING**

2.10 Since the promulgation of the PSMFL, the government has made progress toward improving the budget planning process. This section analyzes developments in budget planning in the medium term context, as well as in the annual budget process.
Fiscal planning – medium-term to annual

2.11 By far, the most important and positive development was the successful introduction in 2003 of a three-year MTFF, which provides strategic guidance into the annual budget process. The MTFF consists of a medium-term macro-fiscal outlook with revenue projections, an aggregate expenditure forecast by economic classification and the corresponding domestic and foreign financing. Based on the macro-economic projection and structure of revenue policy, the Ministry of Finance estimates domestic revenue and collects information from development partners on ODA for the medium term. Using these estimates, the Ministry of Finance allocates expenditure ceilings, with the primary objective of maintaining macro-fiscal stability. In recent years, the MTFF has set an overall budget deficit cap of 3 – 4 percent of GDP annually.

2.12 The budget preparation timetable is clearly laid out in the PSMFL and the Government has followed this timetable consistently. The Government submits the MTFF to the Parliament at the beginning of May each year, as stipulated in the PSMFL. The Parliament reviews and approves the aggregate macro targets and the overall budget deficit target. Upon approval (at the end of the spring session) by the Parliament, the Ministry of Finance starts preparing the annual budget in consultation with sector ministries and provincial governments. Once the aggregate expenditure ceiling is set, ministries and agencies can plan individual budget requests. The Ministry of Finance cannot breach the overall budget deficit target set annually by the Parliament, unless Parliament amends the budget. The Minister of Finance has the authority to reallocate funds within the aggregate ceilings, but not to exceed the overall ceiling without prior approval from Parliament.

2.13 Parliament reviews the MTFF and approves the aggregate expenditure ceiling, the overall deficit target, and the macro-economic parameters. After this approval, the Ministry of Finance commences discussions with sector ministries and provinces for finalizing the annual budget. The Ministry of Finance submits the draft budget proposal to the Cabinet in the middle of September. The Cabinet then considers the budget proposal, directs the Minister of Finance to make necessary amendments, and submits the revised proposal to the Parliament on October 1. The Parliament then considers the proposal and approves the budget by December 1.

2.14 The Government is putting in place a performance framework into the budget cycle. Performance budget proposals from the Ministry of Education, Culture and Science and Ministry of Social Welfare and Labor were piloted in the 2008 budget, and extended to all line Ministries in the 2009 budget preparation. Under a performance budget framework, resources are no longer based exclusively on inputs (e.g. salaries, operations and maintenance, capital expenditures) but based on programs which are expected to deliver planned outputs (i.e. public goods and services). The following steps are required to quantify the output:

1. Activities are identified for each output;
2. An indicator of performance is defined;
3. A quantitative or qualitative target for the performance indicators is set;
4. Expenditures are planned for each activity according to the desired output target;
5. Unit costs are estimated by dividing planned expenditures by the quantified target.

1 Source: Manual of procedures for the Medium-Term Budget Preparation, June 2008, Ministry of Finance, Mongolia
2.15 The introduction of the MTFF has been a positive step. The Parliament is now able to discuss overall policy issues and approve the aggregate budget ceilings three months before the annual budget is discussed by Parliament. There are however, certain areas that need to be further strengthened to improve the efficacy and effectiveness of the MTFF.

2.16 There is a need for robust sectoral strategies that would guide medium term sectoral resource allocations under the aggregate MTB level. The sectoral strategies are not adequately sequenced, prioritized or credible. Consequently, sectoral allocations are mostly incremental increases over the previous year’s actual expenditures. There are currently master plans for education and the health sector, and the respective agencies are now converting these master plans into medium term work plans. Once this is accomplished, it will be possible for the MTB to naturally incorporate sectoral strategies into the medium term resource allocations. In the education sector, the government is piloting aggregate ceilings for categories of expenditures, which allow sector ministries to allocate funds into component programs.

2.17 High-level strategies should be harmonized to better inform medium term resource allocations. Currently, Mongolia is developing a long-term National Development Strategy and an MDG-based growth strategy; these will be added to the list of high-level strategy documents, which includes the Socio-Economic Guidelines and the Government Action Plan. All of these strategies aim to strategically inform budget allocations. However, developing this many strategies taxes government capacity and causes the MTB to be pulled in too many ‘strategic’ directions. The result is that the status quo is maintained, with the MTB providing incremental allocations to sectors. The OECD 2006 Survey on Monitoring the Paris Declaration also indicates that the links between policy priorities and the budget are weak. The key government policy documents should be: (i) the Government Action Plan; (ii) the Socio-Economic Guidelines that translate the GAP into annual and rolling action plan; (iii) the MTBF which essentially sets the corresponding medium term (N+3) budget framework; and (iv) focus on developing medium term expenditure frameworks for sector ministries that take into account the Government Action Plan, Socio-Economic Guidelines, medium term budget framework, and then translates them into detailed sector expenditure plans. Currently sectoral medium-term expenditure frameworks are missing.

Box 2.3: Why a centralized public Budget management framework is appropriate in Mongolia

Back in 2002, some of the most important recommendations for Mongolia as highlighted in the Bank PEFMR at that time were to regain control over public resources by “recentralizing provisions of all public goods”, “introduce top-down budgetary process”, and “centralize policy-making role to line ministries”.

Since 2003 the budget management framework in Mongolia has been centralized. This means that the Ministry of Finance is responsible for collecting almost all revenues and providing approved budget appropriations directly to service delivery units. These service delivery units execute their budgets based on approved plans via the centralized but execution system (GFMIS) via respective provincial treasury offices. Large budget entities and more that 250 districts (soums) have been connected in real time to GFMIS via district treasury offices.

With regards to this centralized collection of revenues and management of expenditures, since 2003, the following improvements have been achieved:
- Resources are reaching service delivery units in a timely manner and budget discipline has been achieved;
- Arrears on goods and services, which were prevalent in the decentralized system prior to 2003, have by and large been eliminated;
- Central government can transfer resources across provinces with ease and in real-time via the Treasury Single Account;

Box 2.3 continues/…
Box 2.3

Government is able to determine its consolidated financial position daily and ensure all necessary fiduciary regulations are complied with because centralized budget execution system has this ability;

The PEFMR analysis argues that Mongolia should maintain this centralized budget management system in order to capitalize the above listed improvements as well as on the following additional grounds:

- Most of the population and corresponding public service needs are concentrated in few urban areas. In most of the districts transactions are fairly limited to justify the high cost of decentralized budget execution.
- Managing the Treasury Single Account effectively is optimally done via a centralized budget execution system, managed by a vertical national treasury department structure that exists in Mongolia. A decentralized budget execution would imply a more complex and expensive technology as well as significant improvements in skills and technology at the local level to ensure that the TSA is effective managed, while benefits would be limited and upside risks of the system not being properly maintained would be greater.
- Already in the current GFMIS, large budget entities and more than 250 districts are executing expenditures in real-time and this means that service delivery units have direct control over entering expenditure requests, while the respective treasury department only cross-checks the budget availability and documents submitted prior to processing the transaction;
- Ensuring that there is appropriate central government oversight and timely consolidation of government statements requires a more centralized budget execution system that can provide such reports in a timely manner.

Source: World Bank Staff

2.18 Local government participation in budget planning could be enhanced. The PSMFL has effectively centralized the intergovernmental fiscal relations framework. At the same time, policy making has also been centralized with the sector ministries, as demonstrated by the budget planning process. Budget entities (service delivery units) prepare their annual budget requests and submit them to provincial departments. Provincial departments consolidate these budget requests and send them up to the respective sector ministries. The sector ministry then consolidates all provincial budget requests and presents them to the Ministry of Finance. The Ministry of Finance then allocates funds to each budget entity and passes the funds through the respective sector. Funds are controlled by the head of the budget entity and disbursed through the regional treasury offices. Local government authorities have negligible input into the process and are often critical of the central government’s budget allocations on the basis that they do not reflect the needs of provincial citizens. There is some validity to this argument, and it is recommended that the central government institute mechanisms to include more formal consultation with provincial authorities on the rationale of the budget plan.

2.19 A first step towards strengthening horizontal accountability between local government and service delivery units could be amending the PSMFL to include: (i) annual assessment reports of service delivery units from the provincial government to the parent ministries; (ii) mandate publication of performance reports of budget entities at the provincial level; and (iii) mandate publication at the local level total budget allocations and disbursements to service delivery units from central governments.

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2 There is no constitutional requirement for the proportion of budget distribution from the central government to the local governments. For a description of intergovernmental fiscal relations since the PSMFL implementation, see the World Bank Policy note, “Mongolia Regional Development” (2005). Available at http://siteresources.worldbank.org/MONGOLIAEXTN/Resources/MNG_Policy_Note_Reg_Devt_Final_eng.pdf

3 Local Government comprises provincial (Aimag) and District (Soum) administrations, with the former being responsible for the latter.
Box 2.4: Budget preparation at the Municipality of Ulaanbaatar (MUB)

The budget preparation process in MUB is driven by the Budget Law and the PSMFL. The responsibility for preparation and issuance of budget guidelines is with Department of Finance, Economy and Treasury (FE&T), MUB. The FE&T department receives the budget guidelines from MOF by June 20.

The guidelines are essentially the policy statements that provide departments with a sense of the budgetary environment for the forthcoming year. They provide, inter alia, the details of all budget input formats, and they call for compliance. All budget entities in MUB must submit their strategies, investment plans, and financial statements by July 10. By October 1, FE&T consolidates the budget plans and the Parliament approves the submitted budget by December.

An ongoing debate on budgeting in MUB revolves around budget decentralization from the Central Government to MUB. As stated earlier in this chapter, budget planning is done by sector ministries and the Ministry of Finance, and this has caused problems for MUB. For example, sector ministries are often not aware of the total number of people residing in Ulaanbaatar and therefore under-budget resources—even though MUB has this information readily available.

There is little flexibility in reallocation of resources. In order to reallocate resources from one sector to another, MUB must go through a cumbersome process of obtaining the approval of the respective sector ministries.

However, MUB does not seem to have the capacity for effective budget planning. Therefore, it is recommended that MUB capacity for budget preparation be enhanced, and that the central Government introduce formal consultative mechanisms to ensure that sector ministries to have adequate information to make effective allocations.

Source: World Bank Staff

2.20 At present, the Government has not started preparing a statement of fiscal risks, as mandated by the law (Article 32.2.3). Information on contingent liabilities remains incomplete and a clear analysis of fiscal risks has not been prepared. Such a statement is important for the Parliament to consider when reviewing the budget proposal. However, this requires both capacity strengthening and formulation of a framework for monitoring and recording contingent liabilities.

2.21 There is a need to improve coordination and integration of ODA. ODA is governed by the Law on Coordination of Foreign Loans and Grant Aid, promulgated on June 13, 2003. This Law vests the authority to decide on all loans and grants to the Minister for Finance. In practice, foreign loans are channeled through the Ministry of Finance, and are fully recorded by the Debt Management Division at the National Treasury. Foreign grants, however, are not coordinated through the Ministry of Finance because grant assistance is often discussed directly with respective sector ministries, and funds are released to the Ministry of Finance once the relevant sector ministry approves the grant. There is no structured process under which the Ministry of Finance can learn of and record such assistance. The consequence is that the medium term budget framework fails to capture all the information and cannot effectively allocate resources based on cumulative financial flows to respective sectors.

2.22 Although the Government has embarked on an ongoing medium term budget planning exercise, it is generally not possible for development partners to: (i) align their support to the Government budget calendar because different donors have different fiscal years; and (ii) make multi-year commitments, because most donors work on single year appropriations. These problems result in fragmented planning between the recurrent budget, which is mostly financed by government’s own resources, and the capital budget, which is largely financed by ODA (about 80 percent). There is a need for donors to align themselves to the Government budget calendar and requirements.
Box 2.5: Good practices on budget deliberations

**The United States:** After receipt of the President’s budget request on the first Monday in February, the Congressional Budget Committees hold hearings to receive testimony from Administration officials, experts from academic and business communities, representatives of national organizations, members of Congress, and the general public. During the same period, the other committees in Congress review the sections of the President’s budget submission that relate to programs within their jurisdictions. In addition, during February, CBO sends annual reports on the budget and economic outlook to the Budget Committees. In March, CBO sends its report analyzing the President’s budget request to the Appropriations and Budget Committees. At the same time, the Budget Committees draft the Budget Resolution, which is a formal and binding agreement between the two chambers on total spending, receipts and other aggregates, along with a division of spending levels among budget functions. When the Budget Committees complete their mark-up of the Budget Resolution, they report their respective resolutions to the full Senate and full House. The Budget Act sets April 15 as the date for completion of this work.

**Australia:** After the Government introduces the Appropriation Bills and presents the Budget Papers and, the process allows for one to two months of budget deliberation by the legislature. There is no committee stage in the House of Representatives, which has decision authority over the budget. The Senate Estimates Committees scrutinize the Appropriation Bills and other budget documentation, particularly the Portfolio Budget Statements. The basic function of the Committee is to require the presence of, and seek explanations from, the Ministers who formulate policy and Departmental officers who implement policy. Each of the Estimates Committees takes responsibility for a number of agencies. The Estimates Committee process is generally finished in time for Parliament to pass the Appropriation Bills before the end of June.

**Thailand:** Budget deliberations start with the first reading of the budget, which is called a vote-of-confidence in the government. If the vote is won—as is normally the case—a Scrutiny Committee is selected to examine the government’s budget proposal. In the 105 days has available for consideration of the budget, committee members meet every working day. The Committee meets in plenary in the beginning of the process, in order to consider the overall work program for examining the budget proposal, and at the end when it makes its final recommendations to the House.


Box 2.6: Wells in Mongolia – To be or not to be

The government has a policy to ensure that there are two wells per district. Based on information on well construction by development partners across districts in Mongolia, the Government makes a budgetary allocation to districts that do not receive support from development partners for constructing wells.

In 2006, the government reviewed the program and found that there were districts where there were more than two wells, and districts where there were no wells. This was a puzzling outcome, because the government had carefully allocated funds to make sure that all districts had funds, either from the State Budget or from development partners. Government analysis revealed that during the year some development partners had changed the districts they were supporting with well construction. Because there was no feedback to the Ministry of Finance, the government had continued making allocations according to the original plans.

Source: World Bank Staff

2.23 **The centrality of the MTFF in informing budgeting should be enhanced.** At the moment, new policy initiatives are approved directly by the Parliament even when they have not been vetted through the MTFF. This weakens the sanctity of the MTFF process and provides incentives for by-passing the formal MTFF process. Although it is the prerogative of Parliament members to propose and approve spending initiatives, it is prudent to have a framework in place that allows the technical managers of government to review those policy measures and inform
decision makers about the implications of such proposals. Additionally, it is critical that all proposals be reflected in the MTFF, as this is the main instrument for allocating scarce resources through strategic decision making.

2.24 **Revenue projection could be improved**… During the last five years, actual revenue collection has exceeded projections by an average of 13 percent annually. This has largely been due to higher than expected mineral production and commodity prices. However, the government should be able to factor these developments into its revenue forecasting model. Sound revenue modeling generally aims to project revenues such that actual collections are within five percent of budget estimates.

2.25 … **As could expenditure estimation**. In four of the past five years, the government has had to present mid-year budget amendments. Most of the reasons for budget amendments have been: (a) increasing civil service salaries; (b) under-projection of new social transfers such as the marriage allowance; and (c) approval by Parliament of new expenditure programs during the fiscal year. According to the data on FY2006, the main reasons for amendments were increases in basic salary, pension and benefit insurance, expenditures on goods and services, and an underestimate of social transfers. Also, many new programs were approved after the first budget appropriation was adopted by the Parliament. Mid-year budget amendments: (i) weaken the credibility of the annual budget process; (ii) focus the limited capacity of the Government on immediate financial issues, rather than on proper planning for the following year budget estimates; and (iii) provide incentives for agencies to have programs approved by Parliament at artificially low levels, and then to request increases later, as the magnitude of resources needed becomes apparent. There is significant need to improve budget forecasting ability, on both the revenue and expenditure sides.

### Fiscal planning - the Public Investment Plan

2.26 **The Public Investment Plan (PIP) prepared by the Ministry of Finance guides medium term capital budgeting**. The PIP is attached to the MTFF document for consideration by the Parliament. *Notionally*, the PIP is a strategic capital budget planning tool that brings together capital expenditures financed by the State Budget and ODA into a coherent, consistent and prioritized framework. Over the last three or four years, ODA has financed an average of 80 percent of the PIP annually. Since end-2006, the responsibility for preparing the PIP has been vested with the Fiscal Policy Department of the Ministry of Finance.

2.27 **Preparing the PIP in conjunction with the MBTF and vesting both of these responsibilities within the same entity lays the institutional foundation for ensuring that:** (i) the PIP and MBTF are well integrated and consistent; (ii) adequate maintenance costs have been factored into the recurrent budget for maintaining assets. At present, the PIP is effectively a list of projects to be financed by the State Budget and ODA. There is little strategic prioritization or formal linkage with sector strategies. Cross sector collaboration on PIP formulation is weak, capacity to analyze project cost-benefits is inadequate, and ODA does not seem well-aligned with overall Government strategy. Based on discussions with authorities, the following issues have been identified for improvements in order to enhance the consistency and effectiveness of the PIP.

2.28 **Enhancing capacity for conducting cost-benefit analysis and prioritization of the PIP is necessary**. In order to determine the financial viability of capital investments, there is a need for trained staff to analyze the cost-benefit trade-offs for capital investment, and to ensure net positive financial results in a sustainable framework. At the moment, there are only about five staff members at the Ministry of Finance tasked with preparing the PIP. This seems inadequate
for preparing the PIP. Therefore, it would be advisable for the Government to conduct a needs assessment to determine the staff and skills needed for preparing a robust PIP.

2.29 Better inter-ministerial coordination on strategic prioritization of investment expenditures is also crucial. Currently, sector ministries submit lists of projects that are needed at the sector level to the Ministry of Finance, and dialogue simultaneously with donors to obtain resources for financing these projects. The Ministry of Finance does not have the capacity to analyze all of the requests and there is no institutional mechanism for sector ministries, the Ministry of Finance, and development partners to come together to discuss the proposed capital expenditure plans. This coordination issue is further exacerbated by the fact that donors often provide grant assistance directly to the sector ministries, without the formal signature of the Minister of Finance. This is in contravention of the Law on Coordination of Foreign Loans and Grant Aid, which stipulates that all ODA needs to be formally signed and approved by the Minister of Finance. Although the Ministry of Finance has a fully functional debt management and recording system, the same does not exist for grant assistance.

2.30 Making the PIP the sole entry point for capital projects... At present capital projects are financed even when they have not previously been included in the PIP. This weakens the credibility of the entire PIP exercise and provides incentives for agencies to by-pass the PIP process. The Government should consider making it mandatory for projects (external or domestic) to be included in the PIP for the respective year in order to receive financing.

2.31 …and improving data on ODA by sector and category of expenditure. The first step towards improving PIP planning is to have a systematic way of recording ODA. The current situation results in an overlap of expenditures and a lack of accountability for results. It is recommended that the government consider establishing a forum for discussing ODA management issues with donors, and also establishing an inter-ministerial working group to discuss the proposed capital investments in each sector, keeping in view the costs and benefits of projects, sector development strategy, and financing options. Box 2.7 presents a brief description of how a PIP is prepared in Chile.

<table>
<thead>
<tr>
<th>Box 2.7: Good Practice on investment program – Chile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chile has accumulated over three decades of successful experience in the systematic appraisal of public investment. Modern project appraisal for public investment started in 1975, with the establishment of the National System of Investment (SNI) at the Ministry of Planning (MOP), currently administered jointly with the Ministry of Finance (MOF). As to the appraisal, every public-investment project is subject to the same cost-benefit analysis, under a set of clearly specified methodologies published by the MOP. The law mandates that the capital budget sent by the MOF to Congress can only included projects within the SNI, which have also been favorably assessed by the MOP. This process screens out ‘white elephants,’ and also rules out the possibility of investment projects entering the budget at the congressional stage—the only entry door is the SNI.</td>
</tr>
<tr>
<td>The SNI, thus, is a main determinant for a successful public investment in Chile. It refers to a set of norms, techniques and procedures which govern the public investment process. The objective of the SNI is to improve the quality of the public investment, by selecting the projects with the largest net present value—and thereby increasing the country’s net worth. The main tools of the SNI are:</td>
</tr>
<tr>
<td>(1) Methodologies for preparing and assessing projects from a coherent socio-economic perspective—including a specified set of shadow prices, and a social discount rate (currently 8 percent).</td>
</tr>
<tr>
<td>(2) Continuous training of officials to develop adequate technical capacity at all levels of government and in all regions.</td>
</tr>
<tr>
<td>(3) A publicly available integrated data bank of projects (BIP), enabling efficient and coordinated public-finance management and well-informed policymaking.</td>
</tr>
</tbody>
</table>

2.32 **Ensuring there is appropriate funding in the budget to finance recurrent cost of investment projects.** Since 2003, there has been an increase in investment while expenditure on capital maintenance has been reduced (see Figure 2.1). This is a source of significant concern, as capital investments deteriorate faster if they are not maintained adequately. In the absence of a methodology on depreciating assets, adequate provision for maintenance becomes yet more critical. Maintenance costs should be explicitly presented with each investment project, so that decision makers can consider the maintenance costs of projects during the approval process.

2.33 **A first step towards strengthening the PIP could be to constitute an inter-ministerial working group led by the Directorate General for fiscal policy department to:** (i) determine the medium fiscal space taking into account the budget momentum (i.e. medium-long term committed expenditures); (ii) investment needs across the sectors; and (iii) the government action plan. This inter-ministerial committee should be tasked to prepare the medium term policy consistent PIP that would be discussed at cabinet and the parliament. This PIP once approved would be implemented over the medium term with annual review of progress and challenges. And when the Government Action Plan changes, the PIP would change appropriately. With this requirement in mind, the government should commission a needs assessment for capacity and financial resource requirement for such a task to be done.

**EXECUTION OF PUBLIC FINANCES**

2.34 **Before 2003, Mongolia’s budget execution system was fragmented and lacked any effective control.** The Treasury Department operated a basic, locally-developed banking interface software called BUMIS. There were more than two thousand bank accounts, operated by different agencies, and it was not possible to determine the Government’s consolidated cash position at any point. Budget reports were consolidated with a lag of more than 3 months

2.35 **Mongolia has made significant headway in improving the budget execution system.** The PSMFL mandated the Minister for Finance to establish centralized control over all government bank accounts and to taken on the responsibility for centralized cash management. Since 2003 the Government of Mongolia has been able to:

- Establish a functional Treasury Single Account framework, which entailed closing more than 2000 individual government Bank accounts and consolidating them under one umbrella account, managed and controlled by the Ministry of Finance;
- Implement unified IMF Government Financial Statistics, a consistent Chart of Accounts and budget nomenclature. This entailed revising the fragmented accounting...
structuring to fully integrated one and effectively training all budget agencies on its effective usage;

- **Operationalize an integrated debt management information system.** The Government established a dedicated Debt Management Division (DMD) within the Treasury Department to manage public debt. The DMD has established a consistent debt recording and monitoring system. Consequently, the discrepancies in debt information between creditors have been reconciled adequately.

- **Deploy a country-wide electronic payment settlement system at the Bank of Mongolia.** This payment system manages the Treasury Single Account across the country in real time and ensures smooth transfer of funds to provinces and municipalities.

- **Institute a fully integrated government financial management information system (GFMIS) to execute government expenditures real time.** This system reconciles expenditures made at the Treasury with the funds released by the Bank of Mongolia on a daily basis. The system also has undeletable audit trains for each transaction. For additional details, please refer to Annex 2B which describes the findings of the GFMIS compliance check and internal control system review, together with recommendations for improvements.

2.36 **The aforementioned reforms in budget execution are commendable in every respect.** It has taken many countries with higher capacity levels a much longer time to implement such reforms. Table 2.1 shows how Mongolia fairs in comparison with other East Asian countries with regards to core public finance management systems.

<table>
<thead>
<tr>
<th>PFM Component Elements</th>
<th>Mongolia</th>
<th>Cambodia</th>
<th>Vietnam</th>
<th>Indonesia</th>
<th>Philippines</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operational Treasury Single Account System</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Integrated Chart of Accounts consistent with</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>International accounting Standards</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Integrated Budget and Treasury System Linked to the Central Bank</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Updated Debt Management System Providing Input to the Integrated Treasury and Budget System</td>
<td>Yes</td>
<td>....</td>
<td>Yes</td>
<td>Yes</td>
<td>....</td>
</tr>
<tr>
<td>Treasury System Linked with the Revenue Collection Agency(s)</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

*Source: World Bank Staff*

2.37 **The results of these reforms have been:**

- **Arrears on goods and services are under control.** Before the Treasury Single Account and GFMIS were established, wages and salaries were often in arrears for more than two months. Since these reforms, the government has remained current on such payments;

- **Government consolidated TSA balances are in excess of US$65 million.** Before the TSA was introduced in 2003, the government had to resort to borrowing from the central bank to meet its daily expenditure needs because government cash holdings were fragmented across many accounts;

- **Funds are reaching budget entities on time and as per appropriations;**

- **Improved controls over budget execution have reduced leakages,** and contributed to the positive budget balance;
• **Mongolia is now able to provide fiscal reports consistently, accurately, and on time, consistent with the IMF Government Financial Statistics.**

2.38 **A GFMIS compliance check concluded that the business processes and internal controls for GFMIS were adequate for financial management purposes.** With the implementation of GFMIS on January 1, 2005, there was a need to conduct a compliance check to examine the extent to which the business processes and internal controls in the FreeBalance e-Financials software were working in practice. The detailed findings are reported in Annex 2B. This will assist the Ministry of Finance (MOF) to fine-tune GFMIS functionalities. The internal control review relates to ensuring that all underlying funds and information flow processes in GFMIS are also working.

2.39 **GFMIS controls around budgetary, system integrity, payment security, and system management should be improved upon and key internal controls should be reviewed, at least annually, to ensure they are still functioning as designed.** To do so, the systems audit report from the recent Mongolia National Audit Office of GFMIS should be reviewed and respective regulations and system-fixes should be developed to address those concerns.

2.40 **These findings may increase external donor confidence in using GFMIS for their portfolio management.** By using GFMIS for donor portfolio management, the donor community would address one of the key areas from the Paris Declaration on Aid Effectiveness (March 2005), “Strengthening and Using Country Systems.” Box 2.8 below discusses this subject further.

2.41 **Donor funds are essentially managed outside of the Government’s own PFM systems, resulting in fragmentation of donor programs, disconnect in project accounting within the national budget, and over-burdened staff.** This practice also undermines public expenditure management systems. In addition, project management/implementing units (PMUs or PIUs), which are outside of the government structure and funded by projects, have been created to manage these donor projects. Not only do these units require additional resources, they also divert highly skilled talent from the government, since PIUs pay higher salaries than the civil service. Reliance on GFMIS for donor portfolio management would mean that instead of opening special accounts for each project at commercial banks, donors would disburse funds directly to the Treasury Single Account at the Bank of Mongolia. GFMIS would be used to execute eligible project expenditures, account for the transactions, and generate project related reports on funds usage directly from the system. Audits would also be conducted by the MNAO as part of its overall audit of government accounts.

2.42 **The Government could develop a Government-Development Partner action plan with steps and timelines for integrating ODA into country systems, and move towards more sector-wide approaches learning lessons from the successful donor coordination in the education sector.** To this end, A MoF working group could be constituted by order of the Minister responsible for working with Development Partners to develop a phased plan for closing all special project accounts held outside the TSA and to migrate them to GFMIS. This working group should by led by the Treasury Department with representation of all concerned departments. The government should pre-announce this intention to all development partners and determine specific dated milestones for this migration plan.
Box 2.8: Use of country financial management systems

In the World Bank, use of country systems generally refers to the Bank’s reliance on the borrowing country’s systems for the safeguards and fiduciary aspects of operations it supports. Use of country FM systems can be defined as the use of a country’s normal institutional arrangements and processes for financial management. The main components of a country’s financial management system include: (1) Budget preparation; (2) Budget management (execution); (3) Accounting; (4) Treasury management; (5) Debt management; (6) Internal control framework; (7) Management reporting; and (8) Auditing. For treasury management, using country systems involves using the financial systems of the government - regular systems for banking, payment authorization and payments. For internal controls, it involves using the country’s regular rules, procedures, manuals and internal control framework. The Bank’s Operational Policy (OP) 10.02, Financial Management, provides that Bank-supported operations should use the country’s own PFM system, if it is acceptable, as the default option for financial management. Moreover, Bank management has committed to making further progress on the Paris Declaration targets for aid effectiveness, which include a reduction in aid flows outside partner countries’ PFM systems. There are many benefits to using country systems. Country systems:

- facilitate the comprehensiveness of resources administration;
- avoid isolating projects from other government programs;
- enhance capacity building;
- increase country ownership and project sustainability;
- facilitate harmonization and simplification; and
- reduce costs for Borrower and Bank.

Reliance on GFMIS for donor portfolio management would mean that instead of opening special or designated accounts for each project, donors would disburse funds directly to the Treasury Single Account at the Bank of Mongolia. GFMIS would be used to execute eligible project expenditures and reports generated directly from the system on funds usage. In addition to the execution and reporting function, the audits would then be conducted by the MNAO as part of its overall audit of government accounts.

Source: World Bank Staff

2.43 Mongolia has implemented the first generation of reforms to improve budget execution. The next challenges are to:

- **Integrate ODA execution into the Government budget execution processes.** At the moment, most ODA is executed through extra-budgetary accounts set up outside the government’s TSA. This practice fragments budget execution systems and dilutes accountability for and reporting on the resources provided by development partners. It is recommended that the Government discuss with development partners an action plan for migrating ODA into country systems. This would then set out a roadmap for the Government and donors.

- **Roll out budget execution responsibilities to budget entities.** Currently, the primary responsibility for budget execution is with the National Treasury. Budget entities prepare expenditure requests and related forms, and then have to send all the documents to the Treasury Department for processing within the Government Financial Management Information System. This adds to transaction costs for budget entities and also overloads the staff at the Treasury department, who have to enter transactions into the system. Rolling out budget execution responsibilities to budget entities would be consistent with sound principles of budget execution. The Government is already in the process of rolling out GFMIS to large budget entities and districts, and this will allow: (i) budget entities greater control over spending; (ii) Treasury department to take on a more active oversight role and focus on issues pertaining to cash management.
Chapter 2 – Public Sector Financial Management

PROCUREMENT⁴

2.44 Mongolia has made significant efforts in improving public procurement. In 2000, Mongolia promulgated a procurement law. This law centralized procurement and tightened fiduciary controls. However, the centralization of procurement increased procurement lead time (causing delays) and budget entities felt disenfranchised at the loss of control over funds allocated to them by Parliament. The main provisions of the law were generally consistent with good international practice (as compared with the UNCITRAL Model Law on Procurement), but the law contained too much detail for basic enabling legislation. The PPLM at that time included procedural details of procurement practice that would normally benefit from periodic amendment to reflect experience gained and changes in dynamic factors such as exchange rates and the country’s rate of economic growth. Such procedural amendments would require the PPLM to be regularly amended which would then subsequently require Parliamentary approval. Regular amendment to the PPLM could therefore prove to be both burdensome and time consuming to the GoM.⁵ In order to improve procurement efficiency, while maintaining necessary fiduciary controls over public procurement, the Parliament passed the revised Procurement Law in December 2005.

2.45 A new PPLM enacted in February 2006 was a commendable improvement over the previous law. The law was more fully aligned to best international practice, as many of the procedural details were removed. The PPLM also dictated that the PPCD issue supplementary regulations, guidelines and other documentation and introduced a complaints review mechanism. Under the new law, the Procurement Policy and Coordination Department (PPCD) of MOF has received a mandate for advising procurement entities on effective practices, overall monitoring and reporting of public procurement performance. The new law has introduced many improvements in the legal and regulatory framework of public procurement. For example, the law decentralized procurement functions to line agencies, with PPCD’s prior review of major transactions and complaint review mechanisms, and set requirements for reporting by line agencies to PPCD and MOF to Parliament on public procurement performance. To implement the new law, PPCD has provided training on the new law to all line agencies and issued several implementation regulations in the past year. However, despite these efforts, there have been indications that the Government has had difficulties in implementing the law because of weaknesses in the implementation arrangements.

2.46 A February 2007 amendment to the PPLM significantly altered the spirit of the law. The most important changes to the law (i) allowed direct contracting in certain sectors of government funded investment and (ii) significantly increased the threshold below which foreign companies could be excluded from participating in bidding for contracts. The introduction of this amendment deprived the Government of much-needed international competition in areas where there is limited domestic capacity and where there is a risk of creating a monopoly, which may result in higher prices and a lack of transparency. Specific commentary on the February 2007 Amendment and suggested further improvements to the PPLM can be found in Annex 2C.

2.47 The institutional framework and management capacity for procurement are weak. The decentralized approach to procurement allows entities at the ministry, provincial and project level to conduct and manage their own procurement activities. The institutional

⁴ This section draws both from a 2007 World Bank procurement survey and the 2007 OECD-DEC joint venture for Procurement – Results of the Benchmarking and Assessment of the Mongolian Public Procurement System.

⁵ See the World Bank Procurement Assessment Report (CPAR) conducted in 2003 of the Mongolian Public Procurement System.
framework does not currently provide for the adequate control and monitoring of procurement activities and there is a lack of integration of these activities into the financial management system.

2.48 **Specific areas of weaknesses are identified as follows:**

- Procurement plans are prepared after the approval of the budget and thus are not used as a means of calculating the required funds but as a means of spending the budget after it is made available;
- The current system for collecting procurement information and integrating it with financial information is improving, but still incomplete. There are procedures in place for procurement planning and reporting of procuring entities (MoF order dated 5 January 2007). The Government is in the process of developing an integrated procurement management, monitoring and information system (PMMIS) which is expected to provide central and local governments with procurement management and monitoring tools, at project and contract level.
- Safeguards in the financial management system are not adequate to ensure that procurement actions are only initiated when funds are available;
- Completion reports are available but not yet integrated into a financial management system;
- There is a need for improved reporting mechanisms and capacity development;
- There are no quality control or performance evaluation methods for procurement processes.

2.49 **Looking at procurement operations and market practices, there is a lack of formal qualification requirements for procurement officers in the public procurement system.** Very little progress has been made on analyzing the gap between the qualification and skill levels required and the qualification and skill levels that currently exist within the public procurement entities.

2.50 **There is also a lack of formal mechanisms for dialogue between the public and private sector regarding procurement.** Evidence provided by the private sector suggests that public procurement entities are perceived as weak in terms of planning, budgeting capability and technical expertise. The private sector believes that this is contributing to ineffective competition for public sector contracts.

2.51 **Turning to the accountability and transparency of the public procurement system, a robust audit framework is in place but control mechanisms are weak.** Public procurement operations are audited by both the State Inspection Agency and the National Audit Office. Inspections and audits are carried out annually on a systematic basis. Weaknesses in controls are primarily attributed to lack of clearly defined procurement audit procedures and inspectors having limited knowledge and experience with procurement best practice.

2.52 **Public disclosure of procurement information is an essential component of demonstrating transparency and accountability and combating corruption.** The PPCD has created a dedicated procurement website for disclosing information on contract awards, bidding procedures, bidding documents and guidelines, but it is still in its infancy and is under-utilized. Furthermore, due to a lack of monitoring and enforcement capability, not all invitations to bid and contract award details that require notification on the PPCD website are submitted for publication.

2.53 **In light of these findings, the following recommendations are suggested:**

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6 See OECD-DEC Joint Venture for Procurement – Results of the Benchmarking and Assessment of the Mongolian Public Procurement System.
Consider withdrawing the February 2007 PPLM Amendment and incorporate further changes to the PPLM which would improve its clarity.

Review ways to improve the coordination between budget departments and the MOF to ensure better integration of public procurement activities with the GoM’s financial management systems.

Establish an appropriate professional profile for public procurement officers in terms of qualifications, skill requirements, knowledge levels and status and provide access to education and training to enable procurement officers to attain the required profile.

Develop audit manuals and procedures for use by both the State Inspection Agency and the National Audit Office for the conduct of various audits (i.e., compliance, performance and efficiency).

Enforce the utilization of the PPCD website for disclosure of public procurement information and the publication of invitations to bid.

**INTERNAL AUDIT**

2.54 **Internal audit in the Mongolian government primarily addresses compliance with rules and regulations.** Audit inspectors’ focus is primarily regulatory compliance (imposing penalties and giving instructions for reimbursement of money that has been wrongly applied) with no emphasis on the efficient or effective use of public funds. In light of the current lack of capacity within the external audit unit (see below), the GoM should place priority on building up the external audit capacity and then exploring ways to improve the GoM’s internal audit capability. In the meantime, it is recommended that GoM should adopt control systems-based auditing, starting with the assessment of internal controls of the bodies which they inspect. Control systems-based audit should replace compliance inspection as the dominant internal audit methodology across the government.

2.55 **The structure of the Government’s internal inspection is not adequate as portfolio levels are not systematically covered.** Although the PSMFL requires portfolio management at the line ministry and aimag levels, there is no formal internal audit structure in place within the portfolio level, which produces irregular oversight of portfolio financial management. Thus, the GOM should consider the establishment of portfolio level internal audit when adopting control systems-based auditing.

**EXTERNAL AUDIT**

2.56 **Overall, the legislative framework is adequate for the MNAO to effectively audit the Government.** The legislative underpinnings of external audit are contained in the PSMFL Article 38 and further elaborated in the 1995 Audit Law. The responsibility for conducting external audit has been assigned to the MNAO. The Law mandates that the Government submit the financial accounts no later than six weeks after the end of the fiscal year. The main challenge for external audit in Mongolia is to build MNAO’s staff capacity for conducting robust financial audits of financial statements generated by the GFMIS. For instance, the possibility of migrating donor funds into GFMIS would require that MNAO be able to audit them. Audits of donor funds would no longer be conducted by external audit firms, as these outside firms would not be able to access government internal information system. The next level of capacity would be to develop skills for performance audits. However, in view of the limited number of staff, current skills mix, and the critical fiduciary need, it is recommended that priority be given to strengthening skills for improved financial audit of GFMIS.
In order for the MNAO to be able to effectively conduct financial audits of the consolidated government account, the MNAO must have the capacity to conduct financial audits of GFMIS. At the moment, as GFMIS is a fairly new system, the MNAO is in the process of building capacity to conduct GFMIS audits. Conducting financial audits within an information system environment requires skill-sets and audit methodologies that are currently not available within MNAO. Furthermore, once the audit report is submitted to the Parliament, it would be advisable to publish the report, with the audit opinion.

To strengthen MNAO capacity to conduct robust financial audits of GFMIS, Parliament should provide sufficient annual budget for various training of MNAO staff and for MNAO to continue working on systems audit capabilities. MNAO could consider (i) having dedicated system audit teams to receive necessary continued training to perform this task and, (ii) instilling periodic internal examination of MNAO staff for consideration of promotions or demotions to improve the overall quality of MNAO.

DISCLOSURE AND TRANSPARENCY OF PUBLIC FINANCES

Important internal reporting requirements have been fulfilled, which is extremely useful for improving internal cash management and budget monitoring. Significant internal reporting requirements are mandated by the PSMFL (Articles 39-42). The reporting responsibilities of portfolio ministers, general managers of budget entities, and SOE’s are extensive, but are mostly limited to internal consumption. The reforms to key budget execution systems have also made it possible for the Ministry of Finance to report the daily reconciled cash position of the government.

Box 2.9: Operational Evaluation Country Department best practices on budget transparency

OECD Member countries are at the forefront of budget transparency practices. At its 1999 annual meeting, the OECD Working Party of Senior Budget Officials asked the Secretariat to draw up a set of Best Practices in this area based on member countries’ experiences. The Best Practices are designed as a reference tool for member and non-member countries to use in order to increase the degree of budget transparency in their respective countries.

According to the OECD Best Practices on Budget Transparency, budget transparency is defined as the full disclosure of all relevant fiscal information in a timely and systematic manner. The best practices are divided into three parts. Part 1 lists the principle budget reports that government should produce and their general content. Part 2 describes specific disclosures to be contained in the reports, including both financial and non-financial performance information. Part 3 highlights practice for ensuring the quality and integrity of reports.

OECD recommendation for best practice on budget transparency is to publicly disclose: (i) the pre-budget statement; (ii) executive budget proposal; (iii) the approved budget; (iv) in-year budget execution reports; (v) mid-year budget review and assessment; (vi) end of fiscal year budget report; (vii) report of the auditor general; and (viii) citizens budget, and the pre-election report and the long term economic projection.

Sources: OECD Budget Journal

The PSMFL, however, remains silent on disclosure of budget information beyond the Parliament. There is no legal requirement to provide information on public financial management to the public. Prior to 2006, disclosure of budget information was limited solely to the publication of the high level budget. Hardly any information was provided to the public. Mongolia scored very low on fiscal transparency indicators, such as the Open Budget Initiative, which were based on available information as of end-2005.

The World Bank is currently assisting MNAO on this issue and has provided an Institutional Development Fund (IDF) trust fund to help MNAO address the matter. Under this trust fund, MNAO will work with specialists in the system’s audit arena to learn and build the necessary system’s audit capacity.
2.61 **The Government could propose clauses in relevant laws for public release of budget information.** In addition, the Minister for Finance could issue a Ministerial Instruction to all concerned departments reporting to the Ministry of Finance to: (i) list all laws, decrees, regulations, and guidelines that determine respective departmental operations and to publish them on this MOF dynamic portal; and (ii) require departments to submit compliance reports on the same.

2.62 **There are seven key budget documents that OECD Best Practices for Fiscal Transparency highlights as the most important for engendering accountability.** These include: (i) the pre-Budget Statement, (ii) the National Budget; (iii) monthly budget execution reports; (iv) the mid-year budget assessment and economic review; (v) the end of fiscal year report; (vi) the report of the Auditor General; (vii) the citizens budget, pre-election report, long-term fiscal outlook. While considering the availability of these documents in Mongolia, this review considered two additional dimensions of national budget reporting: (i) the executive’s budget proposal; and (ii) the enacted budget. This division is useful since citizens must be able to access the budget before it is approved in order to provide input into budgetary policy making.

2.63 **In 2006, the government made progress in disseminating some key budget documents and information relating to budget planning and execution. These key budget documents are reviewed below.**

2.64 **The Pre-Budget Statement.** This document is prepared by the Ministry of Finance, and approved as a parliament resolution. By law, this document should be submitted to the Parliament by May 1 and approved during the spring session of the parliament. The budget framework statement should provide the basis for determining the general socio-economic development directives and the state budget. The fulfillment of the budget framework is the responsibility of general budget governors.

2.65 In its approved form, the budget framework statement is a brief document with macroeconomic indicators showing the limits that should be used in preparing and approving the budget for the next three years, along with the medium term objectives of the government. The draft budget framework is a much more detailed document, with current macroeconomic analysis and budget projections for three years ahead, including both revenues and expenditures.

2.66 For example, the 2008 budget framework was discussed by the Cabinet on April 24, 2007. This document is available on the Parliament of Mongolia website, and on request from the Ministry of Finance. However, the document is not yet available on the Ministry of Finance’s own website.

2.67 **Executive’s budget proposal.** This is arguably the most important document for the public. For citizens to effectively participate in the budget process, and to influence budget outcomes, they should be able to access information about budgets before the budgets are approved. The executive’s budget proposal is prepared by the Ministry of Finance, discussed by the cabinet, and must be submitted to the Parliament before October 1st. In 2006, the proposal for the 2007 budget was made available to public through a government run website ([www.open-government.mn](http://www.open-government.mn)) in early November. It is important that this document was released at the same time it was submitted to the parliament, since by November the parliament will usually have had two rounds of discussions, and made most of the important changes.

2.68 Furthermore, the document that is posted on the web is in PDF format, making it difficult for analysts and others to use the numbers for alternative analyses. Therefore, it is recommended that the government use spreadsheet or other tab-delimited formats to disseminate quantitative budget information.
2.69 The budget proposal is accompanied by the draft general directives for socio-economic
development for the corresponding year, which analyzes performance for the current year and the
projections for both the coming budget year and the medium term for most important
macroeconomic and social indicators. However, the linkage between this document and the
annual budget proposal is not explicit or easily traceable.

2.70 The Approved Budget. The budget proposal submitted by the executive is discussed
by the parliament and promulgated as a law by December 1st. The law sets the lower bounds for
revenues to be collected to the state budget, and upper bounds for expenditures, broken down by
administrative unit. It also specifies the amount of investments to be made, inter-governmental
transfers to local governments and revenues to be transferred from local to central budgets.

2.71 The enacted budget is available at the Parliament website (www.parl.gov.mn) and
through the State Information Bulletin, the official publisher of laws and other official
documents. However, the information is highly aggregated and thus not particularly helpful for
citizens or analysts in monitoring or detailed analysis. Also, the document includes only the state
budget, so it is not useful for analyzing local budgets.

2.72 Monthly Budget Execution Reports. Monthly reports are important in terms of
showing progress in the actual implementation of enacted budgets. They also serve as a basis for
any mid-year amendments that may be necessary. The monthly reports are prepared by the
Ministry of Finance, and available at their website and from the Monthly Statistics Bulletin of the
National Statistical Office.

2.73 Contents of the monthly reports have become richer in the last year. Recent reports
show revenues for the general budget, including both state and local budgets, by tax types,
expenditures by economic classification, in accumulated terms from the beginning of the year. It
also shows local budgets, with aggregates for each province and intergovernmental transfers. The
most recent report, for May 2007, also contains a brief narrative report explaining the main
indicators in the quantitative report, making the monthly reports even more in compliance with
the OECD Best Practices. In order to further improve reporting, the government could consider
the possibility of providing monthly reports with functional and administrative breakdown.

2.74 Mid-year budget assessment and economic review. Currently, the mid-year report
that is presented to the public is similar to the other monthly budget reports. It is recommended
that the Government improve the mid-year report in terms of both content and review process.
Specifically, the government could officially present mid-year performance to both the
Parliament and the public. This would allow the Parliament to decide whether in-year
amendments are required or not. Also, it would be advisable to include changes over the first half
of the year to economic assumptions that were used to forecast the annual budget in mid-year
reports. These changes should be presented with a comprehensive discussion of the
Government’s financial and non-financial assets and liabilities.

2.75 End of fiscal year report. Preparation and discussion of year-end reports are covered
by the PSFML. However, the report itself is not available to the public. Therefore, we
recommend that the Ministry of Finance release the end of fiscal year report to public as soon as
it submits the report to the State Audit Office and the parliament.

2.76 For the government budget of 2006, some details of the report were available from the
parliament website in the form of analysis of the parliament standing committee members, to
make it easier for the parliament members to discuss the report. The parliament releases a very
short approval of the budget performance for the given year, with aggregated numbers. But as
mentioned above, for citizens and researchers, the publication of the entire report is the first step
to ensure transparency and accountability.
2.77 Report of the Auditor General. The budget performance and annual financial report of the government are audited by the MNAO, in accordance with the PSFML requirements. The standard used in external audits meets the International Organization of Supreme Audit Institutions (INTOSAI) standard for external government auditing. The audit reports are available from the website of the State Audit Office, but are not widely accessed by the public since there is an IT shortage in Mongolia. Also, audits are done for specific components of budget expenditures. For example, there is a separate report on investments made from the state budget.

2.78 The audit reports are discussed by the parliament in order to approve the final budget performance. However, it is not clear whether actions are taken based on the audit findings and recommendations therein. There is no legal requirement for the government to implement the recommendations of the auditor’s report. It is under the purview of the Budget Policy committee to ask the government about any follow-up to the recommendations. However, it is not clear to what extent this is practiced in Mongolia.

2.79 Citizen’s budget, pre-election report and long-term report. For the general public, budgets are difficult to understand. In some countries, governments issue “citizen’s budgets,” which present information in easily understandable manner. There is no such presentation in Mongolia, so the government might consider issuing one, at the national, ministerial and local government levels. Also, there is a legal requirement for a pre-election budget report, at least one month in advance of the elections. The report was done in 2004, but the presentation could be made more clear and intelligible, and accessible to non-professionals. Otherwise, the pre-election report cannot serve its purpose, which is to foster an informed electorate and stimulate public debate. Long term reports, that discuss the sustainability of government policies in the long term, are not prepared or released by the government. These would be useful for assessing whether current policies are enforceable or not, and for making policy changes. The government should consider issuing such reports, at least every five years.

2.80 Local level budgets. During the preparation of this report, the Open Society Forum considered the availability of information on local budgets, both in the capital city and provinces. The general conclusion was that that there is no centralized point where disaggregated data and information on local budgets is presented.

2.81 Usually, budget information is available from the finance division of the governor’s offices in the aimags. However, there is no proactive information dissemination. Especially at the soum level, there is very little information on budgets, both for the local administration and for schools and hospitals that are financed directly from the center. There is also no budget for dissemination to citizens. Given the centralized nature of the budget process, local governments have few incentives to promote budgets, or have them discussed by local citizens.

2.82 There is a need for the Ministry of Finance to run a consolidated website with more up-to-date and aggregated information on the budget. The budget information should show both local budgets and budgets of local budget entities that are financed from the center directly. This would provide citizens with a one-stop portal for obtaining information and allow them to participate in budget dialogue.

2.83 Overall, there is a need for the Government to strengthen the dialogue on public expenditures with civil society. A way forward could be to establish a regular forum during which the Government will present MBTF policies and proposed State Budgets to media and civil society organizations, around the same time that the policies are presented to Parliament. As part of the budget preparation and approval process, the Minister for Finance could plan and pre-announce a timetable for discussing the executive budget proposal with media and civil society 2-
3 weeks before this proposal is submitted to the Parliament. This is to ensure that there is appropriate time for modifying the budget proposal as necessary based on these consultations.