

CURRENT ISSUES IN MONGOLIAN TAX POLICY

Final Report

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Prepared by:

Arthur Mann
Senior Economist

Development Alternatives, Inc. (DAI)
for the USAID-financed Economic Policy Support Project

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PREFACE

This study was prepared in accordance with the following terms of reference:

“The General Department of National Taxation (GDNT) of Mongolia has recently established a Tax Policy Department responsible for analyzing tax policy issues and presenting their findings and recommendations to the Ministry of Finance. They have requested the Economic Policy Support Project, a USAID-funded technical assistance project attached to the Office of the Prime Minister, to provide assistance to the unit. After discussions with the Director of the GDNT, Mr. Batjargal, it has been agreed that this cooperation will start with a joint assessment of current issues in tax policy. The primary focus will be to study the impact of the current tax system on economic growth, and discussion of options that would be more supportive of growth while maintaining fiscal balance. As Mongolia has an ongoing Poverty Reduction and Growth Facility (previously ESAF) agreement with the IMF, analysis of tax policy options will be conducted within the framework of the financial program embodied in that agreement. The hope is that this study will both assist the GDNT in developing its tax policy capacity, and put some options for reform on the agenda of the new Parliament following elections scheduled for July of this year.” The study’s expected output is a “comprehensive written review of current issues in tax policy in Mongolia....”

The consultant was in Ulaanbaatar from April 12 through May 3, 2000. He completed the report at DAI’s home office in Bethesda, MD. He wants to especially acknowledge the cooperation of the following GDNT staff: Mr. Batjargal, GDNT’s Director General; Mr. Erdenebaatar, the Head of the GDNT’s Policy Coordination Unit; Mr. Ganhuleg, a Senior Tax Official in the same Unit; and Mr. Tsogt, the Head of the GDNT’s Information Processing and Statistics Division.

For the reference of future consultants who work on tax policy in Mongolia, in his office at the GDNT Mr. Ganhuleg has accumulated an excellent “library” of papers and publications relating to general and Mongolian tax issues.

EXECUTIVE SUMMARY

Introductory Remarks

The composition and administration of Mongolia's tax system are consistent with a market-oriented model. Having accomplished the transition from a centrally planned economy in less than a decade is no mean feat, and is very laudable. Consequently, this report offers no dramatic suggestions for wholesale tax structure modifications. Rather, its principal recommendations deal with a series of marginal adjustments that, if adopted and properly administered, will move the overall tax system in the direction of enhanced efficiency while simultaneously fortifying the base for higher private sector-driven economic growth rates. All recommendations must be taken within the overriding context of administrative feasibility and fiscal impact. Given that the public sector deficit in 1999 weighed in at over 8% of GDP, it is especially important to take this latter variable into account.

I. The Enterprise Income Tax (EIT)

The EIT's present dual rate structure of 15% and 40% may be having deleterious economic and fiscal effects. It should be reduced to 15% and 30%. The fiscal, economic, and employment impacts of the tax incentives incorporated in the EIT code to attract foreign investment are unknown. They should be analyzed as soon as possible. Based on such an analysis, consideration should be given to modifying or eliminating them along the lines proposed in Section VIII of this report. Loss carry-forward provisions should be incorporated into the EIT in order to stimulate private sector investment. To enhance revenue collection and shore up administrative deficiencies, strong consideration should be given to introducing a gross assets tax (see Section VI.A). Introducing tax legislation regarding thin capitalization and transfer pricing will also aid in strengthening the administration of the EIT.

II. The Personal Income Tax (PIT)

The top PIT marginal rate should be reduced to 30%, and the three net taxable income brackets indexed for future inflation. Administrative tightening should focus on bringing more persons into the tax net so that future PIT revenues will increase as a proportion of total tax revenue. Analysis should be undertaken aiming at central government collection of the PIT under a formula-based transfer system within a greatly modified intergovernmental fiscal relations framework.

III. The Value-Added Tax (VAT)

The VAT's design and structure are very compatible with international standards. Consequently, most of the recommendations briefly dealt with in this section cover the

elimination of minor exemptions and the strengthening of various aspects of VAT administration; see Sections VII.B, VII.C, and VII.D.

IV. Excise Taxation

Mongolian excise tax coverage of expenditures on passenger vehicles, alcoholic beverages, and petroleum and tobacco products is quite rational, as it impacts the consumption of goods that generate negative externalities. The only real issue revolves around their low rates, which should be significantly raised along with the reinstatement of excises on beer consumption.

V. Presumptive Taxation

The standard assessment method of presumptive taxation in place since 1993 appears to be working fairly well, and should certainly be maintained. Two issues emerge. The monthly lump-sum amounts should be upwardly adjusted and, with income growth and structural change rapidly occurring, new activities should be brought into the presumptive (or income) tax net. Consideration should also be given to eventually changing presumptive taxation from its present method to a more sophisticated estimated assessment approach.

VI. New Taxes

While made with some degree of hesitation given the large number of taxes already on the books, the introduction of two new taxes and the future consideration of a third will improve revenue collection and enhance equity. A 2% tax can be viably put in place against an enterprise gross assets base. It will constitute a substitute minimum levy for the “avoided or evaded” EIT, but the regular amount of EIT can be taken as a credit. A second levy is a structures tax as a proxy for a property tax; the latter cannot be introduced since land is not yet privatized. A third form of wealth taxation, real estate and gift levies, might be considered, but can viably be postponed for the moment.

VII. Strengthening Tax Administration

Numerous measures to strengthen tax administration are put forth in this section. The need for and the structure and functions of an autonomous large taxpayer office are elaborated upon in Section IX. Legislation should be drafted to broaden the GDNT’s enforcement powers without having to recur to a lengthy judicial process. Penalties for the violation of tax laws should be raised and made more flexible. The present ad hoc inter-governmental fiscal system and the overlapping General Taxation and Budget Laws create tax administration misunderstandings and inefficiencies; unraveling this will require a thorough analysis and subsequent restructuring of Mongolia’s intergovernmental fiscal relations. Tax auditing must be significantly enhanced in all its aspects, ranging from computerization of files and processes to offering ongoing training activities.

VIII. Tax Incentives

The principal reason for offering tax incentives is the perception that they are “required” due to inter-country tax competition. However, their benefits and costs have not been estimated, and there does exist the possibility that for Mongolia their costs may outweigh their benefits. This remains to be seen. There does exist a viable substitute to the existing tax incentive scheme, which involves the use of a system of investment tax credits and/or partial depreciable asset expensing. Such a system offers numerous advantages over the present tax holiday arrangement. The feasibility of implementing such a mechanism should be seriously analyzed.

IX. Abbreviated Proposal for the Establishment of a Large Taxpayer Office

Tax administration efficiency will be improved via the creation of an autonomous large taxpayer office (LTO). Although a LTO presently exists within the physical and administrative confines of the GDNT, the proposal put forth in this section is far more pertinent to a self-sufficient office having its own computerized systems, personnel, and procedures. The “new and enhanced” LTO should contain four divisions: collections, audit, technical-legal, and data processing. The human resource, equipment, technical assistance, and training needs for a LTO which will monitor and control 75 to 100 large taxpayers are set forth in this section.

Introductory Remarks

The present Mongolian tax system is consistent with a modern market-oriented tax structure in that it levies taxes on income via the personal and enterprise income taxes and on consumption under a value-added tax, selective excises, and customs duties. These taxes assumed their present form in the 1990s during the transition from a centrally planned economic system under which a true tax system was nonexistent. Consequently, the type of taxation and implementation practices are relatively new to both the tax administration (the Ministry of Finance and its tax administration arm, the General Department of National Taxation) and the taxpayers themselves. Despite such relative newness, adaptation to new systems has generally proceeded very well.

As a result, what remains to be done does not involve dramatic and wholesale changes. Rather, there are elements within each tax category which can be better adjusted to provide a tax system that is more appropriate to achieving higher private sector-oriented growth rates within the overriding context of integration into the international economic system. What follows, then, are a series of interrelated recommendations aimed at developing a more efficient tax system. In most cases, these recommendations should be taken as part of a package, and would move the tax system in a more positive direction if not separately adopted.

The underlying rationale for the recommended package is simplicity. Far more sophisticated and/or “ideal” recommendations might be put forth, but this would run counter to the basic reality of any tax system: a good tax must be an easily collectible tax with low administrative costs proportional to revenues. This implies, to the extent possible, administrative simplicity. Tax policy is tax administration. It is useless to develop a set of tax codes and regulations if, by doing so, tax collection becomes overly difficult. Tax administration must be visualized as an integral part of tax policy. If the intimate tax administration-tax policy link is either ignored or not fully accounted for, a breach is opened up which will violate the concepts of horizontal and vertical equity. A weak administration widens the gap between the actual and the potential tax base. Mongolia’s tax administration structures are at an incipient stage. Therefore, the need exists to simplify procedures, processes, and forms while simultaneously strengthening databases, computerization, and personnel abilities.

Tax Equity

The issue of tax and tax system equity always crops up in discussions of taxation. It is certainly important that a tax and the overall system are structured so as to incorporate generally accepted equity standards. In terms of the tax system, this requires some combination of progressive income and wealth taxes together with expenditure taxes (VAT and excises) which tend toward regressivity. Even expenditure taxes can include provisions to reduce their natural regressive proclivities.

With its bias toward expenditure taxes, a cursory glance at Mongolia's tax system would rapidly lead to the conclusion that the overall tax system is regressive in structure. Empirically, this well may be the case, although the VAT probably does not reach most consumption outlays of many low-income persons.

It is argued here that the probable regressivity of individual taxes and the "reasonably acceptable" (within limits) regressivity of the overall system should not generate the need to significantly change either one. For decades taxes and tax systems were viewed as instruments to be used by governments to modify a country's wealth and income distributions. **This should not be the case.** There are many better policy instruments to use. One of the best is the other side of the public budget. Taxes are levied to provide budget revenues to finance public expenditures. It is the expenditure side of the government's budget that can have significant impacts on income distribution. For example, expenditures well targeted at primary education and health do far more to redistribute incomes than usually misguided attempts to use the revenue/tax side for redistributive purposes. Mongolia's State Budget expenditure by function reveals that in 1998 social expenditures made up close to three-quarters of current expenditures (and 46% of total expenditures). Such proportions are laudable.

The foregoing comments represent lessons gleaned from many decades of observing how governments levy taxes that negatively impact upon incentives to produce and grow. This does not negate the fact that perceptions of equity are important, and policy-makers must pay a certain amount of attention to them. But in doing so they must not lose focus on what has greater weight for income distributive purposes---public expenditures.

The Budget Deficit

Due in large part to tax measures taken during 1999, Mongolia's tax ratio (tax revenues as a percentage of GDP) rose above its 1998 level. Based on preliminary estimates of GDP, the tax ratio reached 18.3% in 1999, a slight increase over the 17.6% registered in 1998. On the other hand, the revenue ratio (total general government revenues as a percentage of GDP), which includes both tax and non-tax income, continued its downward trend, reaching 26.1% in 1999. Neither ratio returned to levels achieved in 1997 prior to the Asian financial crisis and the large drops in international commodity prices. Consequently, although the 1999 current fiscal balance registered slightly positive figures at 5.5 billion tgs, the overall fiscal balance remained deeply in the red at almost 85 billion tgs. These figures represent 0.6% and -8.5% respectively as a proportion of GDP.

This is not a salutary or sustainable situation for either the short- or medium-terms. High and sustained budget deficits have deleterious effects on a country's economic health, impacting such key macroeconomic variables as the exchange rate, interest rates, and price levels. Moreover, in the absence of measures designed to further lower the overall deficit, International Monetary Fund support for Mongolia might be endangered. Future fiscal measures must be adopted with an eye toward their revenue consequences.

Whereas it might be validly argued that, on an internationally comparative basis, Mongolia's overall tax burden is relatively high given its level of per capita GDP, the deficit should be reduced over time. The potential supply-side effects of tax rate decreases cannot be counted on to attack the deficit in the short-run. If, in fact, these effects do emerge, their impact will be felt only over a longer interval. The same can be said of enhanced tax administration strengthening, which is a medium- to long-term undertaking that requires continued commitment.

Therefore, the tax policy recommendations that follow should be taken within the implicit context of their impact on tax revenues. With one exception they are not quantified due to the lack of time and adequate data. In this report most of the principal current tax policy issues will be reviewed. Focus will be on the major taxes. Numerous minor taxes and non-tax revenues will not be covered.

I. THE ENTERPRISE INCOME TAX (EIT)

A. Rate Structure

Net enterprise income is presently taxed under a dual rate structure: 15% on the first 100 million tgs and 40% on taxable income over 100 million tgs; i.e., 15 million tgs plus 40% of taxable income over 100 million tgs. A top EIT rate of 40% is high on an internationally comparative basis, and may lead to enhanced tax avoidance and evasion. Moreover, the abrupt jump from 15% to 40% is exaggerated, and may generate the undesirable effect of causing firms to split into several different legal parts to avoid falling in the 40% bracket. This is inimical to enterprise growth, the generation of economy of scale effects, and efforts to reduce tax avoidance and evasion.

Consequently, rate reduction is in order. There are many possible permutations to adopt: a flat uniform rate for all firms at anywhere between 20% and 35%, or a continued dual rate structure to encourage the formation and growth of smaller firms.

Recommendations:

1. Retain the 15% first bracket rate up to 100 million tgs and a 30% rate above 100 million tgs. A rate increase from 15% to 30% would represent an unacceptable fiscal burden on the smaller firms, forcing some into bankruptcy, others into the informal sector, and stunting the growth of a burgeoning enterprise segment. Beginning in year 2001 the 100 million tgs bracket should be indexed by the CPI to retain the small enterprise incentive. While there does exist a valid argument against retention of this lower rate in that it might cause the division of a larger whole into smaller legal entities, the counter argument of stimulating the growth of the small enterprise sector outweighs the former.
2. Fix the top rate at 30%. Given the magnitude of the State Budget deficit, at this time it is not deemed feasible to go below 30%. Static calculations based on a breakdown of 1999 EIT data indicate that reducing this top marginal rate from 40% to 30%

would generate a fiscal loss equal to almost one-quarter of 1999 EIT collections (see Table 1). Since the EIT generated 16.1% of total tax revenue in 1999, this represents an appreciable decrease that would have to be compensated elsewhere within the budget (on the revenue or expenditure sides). Rate reductions below 30% imply even greater revenue losses. At least part of these losses may be compensated over the medium-term by the adoption of subsequently recommended proposals regarding loophole closings (for example, see Sections VII and VIII), tax base expansion, and new levies (see Section VI). It might also be argued that administrative strengthening and economic growth (via supply side effects) will generate future additional revenues. However, the budget deficit is a reality which must be dealt with now. Moreover, the additional revenues that “eventually” may be generated by administrative measures are consistently overestimated by ministries of finance around the world. Administrative strengthening is a long-term and on-going proposition which does not normally generate large revenue enhancements.

TABLE 1
MONGOLIA: ESTIMATED REVENUE IMPACT OF MODIFYING
EIT RATES BASED ON 1999 DATA

ALTERNATIVE SCENARIOS	TAXABLE INCOME(a)	TAXES PAID(a)	EFFECTIVE TAX RATE	ABSOLUTE CHANGE (a)	CHANGE AS % OF ACTUAL
ACTUAL 1999 EIT COLLECTIONS (b)	86,640	25,104	29.0	--	--
RATES UNIFIED AT 35%	86,640	30,324	35.0	+5,220	+20.8
RATES UNIFIED AT 30%	86,640	25,992	30.0	+888	+3.5
RATES UNIFIED AT 25%	86,640	21,660	25.0	-3,444	-13.7
RATES UNIFIED AT 20%	86,640	17,328	20.0	-7,776	-31.0
RATES UNIFIED AT 15%	86,640	12,996	15.0	-12,108	-48.2
RATES AT 15% AND 30%	86,640	19,084	22.0	-6,020	-24.0
RATES AT 15% AND 25%	86,640	16,640	19.0	-8,644	-34.4
RATES AT 10% AND 20%	86,640	12,751	14.7	-12,353	-49.2

(a) Millions of tugriks.

(b) 15% on first Tgs. 100 million of taxable income and 40% on taxable income above Tgs. 100 million.

Source: Elaborated from data provided by the GDNT, Information Processing and Statistics Division.

B. Tax Incentives

The EIT code (see the English translation of the Economic Entity and Organization Income Tax Law of Mongolia) contains numerous tax exemptions and credits to attract foreign investment (Article 7). These form part of the Foreign Investment Law, which also concedes tax exemptions cum incentives under several other taxes (e.g., VAT, personal income tax). But the most significant are offered under the EIT, and the most important of these relate to those business entities with foreign investment (Articles 7.5 to

7.11). To qualify as a “business entity with foreign investment”, the “contribution of foreign investor is not less than 20% of the registered capital”; see the Foreign Investment Law, Article 11.

Article 7.5.1 of the EIT code offers 10 years of total tax exemption and five additional years of 50% tax relief to investments in power and thermal plants and transmission networks, highways, railways, and telecommunications. With the exception of telecommunications, FDI under this article has been slight. On the other hand, Article 7.5.2, which offers five years of total exemption and an additional five years of 50% relief for investments in mining and processing of mineral resources, oil, coal, metallurgy, chemicals, machinery, and electronics has generated far larger investments. Article 7.6 gives total tax exemption for three years and 50% exemption for an additional three years to those firms that export more than 50% of their output; the bulk of FDI has flowed in under this article. Additional investments in an on-going enterprise are 100% deductible (Article 7.8); the article does not specify if they are deductible in the year in which they are made or for some other time period.

As of April 1, 2000, there were 1428 business entities registered with the Foreign Investment and Foreign Trade Agency (FIFTA), which is attached to the Ministry of External Relations. Of this total, 1045 were joint ventures and 383 were wholly owned foreign companies. In terms of the number of registered enterprises, the principal sectors were trade and catering services (231), engineering, construction, and production of building materials (189), geological prospecting and exploration (155), production of foods and beverages (129), processing of animal-originated raw materials (106), and light industry (94). The pace of registrations has notably accelerated since 1994; between 1997 and 1999, 869 firms were entered in FIFTA’s registry, and in the first quarter of 2000, 70 additional firms appeared. The country-of-origin list of these firms is headed by China (455), Russia (236), and South Korea (168).

It is important to note the distinction between having registered with FIFTA and having actually become operational. According to GDNT/MOF data, as of December 31, 1999, 826 enterprises with foreign investment were in actual operation. As with FIFTA registration, in terms of the number of operational firms by country-of-origin, Chinese (254), Russian (129), and South Korean (118) enterprises headed the list. The MOF/GDNT database, which is transferred from the Ulaanbaatar City Tax Office, does record the value of foreign direct investment (FDI) registered assets in either tugriks or dollars at the date of initiation of the business, but it is not updated. This is a moot point, for the gross asset values it presents are clearly incorrect. This source reveals that on 12/31/99, total FDI assets (i.e., the value of capital investment at inception) for firms currently operating in Mongolia amounted to 80 billion tgs and 1.1 billion dollars. At an exchange rate of US\$1 to 1000 tgs, this would imply that gross FDI in Mongolia had reached the lofty sum of almost US\$1.2 billion by end-1999. Assuming that Mongolia’s aggregate GDP is approximately US\$1 billion, this value for FDI is not credible.

Attempts to reconcile (or correct) these figures with FIFTA data on **planned** FDI were not successful. According to FIFTA data, the value of registered enterprise planned FDI,

while fairly substantial given the size of Mongolia's economy, is weak in comparison to that in many other east and central Asian economies. Between 1990 and the beginning of April, 2000, cumulative planned FDI amounted to US\$301 million. What percentage of this total has actually been realized is unknown, but it is certainly less than US\$301 million. It was hoped that the MOF/GDNT data would throw some light on this situation. As noted, they do not. Not surprisingly, the leading sectors in terms of the planned FDI dollar amounts are geological prospecting and exploration (US\$71 million), light industry (US\$59 million), and the processing of animal-originated raw materials (US\$32 million). Over time the planned and registered FDI inflow has picked up. In 1999 it amounted to US\$71 million, with light industry leading the way (US\$19 million); in the first quarter of 2000, US\$32 million was recorded, with half this amount corresponding to light industry. For the entire period, China (US\$69 million), Japan (US\$48 million), USA (US\$27 million), and South Korea (US\$25 million) represent the leading FDI country-sources.

There are apparently no solid figures regarding employment creation under the FDI inflow. It is roughly estimated that cumulative job creation has reached around 10,000. If, in fact, these figures are decent approximations to reality, they are not overly impressive. The relatively poor cumulative performance of Mongolia on the FDI-attraction and (especially) employment creation fronts may have little to do with the Law itself. Rather, it may be more influenced by Mongolia's geographical isolation, the lack of infrastructure development, and other myriad factors that influence foreign direct investment flows.

Apparently, neither the impact (in terms of employment and income generation) nor the implicit fiscal loss attached to these concessions has been estimated. **This should constitute a priority activity.** The economic and fiscal impact of these incentives is simply unknown. If, in fact, the economic/employment impact is small but the fiscal losses are significant, the overall structure of Mongolia's tax incentives should be revisited and revised. These issues are taken up in Section VIII below, where an alternative to the present tax incentive program is offered.

Although the Foreign Investment Law has been extant since 1990, the version currently governing foreign capital has been in effect since 1993. In 1998 FIFTA presented five Foreign Investment Law modifications to the Parliament to strengthen the foreign investment process and structure, but they have not yet been approved.

Recommendations:

1. Analyze the impact and the cost of the present fiscal incentives. There are at least two ways to do so. The first is simpler and can be done in the short-run. It essentially involves conducting a series of interviews with entrepreneurs, managers, and government officials to estimate investment, employment, and revenue loss effects. The second, a longer-run proposition, would involve the development of a micro-simulation model using a stratified sample of enterprise tax returns.

2. Analyze the feasibility of replacing the existing tax incentive/holiday system with tax credits and expensing. The rationale for this is explained in Section VIII.
3. With or without modifying the existing tax incentive system, use the EIT rate structure to stimulate regional diversification of investment and subsequent employment creation. At present most new firms are locating in the Ulaanbaatar region. The dual EIT rate structure should be reduced for employment-creating investment beyond, for example, a radius of 100 kilometers from the capital; e.g., offer rates of 10% and 20% for firms locating productive activities beyond a 100 km. radius, and rates of 5% and 10% beyond, say, 300 kilometers.
4. Eliminate tax exemptions under Articles 7.1.7, 7.1.8, and 7.1.9. The first two state that the activity or donation should “serve society”. This is far too vague a definition, leading to varying interpretations and taxpayer abuse; e.g., valuations at inflated figures.
5. Eliminate Article 7.7 that states that a “business entity with foreign investment not referred to in this Article may be granted tax preferences. Decision in this matter will be adopted by the State Great Hural in each case upon its presentation by the Government of Mongolia.” This leaves offering tax preferences wide open to political decision-making in the worse sense of the term.
6. Consideration might be given to offering Article 7.6-type tax incentives to firms which export less than 50% of their output (or none at all), but which will manufacture a product not presently produced in Mongolia.
7. Study the feasibility of significantly modifying the present system of tax incentives along the lines suggested in Section VIII of this report.

C. Loss Carry-Forward

The EIT tax law contains no provision whatsoever for loss carry-forward and loss carry-back. Given the incipient stage of enterprise development, the weakness of tax administration, and the GOM’s fiscal position, loss carry-back issues are best relegated to the future, and will not be touched upon here. But the absence of a loss carry-forward provision will negatively impact upon future enterprise development in Mongolia’s market-oriented economy. Moreover, there exists an interrelationship between loss carry-forward and the aforementioned proposals for reforming the tax incentive law.

By their very nature, newly established enterprises expose themselves to market risks. It takes time to nurture and develop a successful business. This is especially so in Mongolia, where purchasing power in domestic markets is limited (as a function of both the number of viable consumers and low income levels), external markets are relatively distant and access to them is restricted due to underdeveloped infrastructure, and entrepreneurial ability is incipient. The lack of a loss carry-forward article in the EIT code therefore discriminates against new and risk-taking firms. Additionally, given the transition to privatization of many SOEs, this would aid in such a transition. In fact, the existence of a loss carry-forward provision may make the SOEs more attractive to prospective investors in light of the reality that many SOEs will require an extended period of restructuring.

It is recognized that the GOM may be reluctant to incorporate a loss carry-forward provision in the EIT law due to its negative impact on tax revenues. There is no doubt that, in the short-run, EIT revenues will drop. However, such tax losses will most likely be more than compensated by increased investment that will generate higher future tax revenues. Moreover, in the recommendation that follows, full loss offset will not be proposed. Rather, it will be limited to a finite time period, and will not be credited with interest; this latter provision reduces the present value of the government's short-term tax loss (and the firm's tax saving). As a corollary, the auditing of enterprise tax returns must be strengthened.

Recommendation:

1. Amend the EIT code to allow loss carry-forwards up to five years. A five-year period would place Mongolia at the low end of the international spectrum, in which some countries even permit indefinite loss carry-forward. There is no need to reinvent the wheel; a draft law regarding loss-carry forward has been in existence since 1997.

D. A Minimum Enterprise Tax

In countries where tax administration is weak and enterprises are adept at tax planning (tax avoidance) and/or outright tax evasion, a minimum enterprise levy can provide a good backstop to the EIT. The principal issues that must be addressed relate to the choice of a tax base which is both equitable and relatively easy to identify and administer, the tax rate, its applicability to firms that receive tax holidays, and its impact on foreign tax credit eligibility.

The principal alternative minimum tax bases are receipts and assets, which may be defined and measured in gross or net amounts. Mongolia's presumptive tax is also a form of minimum taxation; it is taken up separately in this report (Section V), as it clearly does not apply to enterprises that fall in the EIT net. In Section VI.A. the case is presented for the imposition of a gross assets tax. Its applicability to firms receiving tax incentives would be a moot point if Mongolia's incentive system were reformed along the lines suggested in Section VIII. If tax preferences are retained essentially as presently extant, the minimum tax offers a method of generating a basic amount of revenue from such enterprises.

Recommendation:

1. Draft, develop, and apply a minimum tax of 2% against enterprise gross assets; see Section VI.A.

E. Tax Code Modifications to Avoid Future Tax Avoidance and Evasion

As Mongolia's enterprise sector develops and grows via increased domestic and foreign investment, its registered companies will become more profitable and more adept at using "creative accounting" to both avoid and evade the payment of the EIT. It is therefore

incumbent on the GDNT to prepare its staff to recognize and deal with tax problems in areas not well envisioned under current EIT legislation. Two of these areas are mentioned here.

1. Thin Capitalization

Thin capitalization refers to the practice of substituting debt capital for equity capital to finance company assets. The term is usually associated with lending between a foreign investor and a local subsidiary, but may also occur between two associated local firms. By increasing debt financing beyond “reasonable” or “optimal” limits, the objective is to lower taxable profits, because interest paid on the debt is deductible. This practice is apparently already being used in Mongolia.

EIT legislation should incorporate rules designed to limit this practice. Internationally, tax authorities have adopted several different approaches to restrict such behavior, but the approach best applicable to Mongolia at this time is that of applying a fixed ratio to the debt:equity relation. In brief, part of the interest paid to the creditor is disallowed if the debt:equity ratio surpasses a given level. A difficulty arises because “appropriate” debt:equity ratios can reasonably vary between sectors and companies. A 2:1 ratio may be used as a reference point, and attempts to adopt varying ratios by sector complicate administration.

Recommendations:

- a. Incorporate rules in EIT legislation to restrict the practice of thin capitalization. One easy way would be to set equity requirements for enterprises with foreign investment at US\$75,000 to US\$100,000 and those for domestic corporations at a lower figure.
- b. Offer training to pertinent GDNT staff to recognize and deal with thin capitalization.

2. Transfer Pricing

Transfer pricing involves the intra-firm sale of goods and services between branches and affiliates of a single company that operates in different countries. In many cases these prices, instead of constituting arm’s-length valuations, are simply administered prices reflecting tax considerations; i.e., they are set to increase taxable income in low tax countries and to decrease taxable income in high tax countries. Rules must be established to regulate the setting of such transfer prices. Although there do exist international guidelines for determining arm’s-length prices, it is not an easy task since it can involve legitimate differences of interpretation between national tax authorities and multinational corporations.

Recommendations:

1. Although Mongolia's adoption of a minimum (gross assets) enterprise tax may reduce transfer pricing abuse, it should incorporate transfer pricing statutes in the EIT legislation. There are several internationally acceptable alternative methods that might be used to determine arm's-length prices. Each should be studied, and the one that best conforms to Mongolia reality and administrative capabilities should be adopted.
2. Offer training to pertinent GDNT staff in dealing with the transfer pricing issue.

F. Additional EIT Considerations and Related Tax Issues

The EIT is in urgent need of an overall framework under which enterprises can enjoy stability and a better sense of security. This is especially true of enterprises with foreign investment. Stability agreements in the mineral tax law have apparently been violated by the GDNT. There appears to exist unequal treatment on the part of GDNT auditors regarding their handling of foreign versus domestic enterprises, treatment that is perceived as constituting harassment. The GDNT Taxation Office denies this. Valid or not, perceptions matter. The absence of an overall framework, inconsistencies in rulings regarding applications of the tax code, the disallowance of deductions normally permitted under international tax and accounting standards, and the poor definition of terms in tax legislation may be having negative consequences vis-à-vis foreign investment. Due to these factors, some foreign enterprises are reevaluating their investment options in Mongolia. Others may not come at all. The recommendations below go part of the way toward remedying some of the aforementioned defects.

Recommendations:

1. Adopt a genuine overall EIT framework. This will require external technical assistance. The 1995 draft of the Law on the Supervision of Tax Levy, Payment, and Tax Collection submitted by a consultant to the GDNT (and adopted in part) represents a model that would be useful to emulate for the revised EIT draft law.
2. Institutionalize training for all tax administrators, especially for tax auditors. For the latter, on-going training programs are essential with respect to international accounting standards and practices under both the EIT and other taxes.
3. Place stability agreements in the EIT. They are essential to attract foreign investment. Proposed amendments to the Foreign Investment Law of Mongolia include a stability agreement (Article 18), but these amendments have not yet been adopted by Parliament.
4. Translate from Mongolian to English the implementing guidelines for all taxes and make them available to taxpayers.
5. Seek technical assistance to clarify the definition of terms in the EIT law.
6. Permit and adhere to advanced rulings. Stability of and consistency in advanced rulings are critical.

7. Adhere consistently to guidelines; there should be no room for individual interpretation.
8. Add indirect to direct expenses in Article 5.1(1) of the EIT law.
9. Permit the deductibility of bad debts.
10. Allow deductibility for inventory obsolescence.
11. Develop and computerize a rulings cum interpretations database accessible to GDNT personnel and taxpayers.
12. Introduce more flexibility to depreciation costs by permitting write-offs.
13. Reduce the withholding tax rate from 20% to 10% on the monies borrowed from foreign banks and permit deductibility under Mongolian statutes. External borrowing occurs due to the large interest rate differentials between Mongolia and abroad. Revisit this withholding tax rate change if and when these differentials diminish.
14. Modify EIT code Article 6.1.(7)(d) to allow reimbursement of intra-company costs.
15. Modify the composition of the GDNT's Tax Dispute Council by adding private sector businesspersons.
16. Study the alternatives for clarifying the assignment of the EIT itself and its taxpayers; see Section VII.C.

II. THE PERSONAL INCOME TAX (PIT)

In 1999 the personal income tax (PIT) generated 6.9% of total tax revenue, or 12.5 billion tgs. Even by developing and transitional country standards and taking into account Mongolia's per capita GDP, this falls somewhat short of reasonable (or average) expectations. On the positive side, both 1998 and 1999 witnessed a growth rate of nominal collections above the rate of inflation, meaning that real PIT revenues have increased. Moreover, the 1999 revenue rises occurred despite very sizeable increases of the taxable income brackets to compensate for past inflation; e.g., while prior to May, 1999, the top marginal tax rate of 40% on taxable income kicked in at 1,152,000 tgs, it now begins at a much higher 4,800,001 tgs. Nevertheless, there are serious flaws on the administrative side of PIT collection, some of which will be touched upon in Section VII.

The PIT taxable income base includes most forms of income as defined in internationally acceptable statutes, albeit some forms of income are taxed at flat rates that most likely fall below the rate to which the receiving taxpayer would be subject without these special considerations; e.g., dividend and interest income, the bulk of which accrues to higher bracket taxpayers, will be taxed at a 15% flat rate as of January 1, 2001 (at present the rate is zero). Such special treatment of certain income sources has its incentive objectives, and is not necessarily objectionable.

The PIT is collected by the GDNT district tax office in Ulaanbaatar and by the soum (part of the GDNT) tax offices in the aimags. According to the General Taxation Law of Mongolia, the PIT is a central government tax; see Article 16. Nevertheless, the Budget Law states that PIT collections are part of the local government budget in the jurisdiction where they are collected. In practice, the Budget Law takes precedence.

There are a number of PIT issues that emerge:

- Current tax rates are 10% on the first 2,400,000 tgs of annual taxable income, 240,000 plus 20% on the amount above 2,400,000 tgs up to 4,800,000, and 720,000 tgs plus 40% of the amount above 4,800,001 tgs. The marginal tax rate jump from 20% to 40% is excessive, and may dampen work and tax compliance incentives. That high marginal tax rates correlate positively with the propensity to evade taxation in a developing country was empirically substantiated in Arthur J. Mann and Robert Smith, “Tax Attitudes and Tax Evasion in Puerto Rico: A Survey of Upper Income Professionals,” Journal of Economic Development, V.13 (June, 1988), pp. 121-141.
- With inflation rates close to or above double digits, bracket creep will continue to erode real after-tax personal incomes. The May, 1999 significant upward adjustment in the limits of the taxable income brackets dealt with the effect of past inflation, but discretionary adjustments usually lag well behind events.
- To exempt low levels of income from the taxable income base, the PIT law provides an annual tax credit of 36,000 tgs. If the intent of the law is to exempt from income taxation a basic level of income, it is clear that 36,000 tgs is far too low. An alternative method of exempting a minimum income level from personal taxation, and which can simultaneously be better adjusted to individual taxpayer circumstances, is that of offering personal exemptions (e.g., head of household, number of dependents) from adjusted gross income. Of course, this complicates the task of the tax administration and is open to taxpayer abuse. At the least, future incorporation of such an option should be analyzed.
- Many Mongolians working with foreign aid-financed projects and foreign organizations are paying little or no tax, and taxes are not being withheld by their foreign employers. This is clearly not equitable since their salary levels are far above those of public employees, who are subject to source withholding.
- Although Article 7.1 clearly states that temporary resident taxpayers are subject to normal tax rates, inconsistent and incorrect tax inspector interpretation permits them to be taxed at a 10% rate (Article 7.5a).
- PIT revenues are collected and retained at the local government level, although tax rates are set by the central government’s parliament (Ikh Hural). For the sake of equity and administrative efficiency, the PIT should be solely a central government levy, with a formula-based transfer system to distribute centrally-collected revenues to the local government units. This opens up a Pandora’s box of intergovernmental fiscal relations issues regarding tax and expenditures assignment and transfer formulas. Some of these issues are briefly taken up in Section VII.C.

Recommendations:

1. Reduce the top marginal rate to 30% in accordance with the maximum recommended EIT rate of 30%.
2. To avoid future bracket creep and the need to recur to Parliament every time the tax income brackets require adjustment due to inflation, bracket intervals should undergo automatic annual adjustment according to the consumer price index (CPI) for Ulaanbaatar (using annual averages). Indexing should commence in 2001 to be applicable to the filing of final year 2000 tax returns.

3. Immediately raise the tax credit from 36,000 to 100,000 tgs and index annually by the CPI.
4. Pursue immediate administrative efforts to incorporate in the PIT net all Mongolians working with foreign assistance projects in addition to non-resident taxpayers being “under-taxed” at 20%.
5. Reduce the bog exemption for households with private stocks from 150 to 100 (Article 9.7) to better align it with the tax credit. This represents a good and administratively easy way of bringing rural households into the income tax net.
6. Put on hold carrying out another study by a consultant with respect to Mongolia’s intergovernmental fiscal system until the GOM makes a solid commitment to act on reform recommendations. There already exist numerous studies covering this critical issue; see Section VII.C. At this juncture another one is not needed.

III. THE VALUE-ADDED TAX (VAT)

The design and basic structure of Mongolia’s VAT is quite compatible with international standards regarding value-added taxation, and the recommendations found below are more marginal than profoundly substantive. Several of the administrative issues raised apply just as much to the VAT as to all other principal taxes; e.g., enforcement, penalties, inter-governmental fiscal relations, audits.

In 1999, VAT collections on domestic sales and on imports amounted to 58.9 billion tgs, or 32.3% of total tax revenues. As such, the VAT plays a vital role in the GOM’s finances. The VAT on imports generated 54.0% of the total VAT. The domestic VAT is collected by the GDNT capital city district and soum tax offices in the aimags. According to the VAT law (Article 13.2), 80% of these revenues should be transferred to the state budget, with 20% remaining at the sub-national level. Inevitably, this process is not as smooth as the law infers, and there do crop up transfer short-falls and delays. The collection of VAT on imports is the responsibility of Customs.

A thorough evaluation of the VAT was carried out by an IMF team a little over a year ago (April 14-28, 1999), and there is no need to repeat such an exercise here. The detailed report is available in Mongolia under the title “Mongolia: Improving the Design and Administration of the Value Added Tax,” April 26, 1999 (IMF, Fiscal Affairs Department). Not surprisingly, it was estimated that taxpayers only declare and pay some 55% of what they owe. Although most of the recommendations pointed out in the IMF’s report remain valid, to its credit two of the major defects have already been implemented by the GOM: it raised the VAT rate from 10% to 13%, and lowered the registration threshold from 15 to 10 million tgs.

Although there is a difference of opinion, apparently reasonable progress has also been made with respect to another principal flaw, that of VAT refund arrears. The GDNT’s Taxation Office version is that, at least for the 46 large taxpayers, the VAT refund system is not working well. Most refunds are not being made. Rather, refunds come in the form of applying what is due in refunds to the payment of other taxes owed by the taxpayers.

While this is certainly permissible under the VAT tax law (Article 11.4), it violates an implicit refund commitment, and most likely creates cash flow problems at the enterprise level. Under the MOF version, the 1998 refund problem (i.e., no refunds were made) was significantly improved upon in 1999. During the first quarter of 2000, of the 1.1 billion tgs in VAT refunds requested from the MOF by the GDNT, some 800 million tgs were paid, leaving around 300 million tgs in arrears to be paid from the state budget by end-April, 2000. However, there are another 700 million tgs in refund arrears to be paid from local government budgets. While this represents a significant improvement over the 2.8 billion tgs outstanding as of end-June, 1999, it remains an inordinate amount. Therefore, even though refunds are being made, there do exist substantial amounts of outstanding arrears beyond the proscribed 30 day limit (VAT Article 11.5).

Recommendations:

1. Eliminate the exemptions for financial leasing (Article 9.1h), services of tour operators (within Article 9.1.10), and technological equipment as “part of the assets of a business entity with foreign investment” (Article 9.2.10).
2. Eliminate the VAT on gold exports (Article 6.4) and tax the value of gold exports either under export taxes or (preferably) via a 10% withholding tax on the mining company’s sales abroad. This latter method addresses the public revenue loss caused by selling directly overseas instead of selling to the BOM. If the mining company is properly audited, it could opt to pay the normal EIT in lieu of the 10% withholding.
3. Strengthen the GDNT’s enforcement powers; this is discussed in Section VII.B.
4. Better define the system of inter-governmental tax jurisdiction as it refers to the VAT (and other taxes); see Section VII.C.
5. Modify and strengthen penalties; see Section VII.B.
6. Strengthen and improve audit capacity; see Section VII.D.

IV. EXCISE TAXATION

Excise taxes on selective goods play a positive role in Mongolia’s tax structure. Excises currently burden tobacco and petroleum products, alcoholic beverages, and passenger vehicles. Their rationale is guided by the negative externalities generated by the consumption of alcohol and tobacco and by the use of vehicles and fuel (environmental pollution). Given a normal positive correlation between incomes and expenditures on passenger vehicles, a well-designed excise tax on passenger vehicles can be a progressive levy. On the other hand, although the excises on alcoholic beverages (with the exception of wine) and cigarettes are most likely regressive, this does not obviate their negative consumption externalities. They should continue to be taxed over and above the VAT and import duty rates.

With one recent omission, as presently legislated the excises levied are well targeted and rational. They are relatively easy to administer since they are collected from a limited number domestic producers at the factory gate and/or at customs entry posts. Due to this relative ease of collection, it is probable that the degree of excise tax evasion is

significantly less than that under the VAT and the income taxes. Most of the rates are specific as opposed to normally preferred ad valorem ones, but the fact that they are quoted in US dollars avoids real revenue erosion due to domestic inflation. Moreover, they are applied to goods whose valuation would cause administrative problems. They are better left as specific since the physical unit base is not disputable. The only ad valorem rates apply to domestically produced undistilled and distilled spirits.

In 1999 total excise tax revenue amounted to 26.7 billion tgs, or 14.6% of total tax revenues. The leading revenue generators were the excises on alcohol and petroleum products, with 41.6% and 33.1% respectively of total excises.

The only significant issues in Mongolia's use of excise taxes revolve around one omission of recent origin and the height of the specific rates. In January of 2000, the excise on beer was eliminated. Domestically produced beer had previously been taxed at US\$0.50 per liter. Imported beer is also free of excise taxation, although it remains subject to customs duties and the VAT on imports (plus transportation costs). Other than to benefit the domestic beer lobby, there is no reason to eliminate this tax. The ostensible reason for this measure was to lower the price of beer vis-à-vis that of vodka, thereby shifting alcoholic beverage consumption toward beer. But the same effect can be obtained by raising the excises on vodka, the consumption of which generates higher negative externalities in consumption.

The excise tax on wine, all of which is imported and most likely consumed by higher income persons, is a mere US\$0.50 per liter. Cigarettes, all of which are also imported, are subject to an internationally low excise of US\$0.20 per 100; their average retail price is 600 tgs for a package of 20.

The most egregiously low excise tax is that on passenger vehicles. Prior to the year 2000, this levy was based on a combination of engine cylinder capacity and age of the vehicle. As of January, 2000, the cylinder capacity criterion was eliminated, and the excise is presently a mere \$US500 for a car manufactured in the past three years; for a manufacturing date more than three but less than 11 years ago, the excise is US\$1000, and it is US\$2000 for all vehicles older than 10 years. There is no rhyme nor reason to such a tax schedule. Whereas the absolute amount of customs duties and VAT paid on passenger vehicles varies directly with the value, the excise itself bears no relation whatsoever to vehicle value. A Mercedes Benz pays the same excise as the least expensive model of Mitsubishi! This is a clearly regressive levy, albeit commencing at above average income levels.

Recommendations:

1. Reinstate the excise tax on all beers.
2. Raise excise taxes on wine and cigarettes.
3. Raise and modify the specific base of excises on motor vehicles. Cylinder capacity represents an indisputable criterion, and valuation is easy to verify using catalogues or information available on the internet. Given this latter reality, the tax base can

feasibly be converted to vehicle value and the excise applied at progressive ad valorem rates.

V. PRESUMPTIVE TAXATION

Presumptive taxation has been defined in many ways. The definition used here is that it relates to the use of simple, direct, and cost effective methods of incorporating into the tax net self-employed individuals and small businesses that form the so-called hard-to-tax sector. With the exception of professionals, the majority of these units fall within or on the margins of the informal sector. They either do not report any income at all to the tax authorities or underreport incomes. Presumptive taxation represents a proxy for an income tax, but it is based on average as opposed to actual income.

Internationally, the most widely employed methods of presumptive taxation are standard assessments, estimated assessments, and minimum taxes. Under standard assessment schemes, a simple lump-sum tax is levied on the basis of the type of work or service rendered by the individual or business; the levy should bear some relation to the presumed average income level generated by said activity. Estimated assessments involve a higher level of sophistication, whereby the lump-sum tax liability is estimated using indicators of business activity (and hence income); e.g., number of employees, number of square meters occupied by the business, amount of machinery. The third category, that of presumptive lump-sum minimum taxation, is based on gross receipts or assets.

Since 1993 Mongolia has employed the standard assessment method of presumptive taxation. For an economy in which informal sector aggregate income ranges anywhere from 15% to 40% of GDP, this is not a bad beginning. The lump-sum amounts are higher for Ulaanbaatar than for other aimags, and not have not been adjusted upward since 1997. It is not intended to be a high revenue generator. Rather, its objective is to accustom the affected persons and businesses to paying some sort of direct tax, thereby creating the impression of horizontal equity, broadening the tax base, and perhaps facilitating the transfer of the mini-taxpayer from the informal to the formal sector. It is administered by the GDNT local tax offices in the districts, aimags, and soums, and its present administrative cost in proportion to collections apparently does not reach double digits. These basic features are reasonable, and there is no urgent need to significantly modify them at this juncture. In fact, in Mongolia's transition economy, there exist solid conceptual arguments in favor of retaining and expanding presumptive levies. Given that the presumptive tax base is average and not actual income, this may generate decidedly positive incentive effects since, for above average incomes, the marginal rate of taxation is zero.

What should be modified are two elements: the monthly lump-sum payments and the drawing into the presumptive tax net a larger number of activities. The former have not been changed since 1997 despite inflation and economic growth. This should be done as soon as feasible. Care must be taken not to "over-adjust" in the sense that significantly higher amounts might well drive small enterprises deeper into the informal sector in an

effort to completely escape direct taxation. As the economy expands and undergoes structural change, new types of activities are emerging. These should be identified and incorporated into the presumptive tax net. This is especially the case for Mongolia's self-employed professionals, who actually belong within the formal personal income tax net.

For the near- to medium-term serious consideration should be given to moving the presumptive tax base from standard to more sophisticated estimated assessments. What is suggested here is **not** a sudden move to replicate France's forfait or Israel's tachsv systems. These systems have taken decades to put in place, and are continually adjusted. Rather, analysis should begin on placing small taxpayers who do not normally keep records or file returns in categories that are a function of the estimated amount of turnover (gross receipts). Indicators such as the number and skills of employees, inventory levels, passenger capacity of vehicles used in the business, and service capacity (number of chairs or tables in a restaurant) can be adopted. Many country models abound. For example, Mongolia might want to analyze the Bolivian or South Korean models.

Other options beyond what is being currently practiced are also available, and should be studied in terms of their administrative feasibility: presumptive taxes on unregistered and registered importers, withholding schemes on any payment made by a government agency, and graduated business license fees.

Recommendations:

1. Upwardly adjust the present monthly absolute amounts by percentages slightly less than the inflation that has occurred since 1997.
2. Develop procedures and mechanisms to incorporate additional hard-to-tax groups (e.g., professionals) into the tax net; e.g., obtain names of self-employed professionals from professional and business association membership lists.
3. Analyze the future administrative feasibility of moving from a standard to an estimated assessment base.

VI. NEW TAXES

In a country where there already exist 19 different central government taxes, it is with some hesitation that recommendations are made here to introduce three new levies. After all, administration of extant taxes is quite problematic, and there remains much to be done in almost all areas pertinent to the strengthening of tax collection processes and mechanisms. Nevertheless, there is a great deal of justification for these recommendations.

At the conceptual level, any country's tax bases consist of income, expenditure, and wealth. Mongolia's current tax system is based on income and expenditure bases, but the wealth tax base is not being exploited. If only for the sake of equity, wealth should be taxed. At the practical level, the administrative difficulties of accessing the three new tax

bases are not overly complicated, given that a good deal of the required information already exists in manageable databases.

A. Gross Assets Tax

As previously discussed in Section I.D, an assets tax represents a viable parallel or substitute minimum levy for the EIT when avoidance and evasion are widespread. Many countries in Latin America and the Middle East have been faced with just this type of problem, and have adopted some form of asset taxation. Thus, there exists a wealth of country-specific experience for Mongolia to draw upon in designing an enterprise assets tax. The cases of Mexico or the Philippines might prove to be good models.

Since gross receipts are loosely linked to profitability, it is more appropriate to consider gross or net assets. Given that the EIT tax base includes incomes from both debt and equity capital, gross rather than net assets become the better alternative for this minimum tax base; if the tax base were restricted only to income from equity capital, net assets would be the proper alternative, since debt capital would not be taxable at the corporate level. In other words, a gross assets base does not discriminate in favor of debt-financed assets. This also ties in well with the recommendations proposed in Section II.E regarding limiting thin capitalization and establishing rules regulating transfer pricing.

Admittedly, one valid criticism of the gross assets tax deals with corporate liquidity. Under the EIT, enterprise profits generate the liquidity required to finance the levy. This is not the case with an assets tax. However, instead of forcing the enterprise to sell assets to pay the tax, averaging provisions can be incorporated to overcome short-run liquidity difficulties. Moreover, those enterprises with low asset valuation can be exempted from the tax; this requires setting a threshold. Another valid issue is asset valuation, which may vary due to inflation or because the asset(s) in question is (are) not regularly traded.

The primary objective of a gross assets tax is to ferret out and collect taxable enterprise income that escapes the EIT net. It should be designed to be roughly equivalent to the EIT tax obligation. For example, with a 30% top EIT rate and an assumed return on enterprise assets of 8%, a 2% tax on the gross assets base would be called for. The selected rate will depend upon revenue targets, the base itself, and the extent of estimated EIT evasion. The potential revenue that can be derived from the assets tax is difficult to estimate a priori. Given its application here as a minimum tax, it is expected that tax revenue will rise because it establishes a minimum below which enterprises cannot go. However, it must be realized that the EIT taxes paid can be taken as a credit against the gross assets tax levy; i.e., if the former is greater, no gross assets levy would be due. Administration of this tax is not complicated. The GDNT has a computerized database with the financial statements of its registered enterprise taxpayers.

In the case of Mongolia, where the GOM is seeking FDI, international taxation issues must be taken into account. The simultaneous existence of the EIT and the gross assets tax will require making the regular amount of EIT creditable against the assets tax to not jeopardize the use of a foreign tax credit. This comes about because, in some country-

specific cases, the gross assets tax as a minimum tax does not qualify for a foreign tax credit. Thus, if the minimum tax were creditable against the EIT liability it would lower the value of the foreign tax credit. Therefore, it is important to take into account the “stacking order” of the two levies in order to make the normal EIT creditable against the gross assets tax.

Recommendation:

1. Analyze the possibility of levying a 2% tax against enterprise gross assets, especially taking into account the ease of administration. If deemed appropriate and feasible, prepare the draft legislation.

B. Structures Tax

Property (land and structures) taxation constitutes the most applied form of wealth taxation in tax systems around the world. It is normally applied at the local government level, and often makes up the most important source of own-tax revenue for sub-national jurisdictions. It finds its theoretical justification in both the ability-to-pay and the benefit principles of taxation. Its base may be site (land) value, estimated annual net rental value, or assessed value of land and improvements (structures).

In the case of Mongolia, where land is not yet privatized, at present property taxation will have to take the form of the taxation of structures (improvements). The GDNT has already analyzed the feasibility of taxing buildings, and should proceed with this effort. Apparently, there exists a fairly up-to-date database (or cuasi-cadastre) containing all the information required to administer this tax based on the assessed value of improvements. In view of the recent transition to a market-based economy and the lack of historical experience with an active property market, the accuracy of the assessed values of the structures is unknown. For the sake of administrative simplicity, a flat rate should be applied.

Recommendation:

1. Proceed with already initiated efforts to develop and prepare draft legislation concerning a structures (buildings) tax. Revenues generated from this tax should be used to buoy local government finances, including a redistributive formula from the richer to the poorer local jurisdictions.

C. Estate and Gift Taxation

For equity reasons, most countries around the world apply some sort of taxation to the estates of the deceased. The tax usually takes the form of either a levy imposed on the estate itself without reference to the inheritors or a levy on those who receive the inheritance. The former is easier to administer. To avoid a wealth transfer prior to death, a gift tax normally complements the estate levy. Rates are usually progressive, and threshold exemption levels may be set at any desired height as a function of social policy.

Recommendation:

1. At the present juncture of Mongolia's transition to a market economy, this form of wealth taxation is not a high priority. Far higher priority should be given to the assets and building taxes. Moreover, estate and gift taxation is not a large revenue-generator. Nevertheless, as the Mongolian economy grows and income and wealth distributions become more skewed, this type of taxation should eventually be incorporated into the tax structure.

VII. STRENGTHENING TAX ADMINISTRATION

A. Large Taxpayer Office (LTO)

The Taxation Office of the GDNT oversees 46 large taxpayers. It is physically and organizationally an integral part of the GDNT with no "autonomous" existence. An abbreviated proposal to establish an independent LTO is found in Section IX of this report. Subsequent to the GDNT's structural reorganization in February of 2000, the Office consists of an Assessment Unit, a Tax Collection Unit, and an Inspection Unit. There are, respectively, 4, 5, and 5 professionals assigned to these units at GDNT headquarters. The 14 professionals assigned to work with large taxpayer cases deal with the VAT, the EIT, and excises, but also supervise the collection of the 80% of the VAT assigned to the aimag tax offices. This latter task only occupies approximately 10% of total LTO time.

For all of 1999, the 46 taxpayers under LTO aegis generated 54% of total domestic VAT revenues (i.e., excluding the VAT on imports), 49% of EIT collections, and 59% of all excises. The list of 46 large taxpayers is in flux, with plans to add significantly to this number, with special emphasis on enterprises with foreign investment. For example, three large taxpayers were recently placed under LTO control by transferring them from the tax office rolls of the city of Ulaanbaatar. There is an ongoing jurisdictional struggle with the latter, which is reluctant to "release" enterprises from its registry and jurisdiction.

According to the Director of the Taxation Office, all 46 taxpayers are audited on an annual basis, and VAT refunds are audited quarterly. All three taxes are simultaneously audited. There are two interrelated issues raised by these simultaneous audits. Are the auditors able to do a satisfactory audit on all three taxes at once, and are the auditors themselves sufficiently well trained? Moreover, the planned expansion of the large taxpayer base from the present 46 to a higher number means that the Taxation Office will have to significantly increase the number of collectors, assessors, and (especially) auditors.

Recommendations:

1. Create an “independent” LTO physically separate from the GDNT headquarters. A summary proposal for the establishment of this LTO and its personnel requirements is laid out in Section IX of this report.
2. Expand coverage up to 100 enterprises and/or to that number of enterprises that accounts for 75% to 80% of all EIT, VAT, and excise tax revenues. Some of the enterprises in the current LTO portfolio may not constitute the 46 largest taxpayers; even prior to expansion of coverage they should be replaced by larger taxpayers.
3. Modify the current Budget Law of Mongolia, which apparently precludes the establishment of a truly autonomous LTO.

B. Strengthening of Collection Enforcement Procedures and the Penalty Structure

The collection of tax arrears is difficult and ponderous, and for these and other reasons is not well enforced. Article 24 of the law on the Supervision of Tax Levy, Payment, and Tax Collection states that, in the case of tax arrears, if the tax administration is unable to collect taxes on an undisputed basis from the taxpayer’s bank account (Article 23), they can be collected if the taxpayer gives “written permission to collect taxes from his/her property, salary, and other income”. Needless to say, the determined tax avoider/evader will not readily give such permission.

To collect tax arrears, the procedure currently followed by the GDNT is to send the taxpayer a letter requesting payment. Legally, the taxpayer has 10 days to respond, but the deadline is usually extended to 60 days (Article 20.1). The GDNT may then proceed to place a lien on the taxpayer’s assets by seeking a court order (Article 27). In cases of suspected tax fraud, property may be sealed (Article 37) and business activities temporarily suspended (Article 39). In fact, these procedures are hardly (if at all) ever used, since a court order is required and the tax inspectors work under the general directive of being “nice” to taxpayers. The court order procedure is lengthy and hardly ever invoked. The courts tend to side with the taxpayer, and judges are not well versed in the new tax laws.

Penalties for the breach of tax laws are either too low or too inflexible. In the former category are the administrative fines imposed under Article 40 of the law on the Supervision of Tax Levy, Payment, and Tax Collection. For example, failure on the part of the individual or enterprise with taxable income to register for tax purposes is subject to a fine of a mere 3,000 to 5,000 tgs for the individual and 60,000 to 150,000 tgs for the enterprise; failure to file a tax return and late filing are subject to a fine ranging from 1,000 tgs for individuals to 20,000 tgs for enterprises.

On the inflexible side of the ledger is the 0.5% **daily** interest charge imposed on taxpayers’ late unpaid balances. Market interest rates vary on a day-to-day basis, and this penalty rate should not be set at one rate in the tax statutes. As inflation has receded from previous high levels, domestic interest rates have also fallen substantially. This has

certainly been the case regarding the BOM's lending rate. Therefore, the late payment rate might be set at quarterly intervals at a given level above the BOM's lending rate.

The 1996 draft law on the supervision of tax payments and collections was decidedly more forceful, but it was watered down in Parliament. Therefore, to enable the GDNT to better carry out its mandate to collect taxes, the following recommendations are in order. It is recognized that they are not easily approved nor implemented. It is one thing to recommend. It is far more difficult to implement.

Recommendations:

1. Draft legislation to broaden the GDNT's enforcement powers to encompass the temporary closure and/or seizure of assets **without recurring to a lengthy judicial process** in the cases of both tax arrears and tax fraud. This should include the authority to withhold government payments (e.g., to suppliers of government goods and services) and deny government loans.
2. Adjust the penalty amounts upwards and subsequently index for inflation.
3. Charge penalties for unpaid taxes as a **monthly** percentage of the balance, with a ceiling to prevent unreasonable penalty accumulations in cases of extenuating circumstances. Set the penalties at an interest rate several points above the BOM's lending rate, and adjust this rate on a quarterly basis.
4. Strengthen efforts to train and/or retrain judges in modern tax law. Study the possibility of setting up courts specialized in taxation.

C. Inter-governmental Fiscal Arrangements.

The 1992 Law on Mongolian Administrative and Territorial Units sets the legal basis for governmental divisions and decentralization. Below the central government level, there are Ulaanbaatar with its capital city and districts, the 21 aimags (provinces), and the 330 soums with their bag subdivisions. Fiscal matters within this framework are governed by the General Taxation Law of Mongolia and the Budget Law of Mongolia, which lay out revenue and expenditure assignments. Sub-national governmental units (i.e., those below the central government and its State Budget) have been assigned responsibility for carrying out wide-ranging activities in education, health, transport, and public utilities. However, the concomitant revenue base is severely restricted under a tax assignment scheme that assigns the major taxes to the central government. With the exception of Ulaanbaatar and larger aimags, central government transfers must cover the bulk of sub-national unit expenditure responsibilities. For these units own-revenues average approximately 3% of the total.

The present "decentralized" framework creates at least two major problems related to inter-governmental fiscal relations. In the first place, there exists no permanent arrangement by which central government monies are transferred to the sub-national units; the latter's revenue needs are annually negotiated on an ad hoc basis. Secondly, there is an ongoing jurisdictional dispute between the central and sub-national governments regarding the payment of taxes, especially the EIT. This dispute is

especially prevalent between the MOF/GDNT and the city of Ulaanbaatar, where one company physically located in the city pays the EIT to the central government and another to the city government. The problem here is the Budget Law, which assigns taxpayers and taxes to each jurisdiction (central vs. sub-national governments). These assignments of both taxes and taxpayers are not stable, and are subject to “negotiations” between the MOF and GDNT representing the central government and the Ulaanbaatar City Tax Office and other local governments. Both levels jealously harbor their tax sources, with the disputes usually revolving around the EIT. There is little doubt that this “division of labor” creates tax administrative inefficiencies and unduly complicates the GDNT’s work. Moreover, each GDNT tax office now has to collect national, aimag, and soum taxes.

The present revenue assignments should be significantly modified within the overall context of fiscal federalism. Such taxes as the PIT, EIT, VAT, customs duties, and some excises should be assigned to the central government. Other taxes are negotiable within the Budget and the Decentralization Laws. Sub-national governments should be able to “piggy-back” on the income tax bases. Revenue sharing and transfer formulas must be established to provide sub-national governments the fiscal resources to effectively carry out their expenditure assignments.

Modifying Mongolia’s system of intergovernmental fiscal relations is far beyond the purview of this report. It constitutes a medium to longer-term project that clearly has implications far beyond taxation and tax administration. The international literature on intergovernmental fiscal relations and reform proposals is prolific. For Mongolia-specific analyses see Juliana Pigey, “Report on Local Government Finance and Management: Issues and Recommendations” (May, 1996), EPSP; Alex MacNevin, “Intergovernmental Fiscal Relations and Decentralization in Mongolia” (August, 1997), EPSP; and Mark Gallagher, “Fiscal Policy Making, Planning, and Operations” (1996), EPSP. For a recent novel idea on tax assignment, see Richard Bird, IMF Working Paper 99/165, “Rethinking Subnational Taxes: A New Look at Tax Assignment” (December, 1999).

Recommendation:

1. Appoint a body to analyze the overall context of intergovernmental relations. Membership should include public and private sector representatives. Public sector members should represent all levels of government.

D. Tax Inspection/Audits and Related Issues

One of the most important tax administration functions is that of auditing taxpayers. The auditing function is key to both tax administration and tax policy. As stated in the introduction to this report, tax policy is tax administration. If the tax authorities are unable to collect those taxes legislated in the tax law in a fair and transparent manner, all the criteria on which a tax system is based---efficiency, equity, neutrality, and clarity---are violated to the detriment of the taxpayer and the nation. Poor administration negates good tax laws and tax structures. There is also a clear link between audit issues and the

penalty and enforcement issues covered in Section VII.B. The auditing function is facilitated by the underlying threat of the application of genuine enforcement procedures and penalties.

What follows here is the **not** the result of an in-depth attempt to study the auditing function. It is based on a limited number of interviews, one with a GDNT auditor and others with private sector and SOE taxpayers. Therefore, conclusions must be taken with a grain of salt. To do justice to the nuts and bolts of tax administration requires a consulting assignment focused only on this issue.

In Mongolia each tax office has its own auditing unit (or auditors) which is suppose to work in coordination with the assessment and collection units. At GDNT headquarters in Ulaanbaatar activities are essentially limited to large taxpayer control. Other offices may in some way focus on the larger taxpayers under their jurisdiction, but do not specialize in large taxpayers. Out of GDNT's 1200 employees nationwide, approximately 220 are tax auditors (inspectors). The apparent requirements for employment are a university degree preferably in accounting, with knowledge of international accounting standards.

Both office and field audits are carried out. The GDNT headquarters Taxation Office with its five auditors does a field audit once a year on each of the 46 enterprises under its aegis. Each field audit is comprehensive; i.e., all taxes are audited at the same time. If VAT credit claims are frequent, audits are done with greater frequency. Outside of headquarters enterprise income taxpayers are audited once every two years. Audit plans for the coming year are drawn up and apparently adhered to, but there was no time to verify the quality, scope, and degree of completion of these plans. Nor was any time dedicated to finding out the productivity of the average auditor and audit. Some audit productivity indicators relate to the number of annual audits per auditor and the amount of additional tax liabilities identified per audit and per auditor; these indicators should be broken down into field versus office audits. If these statistics do exist, they can be used to allocate resources to those types of audits that have high yields. If they do not exist, they should be generated, if further breakdowns by type of tax. This is because (usually) auditing a VAT return is faster and easier than auditing an EIT return.

There is apparently no true audit selection process using a simple computer program to pre-qualify tax returns. Rather, audit selection is manual and based on the experience of the auditor. There apparently do exist "red flag" criteria, but what they are and to what degree they are normally used were not verifiable due to time constraints. For cross-checking purposes, some information is gathered from outside sources such as customs; again, the degree of actual application was not verified. Computerization in general is needed. The taxpayer master file is a paper file, as is each taxpayer's current account; i.e., entries are done manually and information is maintained in folders. Tax rulings and interpretations are shared on paper bulletins circulated among tax offices. As such, it is a hit-and-miss proposition. As previously stated, the inconsistency of audit rulings is causing genuine difficulties for the taxpayer. These rulings should be centralized and computerized (and subsequently referred to by the auditors and applied).

There appears to be no organized and continuing effort to identify non-filers and stop-filers. To be fair, within the organizational structure of the GDNT the task of non-filer identification belongs to the State Registration Office, while that of stop-filers is the responsibility of auditors in the Taxation Office. It is granted that the task of identifying stop-filers is easier than that of finding non-filers. Non-filers can be found by using business and association registries; by using Customs Administration lists of importers and exporters; by lists of taxpayers who receive tax incentives; and by door to door surveys selected by statistical methods. The GDNT's current method of finding non-filers is to refer the case to the Police Unit of the of the Ulaanbaatar City Tax Office.

Judging from the experience of taxpayers, there is wide scope for training auditors. It is needed in all areas of the overall audit process, including audit selection methods, the preparation of manuals, and especially international accounting standards. From the viewpoint of the auditors who deal with large taxpayers, they need training with respect to the use of computerized accounting systems which are used by the companies they audit.

Recommendations:

1. Enhanced efforts to computerize files and processes.
2. Elaboration of auditing and auditor productivity indicators.
3. Enhanced use of exogenous data to improve audits.
4. Improved efforts to find non-filers and reincorporate stop-filers.
5. More and on-going training, training, and training across all areas related to the audit function.

VIII. TAX INCENTIVES

Some countries (e.g., Mexico, Jordan, and Indonesia) have abolished the tax incentive approach to attracting FDI, opting instead to lower corporate (enterprise) income tax rates across-the-board to all enterprises, both domestic and foreign. This is certainly an approach that bears analysis in the Mongolian case. In the absence of any cost-benefit analysis regarding the income and employment impacts of current Mongolian tax incentives, the abolition of the present incentive system might be deemed premature. Nevertheless, after reviewing the brief presentation below of the main arguments for and against the use of tax incentives, it will be noted that there are no strongly compelling reasons for retaining the current tax incentive structure.

A. The Pros and Cons of Tax Incentives to Attract FDI

It appears that the principal reason countries offer tax incentives is the perception that they are "required" measures due to international tax competition. They stimulate investment and employment while generating positive multiplier effects on both these variables. However, there arises a genuine analytical difficulty in evaluating their impact. Such evaluations encounter the conceptual problem of determining what a country (and

the rest-the-world) would look like in their absence; i.e., what proportion of actual investment is due to the incentives actually offered, and what proportion would have occurred without them?

Tax incentives by themselves attract little if any foreign and domestic investment. At least just as important are such factors as economic and political stability, adequate infrastructure, labor force skills, a well administered, consistent, and low rate tax system, and the home country treatment of repatriated profits. The permanent and stable characteristics of the tax system and its administration are essential.

At least in the short- to medium-term, tax incentives generate tax revenue losses. They distort the sectoral allocation of investment monies, favoring manufacturing over services and large firms over small ones. They confer no benefits on loss-making firms, which are more prone to be new enterprises; they can be of great benefit to profitable firms that might have invested even in the absence of incentives. New incentive-qualifying subsidiaries of existing firms open the possibilities of transfer pricing abuses, whereby taxable profits are transferred to the tax exempt subsidiary. Sectoral-specific tax incentives and those open to governmental discretion (see EIT code Articles 7.5, 7.6, and 7.7) assume that government is better than the market in selecting those investments that will be most beneficial to the country. Discretionary tax incentives create investment climate uncertainty and possibilities for official corruption. The former, combined with inconsistencies in tax interpretations and other tax administration policies, may discourage investment. The efficacy of tax incentives also depends on variables over which the host country has no control. If the FDI country of origin takes a territorial approach to the taxation of foreign-earned profits by exempting them from domestic taxes (as in Europe), tax incentives can be effective. On the other hand, if the FDI country of origin taxes world-wide profits (as in the USA) and allows limited credits for foreign taxes paid, the lower taxes paid in the host country are negated by higher taxes in the FDI origin country, thereby nullifying the stimulating impact of the incentives. Finally, tax incentives are often self-perpetuating. If not well monitored, a firm may simply close down operations upon expiration of its tax holiday, and reopen as a new company that qualifies for incentives.

B. A Tax Credit and Partial Expensing Approach to Attracting Investment

The use of investment tax credits and/or partial expensing offers a viable substitute to tax incentives. Investment tax credits (ITC) allow the enterprise to deduct from its EIT obligation a given percentage of the cost of a depreciable asset. The latter can be defined as all or selected (depreciable) assets. Partial expensing (PE) permits the enterprise to immediately deduct from taxable income a proportion of the acquisition cost of a depreciable asset; the balance is written off under normal depreciation rules. For example, if the enterprise tax rate were 30%, a 10% tax credit would be equivalent to an immediate deduction of 33%.

Although ITCs and PE are somewhat different, for the purposes of this discussion they can be conceived as the same tax policy instrument. They offer distinct advantages over present tax holidays since they:

- Are more likely to stimulate longer-term investments than holidays, which tend to favor shorter-term investment.
- Limit their benefits to new investment, and do not benefit previous investment.
- Are easier to monitor for tax administration purposes.
- Reward enterprises for acquiring new assets rather than new enterprises.
- Lower the government revenue sacrifice because they retain above normal profits in the enterprise income tax base.
- Do not involve government's choosing winners and losers, since they are available to all investors.
- Obviate the need for a separate foreign investment code, as they become part and parcel of the regular EIT code; the playing field would be leveled.
- Are less susceptible to transfer pricing manipulations.
- Generate up-front benefits that create greater investor certainty, especially where the fear exists that the government might renege on prior agreements.
- Make the tax system more neutral vis-à-vis its impact on investment decisions.

On the negative side, ITCs and PE do create a capital intensity bias, not a negligible consideration in the case of Mongolia; this issue might be better attacked via the use of (hard-to-administer) labor employment subsidies. ITCs and PEs are not neutral across assets since they apply only to depreciable assets, thereby excluding inventories and land. Under PE, benefits must exclude debt-financed assets to limit the combined effect of expensing and interest deductibility.

Recommendation:

1. Seriously analyze the feasibility of substituting a system of investment tax credits or partial expensing for the existing tax incentives/holidays. During the transition period, existing tax incentives must be honored, but would not be renewed after expiration. No new ones would be granted.

IX. ABBREVIATED PROPOSAL FOR THE ESTABLISHMENT OF A LARGE TAXPAYER OFFICE

A. Introduction

The control and administration of large taxpayers is one of the most important steps in tax administration enhancement. Many of the systems, processes, and attitudes designed and generated for and by a Large Taxpayer Office (LTO) create spillover effects which positively benefit all other tax administration units and activities. LTOs exist worldwide. While their establishment to actually collect taxes is mainly a phenomenon found in developing countries, special auditing procedures for large taxpayers are commonplace in both developed and developing countries. Differentiated treatment of large taxpayers

makes eminent sense. In most developing countries a large proportion of tax revenue is collected from a small percentage of taxpayers: 2% or less of taxpayers may generate from 50% to 90% of total tax revenue. Mongolia is no exception. Moreover, the control and monitoring of these major taxpayers is a necessity for both fiscal and macroeconomic stability.

Large taxpayers are different from others, and therefore merit special treatment. They most likely operate both domestically and internationally, have relatively complex business operations and accounting practices (where issues such as transfer pricing can be significant), and carry out a relatively large volume of transactions. Additionally, they might wield significant economic and political leverage.

Establishment of a more autonomous LTO in Mongolia implies neither the creation of a parallel tax administration structure nor the “benign neglect” of the small and medium taxpayer. It will function as part and parcel of Mongolia’s overall tax administration system. It will adhere to extant tax law and regulations, the monies it collects will flow into the same accounts as do those revenues collected by the normal tax departments, and it will essentially use the same processes and systems employed elsewhere. It generates positive spillover effects; e.g., information provided by large taxpayers can aid in detecting tax evasion by smaller taxpayers.

B. General Considerations

The LTO should be provided with its own offices physically independent of other GDNT departments and, budget considerations notwithstanding, the GDNT itself. It should have its own computer equipment and personnel in addition to computer systems and procedures that ensure a rapid and efficient data entry process. Most of the modules should be capable of being used for the administration of other taxpayers, the only exception being a LTO-specific module under which data entry is carried out in the presence of the taxpayer or his representative. After identification of a large taxpayer, their data should be transferred from the general taxpayer register to that of the LTO.

Using a competitive bidding process, the LTO should contract with a bank to establish a bank teller unit within the premises of the LTO. Such a unit would be only for the purpose of receiving payments from large taxpayers. The LTO should have its own decentralized computer systems that will be used to enter and validate tax return and payment data. It should limit its activities to the assessment and collection of personal and enterprise income taxes, the domestic VAT, excises, and selected other levies paid by large taxpayers. It should **not** handle the collection and payment of customs duties and the VAT on imports. This is because, although many large taxpayers may also be large importers, customs procedures are so different from those used for domestic taxes that they are best left in the hands of the Customs Administration. This does not mean that the LTO should adopt a “hands-off” stance vis-à-vis Customs. Quite the contrary. Customs-generated data should become an integral part of cross-database checks carried out by LTO auditors. For example, Customs has ASYCUDA (Automated System for Customs Data Management) via which it generates LTO-useful trade statistics and tax data (CIF

values, duty exemptions, customs duties paid, VAT). An ASYCUDA access terminal should be installed in the LTO office.

C. Organizational Structure and Functions

The LTO should be organized along very simple lines with four divisions: Collections, Auditing, Technical-Legal, and Data Processing. Some of the main functions of each of these divisions are subsequently listed.

1. Collections Division

- Continuously update basic taxpayer information regarding names, addresses, types of economic activity, etc.
- Distribute tax forms, instructions, and other informative materials.
- Receive and post tax payments.
- For collections made via the banking system, handle revenue accounting, commission payments to the contracted bank, and/or control the deposit of revenues collected.
- Require large taxpayers to submit tax returns not filed and apply the full amount of legal penalties. Assess and supervise the collection of unpaid taxes.
- Develop and constantly update taxpayers' current accounts.

2. Audit Division

- Carry out relevant activities (e.g., external data cross-checking, inspections, etc.) to verify the accuracy of tax data reported on tax returns.
- Do appropriate desk and field audits.
- Use already existing programs designed to select taxpayers to be audited. If such programs are deficient or non-existent, modify and/or develop appropriate audit selection programs.
- Charge the adjustments determined to each taxpayer's current account; request and take into account the justifications offered by taxpayers.
- Continuously update each taxpayer's physical document file.

3. Technical-Legal Division

- Maintain large taxpayers apprised and up-to-date regarding tax regulations and amendments via telephone, mail, fax, e-mail, and personal visits.
- Advise large taxpayers regarding compliance with their tax obligations.
- Provide technical assistance by responding quickly to queries regarding tax matters.
- Advise the LTO and GDNT's Legal Division on legal matters and propose tax legislation amendments.
- Provide assistance for activities related to court-ordered tax debt collection.
- Resolve taxpayer appeals that dispute the rulings issued by the LTO.
- Charge the adjustments determined to the respective taxpayer current accounts.

4. Data Processing Division

- Support the operations of the LTO's computer system; assist in file maintenance and the creation of backup copies.
- Serve as a communications link with the GDNT's Information Processing and Statistics Division with respect to modifications to operating systems, sending, receiving, and loading files, etc.
- With the approval of the GDNT's Information Processing and Statistics Division, develop specific and appropriate management operations systems.

D. Processes and Systems

The LTO should be self-sufficient with respect to the computer equipment needed for its operations. Open architecture computer systems are required. The systems developed and/or adapted should be portable, adaptable, and quick. Portability implies the capability of operating on different types of hardware (microcomputers, minicomputers, and networks) to facilitate transparent and rapid procurement. Adaptability means flexibility in the use of stored information, especially for generating audit reports. Quickness permits system modifications to be made when changes occur in the underlying regulations and tax legislation.

Some of the main processes and systems that must be set up to carry out the LTO's operations are:

- A large taxpayer single register. It should contain such elements as a taxpayer identification number; the taxpayer's name and permanent address; the taxes to which the taxpayer is subject; the taxpayer's main economic activity, legal status, and telephone, fax, and e-mail numbers/address; the filing and payment frequency for each tax, and the settlement account number(s) used for tax payments.
- A tax return receipt process. Each return will be submitted only at the LTO premises, where it will be quickly reviewed by a supervisor. A data entry operator will key in all relevant information from the return. If the return is accepted, the original and a copy are stamped and returned to the taxpayer, who then proceeds to make payment. This process should automatically check the taxpayer's identification number, the type of tax being paid, and the balances and credits in each return.
- A receipt of payments process. Payment is immediately made to a cashier, who is located in the LTO and may be either a LTO employee or a teller of the contracted bank. The cashier terminal has direct access to the LTO's computing system. As a receipt is printed the system records the payment as a credit to the taxpayer's account. The system should be designed to allow for the posting of advance and installment payments, regular monthly and quarterly payments, and payments received for additional assessed taxes as a result of field audits. At the end of the business day, it should also automatically generate lists for accounting and control purposes that indicate the amount of collections by type of tax and payment method.
- A "red flag" check. The LTO's computerized systems should be immediately able to detect those taxpayers who have not filed returns on time and/or whose payments are

past due. It should also provide basic information regarding such payments, and should generate batches of notices to be sent to taxpayers to collect arrears.

- Audits. Vital to the LTO’s success are establishing and maintaining large taxpayer audit systems. These systems should be adapted and/or developed to select cases for audit and to control taxpayer invoices and the amounts generated from audit adjustments. An efficient audit selection system establishes coefficients derived from tax returns and external information to highlight those returns that vary from the norm. It should permit the entering and cross-checking of data from suppliers and customers of the taxpayer as well as providing for an audit status report at any time.
- Taxpayer current accounts. For each taxpayer this system should maintain, for every separate tax and for an overall balance under all taxes, an up-to-date record of all credits and debits resulting from payments, settlements, fines, interest, refunds, and other transactions.
- Collection management system. Via this system, tax collection notices are issued. It provides information on the amount of pending obligations and on delinquencies classified by amounts and age of debt. It should also permit the monitoring of all cases involving forced collection, retrieving past due obligations for collection, and checking on and updating case status.
- Basic statistics. Examples are bi-weekly summaries of collections by type of tax, bi-weekly summaries of compliance (returns filed on time, filed late), and summaries of field audit and arrears activities.

E. Human Resource and Equipment Needs

The needs detailed in this section are based on the assumption that the LTO will monitor and control between 75 to 100 large taxpayers. The numbers might be marginally reducible depending on the skills of the personnel hired. For example, in the Collections Division one multi-skilled individual might be able to perform several of the listed tasks. Moreover, in addition to supervisory and administrative duties, each Division Head will participate (to the extent possible given time constraints) in the daily tasks of said Division.

1. LTO Personnel Needs

<u>Position</u>	<u>Number</u>
Office Director	1
Administrative Assistant/Receptionist	1
 <u>Collections Division:</u>	
Division Head	1
Receipt of tax returns (1 supervisor, 2 data entry)	3
Receipt of payments	1
Taxpayer current account maintenance	1

Distribution of forms, cash register closing, revenue accounting, default and collection control	2
<u>Audit Division:</u>	
Division Head	1
Auditors	5
<u>Technical-Legal Division:</u>	
Division Head	1
Dissemination, assistance, collection, Appeals, advice to LTO	1
<u>Data Processing Division</u>	
Computer Specialist	<u>1</u>
Total	19

2. Equipment Needs

In addition to desks, chairs, bookcases, etc. for each of the 19 positions, the following hardware requirements also emerge:

<u>Function</u>	<u>Terminal*</u>	<u>Amount</u>
Management	Screen	1
Receipt of returns	Screen	3
	Printer	1
Receipt of payments	Screen	1
Other collection functions	Screen	1
	Printer	1
Audit	Screen	2
Other LTO functions	Screen	1

*Most terminals should be microcomputers.

For an “autonomous” LTO, a central processing unit (CPU) will also be needed with a minimum storage capacity to handle up to 100 large taxpayers. All data should be retained for at least five years.

It must be emphasized that these numbers are very preliminary, and are presented here before a true needs analysis is undertaken. Such an analysis should be carried out by a hardware expert in collaboration with the GDNT’s Information Processing and Statistics Division.

F. Technical Assistance and Training Needs

Technical assistance (TA) and staff training needs will be an ongoing process, as both will continually crop up as the LTO develops and grows. At least three specific short-term TA needs will be required. In addition to offering technical advice, the short-term advisors will do some on-the-job training. The three advisors are:

- **Organization consultant.** An expert in the organizational requirements of a small LTO in a developing country. This person will review and evaluate the initial organization of the LTO, make recommendations regarding the functions of each LTO division and the interfaces between them, and develop future action plans in coordination with top LTO staff.
- **Operations consultant.** An expert in doing hands-on implementation of the daily operations and procedures of developing country LTOs. In addition to reviewing and evaluating procedures and operations, this person will help develop the LTO's regulations, procedural manuals, and formats for management report, and will also prepare a future staff training program.
- **Computerization consultant.** An expert in the computerization needs of LTOs. In conjunction with the GDNT's Information Processing and Statistics Division, this person will advise and make recommendations regarding the computerization of the LTO's systems and processes in terms of requirements definitions and system design. In light of these computerization recommendations, re-evaluate the organizational and operational plans recommended by the Organization and Operations consultants.

Training needs will depend on the competencies of the personnel hired for the various staff positions, the LTO's organizational structure, and the systems and processes adopted. It can be anticipated that one area where training will be most definitely needed is in auditing techniques and procedures.

PERSONS INTERVIEWED

Batdelger, M. Chief Accountant, Chinggis Beer Company.

Batjargal, D. Director General, GDNT.

Bayaraa, D. Director, Taxation Department, GDNT.

Bender, C. Pension Reform Advisor, Economic Policy Support Project.

Bikales, W. Chief-of-Party, Economic Policy Support Project.

Coleman, J.S. President, Forte Cashmere Company.

Davaajargal, G. Deputy Director, GDNT.

Dorjkhand, T. Economist, Fiscal Policy Department, Ministry of Finance.

Enhbayar. Senior Economist, Fiscal Policy Department, Ministry of Finance.

Erdenebaatar, B. Head, Policy Coordination Unit, GDNT.

Ganhuleg, B. Senior Tax Official, Policy Coordination Unit, GDNT.

Hatting, H.W. Consultant, Telecommunications Engineering and Management.

Henderson, F. Consultant, Public Administration.

Hey, C.D. Consultant, UNDP Enterprise Privatization Project.

Isbrandtsen, N. Commercial Bank Advisor, Economic Policy Support Project.

La Porta, A.F. U.S. Ambassador to Mongolia.

Lim, C.P. Manager, Arthur Andersen Mongolia.

Mungunbat, S. Vice Chairman, Foreign Investment and Foreign Trade Agency.

Munhkaatar. Official, Tax Collection Unit, Ulaanbaatar District Tax Office, GDNT.

Napoleoni, J. CEO, Forte Cashmere Company.

Oyungerel. Head, Tariff and Revenue Department, Customs Administration, MOF.

Pootoi. Tax Auditor, Inspection Unit, Taxation Office, GDNT.

Purvee, Y. Head, Policy and Methodology Division, GDNT.

Ruddell, C.L. Director General, Arthur Andersen Mongolia

Siemering, W. Consultant and Special Advisor, Soros Foundation.

Thys, R. Executive Director, Mon-Forte Cashmere Company.

Tsedendorj. Inspector, State Registration Office, GDNT.

Tserenjamts D. Head, Financial and Economic Department, GOBI Corporation.

Tsogt, O. Head, Information Processing and Statistics Division, GDNT.

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