Mongolia: Promoting investment and job creation
An investment climate assessment and trade integration study

EXECUTIVE SUMMARY OF WORLD BANK REPORT

For discussion at a workshop
with the private sector, donors, and government

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The World Bank
The planning for this study was initiated in the summer of 2003 at the request of the Government of Mongolia. In its PRSP, the Economic Growth Support and Poverty Reduction Strategy (EGSPRS) paper released in July 2003, the government recognized the critical role of a dynamic private-sector as the driving force behind sustainable growth and poverty reduction (Government of Mongolia, 2003). Accordingly, it adopted as one of the central pillars of the EGSPRS the aim of establishing a sound institutional and regulatory environment to complete the transition to a market economy and enable the private sector to become an engine of growth.

But, as the Joint Staff Assessment of the EGSPRS notes, the broad policy statements made in the EGSPRS need to be translated into a coherent private sector development strategy that clearly identifies specific steps that the government might undertake, in partnership with the private sector and international donors (World Bank, 2003). This report is meant to assist in this process.
Executive summary

What this report is about

The aim of this report is to identify a set of concrete steps that the government of Mongolia—in partnership with the private sector and the international donor community—might take to promote private-sector activity and greater integration with the global economy in a way that leads to job creation, broad-based growth and most importantly, poverty reduction. It does this by combining an assessment of the investment climate faced by firms (through analyses of firm and household surveys and supply chains in selected sectors) with a diagnostic trade integration study.

Like in many transition economies with limited traditions of market-oriented private-sector activity, the obstacles to private-sector development in Mongolia are many. There has been no shortage of studies and surveys documenting the challenges that the Mongolian private sector faces. From the burden of taxes, bureaucratic harassment and corruption, to the high cost of and limited access to finance, and the logistical and infrastructural difficulties of getting goods to markets (especially export markets), there is little disagreement about the range of impediments that Mongolian businesses face.

Where there is less consensus, however, is on what needs to be done and on which, of the many things that need to be done, ought to be done first. This report aims to contribute to the ongoing debate and to building a consensus.

Two things distinguish the analytic approach adopted in this report. First, to a greater extent than most past studies, the analysis is based on quantitative data, not just on the perceptions of businesses but also on their actual practices and performance. Second, wherever possible, reference is made to comparable data from other countries, which helps to benchmark the investment climate in Mongolia against international standards. The hope is that in doing these two things, more diagnostic insights can be obtained into the underlying causes of the range of impediments that have been well-documented over the years. And that, in turn, should help to prioritize what needs to be done, and in what order.

The basic diagnosis, which results from this analysis, is this: corruption and the lack of transparency and accountability in government-business interactions are the central impediments to the development of a robust and dynamic private sector in Mongolia.

This basic diagnosis does not mean that other impediments are unimportant or that corruption is the only problem confronting the Mongolian private sector. On the contrary, it is clear from the study that Mongolian firms face considerable obstacles—logistical, infrastructural and institutional, within Mongolia, at the border and beyond the border in China and Russia—in getting goods to and from external markets. Like in other land-locked countries, and perhaps even more so than most, the transport options that Mongolian firms have are limited, costly and unreliable.

But these “natural” difficulties, which stem from Mongolia’s geography and location and which undoubtedly need to be addressed, are overshadowed by the “man-made” obstacles that Mongolian firms face.
The evidence indicates that corruption and a lack of transparency and accountability pervade almost every sphere of business activity. Mongolian businesses recognize this, and corruption is the most frequently cited impediment to doing business in Mongolia. The analysis further suggests that the consequence of this has been the growth of a culture of operating in the “shadow”, which has gotten in the way of firms accessing finance, building market relationships, enhancing productivity, growing and creating jobs.

Table 1: Corruption pervades every sphere of business activity

<table>
<thead>
<tr>
<th>% of firms that view corruption as a major or severe obstacle</th>
<th>% of firms paying bribes for electricity connection</th>
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<tr>
<td>Value of gift expected to secure government contract (% of contract)</td>
<td>% of firms paying bribes for telephone line</td>
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<tr>
<td>% of firms indicating that political ties are important for business</td>
<td>% of firms paying bribes for water connection</td>
</tr>
<tr>
<td>% of cases where unofficial payments needed for registration</td>
<td>% of exporters paying bribes for customs clearance of exports</td>
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<tr>
<td>% of cases where unofficial payments needed to obtain licenses and permits</td>
<td>% of importers paying bribes for customs clearance of imports</td>
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The prescription that follows from this diagnosis is that the top priority ought to be to focus reform efforts on the government-business interfaces that are the key loci of corruption. In Mongolia, that is, first and foremost, the tax system, but also customs and the licensing and inspections regimes.

Mongolia is not the only economy and certainly not the only transition economy where corruption is prevalent. But Mongolia can less “afford” corruption than most countries. Mongolian firms are already at a substantial disadvantage because Mongolia’s geography and history—the lack of proximity to large and prosperous markets and ocean-shipping access to export markets, the limited tradition of market-oriented private sector activity, and the relatively narrow economic base—make its investment climate more difficult to begin with. Corruption and a lack of transparency and accountability greatly compound this initial disadvantage.

The prescription: focus reform on key government-business interfaces, most importantly, the tax system.
To tackle corruption, legislation is needed, in particular, a tax bill and an anti-corruption law.

But laws alone will not suffice. Administrative processes need to be reformed.

Public disclosure initiatives will facilitate administrative reform.

At the same time, efforts have to be made to help Mongolian firms connect to external markets.

Initiatives in three areas hold the most promise:
- Reform of customs
- Completion of the Agreement on Transit Transport with Russia and China
- Adoption of a (partial) open-skies policy

Where things stand

Mongolia has come a long way in its transition from a centrally planned economy to a market economy and has done so while navigating a remarkably successful (and rare) transition to a democratic political system. Many, though far from all, of the basic prerequisites for a successful transition and subsequent sustained private-sector led growth have been met. The macro-economy has been stabilized. Efforts to rationalize and strengthen the financial sector have been initiated and are ongoing. Through liberalization of prices and privatization of most small and medium enterprises, the structure of the command economy has largely been dismantled, and the basic framework of laws, policies and regulations to support a market-based system has been put in place.

The economy has grown continuously since 1993, and since 2002 has been...
growth at over 5%. In fact, in 2004, the economy grew at a rate of 10.6%, the highest in the East Asian region. The contribution of the private sector has risen to just under 80% of GDP. FDI flows have picked up in recent years. The banking sector has recovered from the crises of the late 1990s and the volume of domestic credit has increased substantially.

The expansion in exports has been narrowly based and triggered by favorable (and perhaps temporary) terms of trade shocks. Much of the increase in domestic credit has been in the form of short-term loans for wholesale and retail trading activities, suggesting a consumption boom whose origins are unclear and sustainability uncertain. Value-added per worker is low by international standards and most firms are operating well below capacity.

Growth does not appear to have been broad-based

Of particular concern is the fact that the growth in recent years does not appear to have been broad-based. The changes in the last few years in the sectoral composition of GDP and employment indicates that the sectors that have grown the most rapidly in terms of their GDP share—mining, whose share of GDP rose by 8.3 percentage points being the prime example—are not the ones where much employment has been created, at least judging by changes in sectoral employment shares.

Private domestic investment remains low

Despite the nearly fivefold increase in lending to the private sector, investment by domestic private firms remains low, constituting only 26% of all investment in 2004. Bank-financed private investment is even lower, representing only 8% of all investment.

Job creation, the hallmark of a robust and dynamic private sector, has been limited

Job creation is the hallmark of a robust and dynamic private sector. The evidence, both indirect from information on the size distribution of firms, and direct, from the job creation records of the PICS firms, suggests that job creation has been limited.

The challenge: promoting investment and job creation by the private sector

If Mongolia is to achieve its aim of sustained private-sector led growth and in doing so, generate incomes and jobs for the poor, the private sector has to grow, and that growth has to be broad-based. For there to be growth, there has to be investment by the private sector, and for the growth to be broad-based there has to be job creation by the private sector. Not enough of either is happening in Mongolia currently. To achieve its aims therefore, Mongolia needs to promote investment and job creation by the private sector.

To do this, the first task is to improve the environment in which private businesses operate. But improving the domestic business environment will, by itself, not be enough. For an economy the size of Mongolia’s, with its narrow endowment base and limited domestic markets, private-sector led growth must be anchored in greater trade and integration with the global economy. And so, a second task is to facilitate trade integration.

What the main obstacles are

Corruption and the lack of transparency and accountability that allows it to flourish, tax rates and tax administration, and the high cost of and limited access to finance are the three aspects of the investment climate in Mongolia that are most frequently cited as the most severe impediments to doing business. And while taxes, access to finance and corruption are common complaints of firms in many countries, the share of firms that view these three constraints as major or severe obstacles is higher in Mongolia than in most of the 62 other countries for
which comparable investment climate survey data are available.

On other dimensions as well, the investment climate in Mongolia appears to be less hospitable, or at least perceived to be so by a greater fraction of firms, than in most countries in East Asia, a region to which Mongolia is increasingly looking to integrate with, and many countries in Europe and Central Asia that have undergone similar transitions from centrally planned economies.

Taxes are perceived to be burdensome, and with good cause. The burden of taxes stems from multiple sources, among them certain provisions of the corporate tax code, the corporate tax rate structure, and the range of taxes that Mongolian businesses are subject to:

At over 32%, the tax-to-GDP ratio in Mongolia is extremely high for a country with its level of per-capita income. Effective tax rates faced by firms are higher than the nominal rates indicated in the tax code because deductibility of certain business expenses is not permitted. The lack of a loss carry forward provision in the tax code discourages investments. The dual tax rate structure creates an incentive to avoid taxes by staying "small" or appearing to be small by splitting up. Tax avoidance appears to be common though it is costly. Labor taxes, in particular, social security taxes, are unusually high.

Problems with taxes are rarely limited to the tax code itself. Cross-country evidence indicates that dissatisfaction with the tax code and tax rates goes hand-in-hand with complaints about the tax administration. The burden of taxes tends to come equally from inconsistencies in tax administration. That appears to be the case in Mongolia as well.

The burden of tax inspections in Mongolia is high. Because tax inspections and audits are not conducted within a risk-management framework, in 2004, of the roughly 26,000 registered corporate tax payers, 10,770 were visited and inspected by tax inspectors, and nearly four-fifths of these firms were assessed fines and interest. And the average number of days—9 days—spent meeting with tax inspectors—was considerably higher than in most other countries in both East Asia and Central Asia.

Despite (and perhaps because of) the frequency of tax inspections, the corporate tax base is narrow and compliance rates low. Moreover, there is substantial variation in the effective tax rates faced by individual firms. For instance, in the group of firms that reported net income of between 10 and 25 million MNT, the effective tax rate implied by the tax payments these firms actually made, ranged from a low of 3.3% to a high of nearly 30%. These variations suggest inconsistencies in tax administration.

The inconsistencies in tax administration stem from the excessive discretion enjoyed by tax inspectors and the rent-seeking this invites. Because of this, tax evasion is widespread. Over a third of the firms appear to be under-reporting sales. Under-reporting of labor costs is even more widespread and much more severe in degree, reflecting the efforts of firms to lower the excessive burden that social security taxes place on them. Tax evasion has hidden long-term costs for the firms that evade taxes. In particular, tax evaders are much less likely to have access to finance.

Nearly four-fifths of the registered Mongolian firms surveyed perceive corruption to be an obstacle to the operation and growth of their business, with over half reporting that it is a major or severe obstacle. Corruption is the investment
climate constraint most widely perceived to be a major or severe obstacle.

Perceptions of corruption as an adverse feature of the business climate are more widespread in Mongolia than in several comparator countries as well as some current and future competitor countries. The problem of corruption appears to have worsened considerably in the last five years. Government procurement processes are seen as particularly opaque and corruption-ridden. Corruption amongst the political elite appears to be on the rise. Cross-country comparisons indicate that having political ties is relatively more important for doing business in Mongolia than elsewhere. Land registration and allocation has become a locus of corruption.

The cost of finance is high

The cost of credit was second only to corruption as the most frequently cited impediment to business. And indeed the cost of finance in Mongolia is higher than in most of its comparator and competitor countries.

Interest rates have declined in recent years, but they continue to be 10-15% higher in real terms than in other countries. The degree of bank-based financial intermediation in business activity is low. Less than a third of the firms have a bank loan. Unlike firms in China and Malaysia, Mongolian firms rely largely on internal funds and finance from informal sources for their investment and working capital needs. Long-term credit remains scarce in Mongolia.

Lack of access to credit is also a common complaint

Lack of access to credit is a common complaint, and access to credit is indeed difficult. Bank lending in Mongolia is almost exclusively collateral-based and immovable assets are the predominant form of collateral. Collateral to loan values are higher in Mongolia than in any other country. But the limited use of credit may also in many cases be self-imposed. Many firms do not apply for loans and many state no need for loans.

Structural weaknesses make bank lending a risky activity and that, more than a scarcity of capital, is the reason for the high cost of and limited access to finance

In growing economies with high interest rates, the presumption is often that an economy-wide scarcity of capital, relative to the demands for working capital and investment funds, is the binding constraint—i.e., the main reason why interest rates are high. Mongolia does indeed need additional capital from abroad. The evidence, however, suggests that the interest rates are high not only, or even primarily, because of a scarcity of capital. Rather, the high interest rates are due as much to systemic and structural factors that make bank lending a risky activity and limit the range of financial products that are available.

The stringent collateral requirements are a direct indication that bankers perceive lending to be risky. The fact that the spread between deposit rates and lending rates is amongst the highest in the world also suggests that the risks inherent in lending are high. Poor corporate governance and a culture of operating in the shadow make it difficult for banks to assess creditworthiness, forcing them to rely almost entirely on collateralized lending. The weaknesses in the legal and administrative framework for bankruptcy and debt recovery make even collateral-based lending risky and costly. The legal framework for leasing is also weak, limiting the range of financial products available to firms. On average, less than 1% of the investment funds of firms comes from lease financing.

The trade and foreign investment regime is remarkably open, but…

Mongolia, which joined the WTO in 1997, is a remarkably open economy, with an uniform tariff of 5% on almost all items, few export taxes and no quantitative restrictions. It has a minimum level I trade restrictiveness rating on the scale computed by the IMF. Import tariffs levels are among the lowest in Asia. The foreign investment regime is equally liberal.
In principle, this simple and relatively liberal trade and investment regime has the potential to enhance transparency, simplify customs procedures, and reduce market distortions. In practice a number of problems have prevented this potential from being realized.

The unpredictability of the time it will take to clear customs is a key concern of businesses engaged in trade, who are much more likely to perceive customs processes to be a serious impediment than firms that do not engage in trade. Paper-based processes are the main source of delay in customs. Past automation efforts have not solved the problem.

Customs valuation processes appear to be a locus of corruption. A quarter of firms that export and just over a fifth of the firms that import report having to pay a bribe in order to expedite customs clearance or avoid excessive duties. Incentive structures and administrative processes within the Customs General Administration facilitate corrupt practices. The granting of import duty exemptions also provides opportunities for rent-seeking.

The surface transport options available to Mongolian exporters and importers are limited, costly and unreliable. Mongolia’s external trade is almost entirely dependent on a single rail link running from Sukhbaatar in the north on the border with Russia, through Ulaan Baatar to Zamyn Uud in the south on the border with China. Because of the difference in gauge of Mongolian and Chinese Railways, at the border either the axles on the wagons need to be changed, or the containers need to be transferred. Access to third-country markets is through this rail link to ports outside Mongolia. The shortest and most widely used corridor is one to the port of Tianjin in China.

Simply crossing the border into/from China is costly and time-consuming. Border crossing charges (because of the difference in gauge) make up nearly 25% of overall costs of transport to the port. The imbalance between exports and imports in the containerized rail freight traffic along this corridor (exports are 10% of imports) further adds to the cost because of the cost of returning empty containers to port. Transit times to port are uncertain because of the unpredictability of delays at the border. The unpredictability stems partly from the lack of a dedicated (China Railways) wagon service for Mongolia’s trade, with the result that the availability of rail-wagons at the border is subject to the vagaries of China’s domestic freight service needs. Compounding this uncertainty is the unpredictability of the time needed for completion of customs formalities and the handover of paperwork across the border. The uncertainty in transit times adversely affects the competitiveness of Mongolian exporters and can result in substantial costs for importers as well.

Technical and other barriers to trade beyond the border in China and Russia are serious impediments to Mongolia’s trade integration. Inadequate harmonization of customs procedures with Russia and China is a major cause of the delays, unpredictability and high costs Mongolian firms face. As mentioned above, shortage of China Railways wagons cause unpredictable delays in transit times to and from Tianjin port. Cross-border road linkages with China are hampered by restrictions on the movement of trucks.

Tariffs in China and Russia are higher for processed products. Exporters of meat, wool, cashmere and processed skins face additional barriers due to restrictions imposed by Russia and China on products of animal origin. Direct exports of meat to China and Russia are possible in principle, but difficult in practice. Third
country exports and imports of animal products from Mongolia via China are even more difficult.

Regardless of their position in the supply chain—tour operators, ger camps, guesthouses or hotels—firms in the tourism industry identify the lack of adequate and reliable air transport services, both domestic and international, as the main impediments to the growth of their businesses. Exporters of livestock-based products, and in particular meat, face a different type of transport constraint, and that is the lack of refrigerated transport and logistics options.

**What needs to be done**

A major tax bill is rightly on the top of the government’s reform agenda. Elements of the corporate tax code discourage investment and the adoption of modern business practices, which Mongolia can ill-afford, and encourages tax avoidance and tax evasion, which Mongolia needs less of. Reform of the corporate tax code must address these limitations.

Legitimate business expenses should be deductible. The corporate tax law should include a loss-carry forward provision. Unification of the tax rate is the first-best option for reducing tax avoidance, but in the second-best situation currently prevailing in Mongolia, an increase in the threshold above which the higher rate applies is a reasonable compromise. Special exemptions and tax holidays for certain sectors or categories of firms should be replaced by a system of investment tax credits available to all firms. A thorough review of the social security system is needed, with the aim of identifying ways to reduce the burden of social security taxes on firms.

Reform of the tax code along the lines described above will not by itself fully alleviate the excessive burden of taxes faced by the Mongolian private sector. The analysis indicates that this burden stems as much from the inconsistencies in the administration of the tax code. Without reforms in tax administration to eliminate these inconsistencies and lower the exposure of firms to arbitrary and predatory behavior on the part of tax inspectors, reforms in the tax code are unlikely to achieve their aim. A comprehensive reform of the tax administration is therefore an equally urgent task.

A detailed listing of the specific reforms that need to take place is beyond the scope of analysis of this report. However, the general thrust or strategic direction of the needed reforms is clear. The tax administration needs to move from a culture of “policing” (and the arbitrariness and rent-seeking behavior that accompanies it) to a culture of “service” and compliance mentality. An essential element of such a reorientation is the adoption of a risk-management approach to tax inspections and audits.

To coordinate and implement measures to promote transparency in government-business interactions, the government should consider constituting an Open Government taskforce composed of senior representatives from the key agencies that deal most directly with private businesses as well as representatives from the private sector, civil society and the parliament. This taskforce would have a broad mandate to collect and make publicly available, information on the plans and activities of key government agencies as well as the rules under which they are meant to operate and the rights of private businesses and citizens in their interactions with these agencies. For this taskforce to fulfill its envisioned mandate, secrecy laws governing access to information would need
An anti-corruption law needs to be passed and it needs to require income and asset disclosure.

Addressing the legal and institutional gaps that make lending risky would lower the costs of finance and improve access.

Existing gaps in the institutional and legal framework for contract enforcement in Mongolia, primarily in the area of bankruptcy, debt collection, and the liquidation of collateralized assets make bank lending risky for all banks and limit the range of financial products that are offered. Measures to address some of these gaps would, by lowering the risks associated with lending, lower the risk premiums that are in part responsible for the high cost of finance, and lower the high collateral requirements that reduce access to finance.

The procedures for debt collection in Mongolia need reform. The problem is not with the laws per se, but with the administrative arrangements in place— involving both the courts and local government functionaries—for implementing the law. In some other countries, specialized quasi-legal institutions have been set up to facilitate the process of debt collection. Mongolia may want to consider establishing such debt recovery tribunals. Collateral foreclosure and bankruptcy laws and procedures need reform. Creating a movable assets registry would improve access to finance. Strengthening the legal and administrative framework for leasing would also improve access.

The evidence indicates that the licensing and inspections regime in Mongolia suffers from red-tape and rent-seeking, just as the tax and customs administrations, the other specialized agencies that deal with the private sector, do. There is clearly a need for reform. But because licensing and inspections involve technical details that vary from activity to activity, and because they serve an underlying public purpose, which risks being undermined in a hasty attempt to eliminate red tape, the reform agenda needs to be elaborated more carefully. There are instances, such as in the case of veterinary and hygienic inspections in the livestock sector, where the need is for more and better inspections, not fewer. The same may be said for environmental inspections.

The first step in formulating a more detailed and nuanced agenda therefore is to undertake a thorough review of the licensing and inspections regime, to identify where it needs to be rationalized, as well as where it might need to be additionally resourced.

Reform of customs processes is needed with the twofold aim of reducing delays and reducing rent-seeking. To reduce rent-seeking, administrative processes and incentive and compensation schemes within the customs administration need to be reformed. To reduce delays will require, in addition, automation of key processes, harmonization of procedures with customs in Russia and China, and more efficient linkages with other domestic agencies such as the SPIA and GDNT. The introduction of a customs-single-window, spanning the different agencies from which clearances are needed, would help in this regard.

A tripartite Agreement on Transit Transportation between Mongolia, Russia and China is essential for Mongolia’s trade integration. Negotiations on such an agreement have been ongoing for over a decade. Completion of these negotiations has to be the government’s top trade policy priority.

Mongolia has limited human, technical, and financial resources for trade

Executive summary
negotiations. With China’s accession to the WTO and the pending Russian accession, Mongolia needs to build capacity and conserve resources to negotiate trade conditions with its two neighbors to increase trade facilitation. But the government also plans to actively negotiate a number of other bilateral preferential trade agreements. Preferential trade agreements are bureaucratically demanding, for instance, because they require customs authorities to administer rules of origin regulations. And because preferential agreements involve protection they inevitably expose domestic firms to adjustment pressures when the preferential arrangements come to an end, as was revealed with the end of the MFA in early 2005. The government needs to choose wisely where to allocate its scarce negotiating capacity.

The government might want to consider a (partial) open skies policy towards charter flights for tourists and air freight services. Such a policy would directly alleviate the critical barriers faced by the tourism industry—the inadequacy and unreliability of scheduled air services—and the livestock-based industries—barriers to movement of animal origin products through China and Russia. If the policy were coupled with a lifting of the ceiling on domestic air tariffs, it would have the potential to significantly jumpstart the tourism industry. And while there remain other technical barriers to the export of animal origin products that would need to be resolved, the availability of air freight services would eliminate a major disincentive to foreign investment.

There are examples of other low-income countries that have successfully adopted such policies. Cambodia’s decision in 2000 to partially open up its skies led to a dramatic increase in the number of tourists visiting Cambodia. Similarly, liberalization of Kenya’s civil aviation sector has led to Kenya becoming the largest exporter of perishables (cut flowers and leguminous vegetables) transported through air freight to Europe.

The government of Mongolia has understandably sought to identify ways through which to promote a diversification of Mongolia’s production base in an effort to reduce the vulnerabilities associated with being a primary commodity exporter. However, in formulating trade and investment policies in support of these objectives, it is important that the government avoid misdiagnoses that would lead to, and has sometimes led to, inappropriate policies.

The continued imposition of the export tax on cashmere, and the prohibitions on the exports of raw hides and skins are examples of existing policy that reflect such misdiagnoses. More worrying are indications that the government “aims to impose differentiated import duties in order to promote domestic production, encourage the transfer of advanced technology, as well as for the concerns related to food security and better quality foodstuffs.”

The misdiagnosis lies in attributing the difficulties of the domestic processing industries to the low uniform tariff regime. This report provides compelling evidence that Mongolian businesses, including processing firms, face multiple other constraints, from the inconsistencies in tax administration and the prevalence of corruption to the high costs of finance. Low import tariffs are not the problem. Mongolia’s open liberal trade regime is a plus and ought to be maintained.