

CENTER FOR INSTITUTIONAL REFORM AND THE INFORMAL SECTOR

University of Maryland at College Park

Center Office: IRIS Center, 7100 Baltimore Avenue, Suite 510, College Park, MD 20740
Telephone (301) 403-8153 • Fax (301) 403-8163

REFORM ISSUES IN MONGOLIA

October, 1991

Peter Murrell
Country Report No. 1

Author: Peter Murrell
Project Name: "Mongolia: Support for Economic Transition"
Project No. 940-0015
BOA No. ANE-0015-B-00-1019-00
Delivery Order No. 1
AID Project Office PRE/SMIE (Catherine Gordon)
AID Office funding the delivery order: APRE/A

Reform Issues in Mongolia

Peter Murrell
Project Coordinator
“Mongolia: Support for Economic Transition”
Institutional Reform and the Informal Sector
University of Maryland

October 1991

Project No. 940-0015
BOA No. ANE-0015-B-00-1019-00
Delivery Order No. 01
AID project office: APRE/SMIE
AID office funding the delivery order: **APRE/PD**
AID office's project: **APRE/A**

Table of Contents

A.	Some Judgments on the Present Economic and Political Situation	1
1.	Commitment to a Market-Oriented Society	1
2.	The Progress of Reform	2
3.	Present Economic Situation	3
4.	Privatization	6
5.	Policy and the Market Process	7
6.	Democracy and the Policy Process	7
7.	The Governmental Policy-making Structure and the Makers of Policy	8
8.	Non-State Actors	8
9.	Approach of the World Bank and the IMP	9
10.	Status of Existing Legislation	10
11.	Intellectual Resources for Policy-making	11
B.	Topics	11
1.	Achieving Competitive Markets: The Role of Market Institutions; the Effects of Governments; the Role of Small Business Policy	12
2.	Budget Processes in Market Democracies	13
3.	Prices in a Market Society	14
4.	Property Rights under Capitalism, with Applications to the Problem of Land	15
5.	Role of Government and Regulation in Market Economies	17
6.	Taxes	17
7.	Privatization	18
8.	Macroeconomic Policy	19

The purpose of this document is threefold. First, we report briefly on some of the findings of IRIS's "Mongolia: Support for Economic Transition" project during its **first** month. Second, we provide a brief survey of the Mongolian economic situation. This survey does not aim to be comprehensive. Rather, it focuses primarily on the facts that seem most relevant to our final objective -- identification of the key institutional reform issues that the IRIS-Mongolia project will address. These issues are discussed in detail in the final section.

The following is based upon information obtained during the first reconnaissance trip to Mongolia (July 27 to August 5) and on interviews with officials of multilateral organizations, other consultants working on Mongolian issues, U.S. government officials, and experts experienced in policy-oriented issues and in the economics of transition.

A. Some Judgments on the Present Economic and Political Situation

1. **Commitment to a Market-Oriented Society**

We have **n o r e a s o n** to disagree with the widely held belief that a genuine commitment to market-oriented reforms exists in Mongolia. This was obvious during the January IRIS workshop and is reinforced by interviews conducted during the recent visit. The commitment is evidenced in Mongolia in a number of ways: a sense of openness within the society, a willingness to try the new, the ease with which rudimentary democratic processes have been established in the last year, the **firm** understanding that the Soviet Union will no longer treat the country as an economic colony, and the realization that the support of the world's democracies is needed for future economic assistance to be available. There is no need to engage in a lengthy discussion of these points.

There are several important points to note, however, that are often overlooked in assessing the firmness of the Mongolian commitment to market reform. First, decentralization of society has proceeded apace in the last year. Important officials from previous regimes already hold positions in the new decentralized society and **their** fortunes will certainly not be helped by a reversal to centralization. Second, Mongolia's predominantly young population is a strong factor in inhibiting a return to centralization. The old system was one in which entry of the young was restricted by slow bureaucratic turnover and the absence of any private sector to enter. Upward mobility of able young people is much more prevalent in market societies, where new institutions and **firms** can challenge the old. Any turning back to the old regime would mean that the younger elements would have to wait their turn. This simply would be unsustainable in Mongolia, given the age structure of the population. (Many political scientists emphasize the same points in explaining the changes in Eastern Europe and the Soviet Union.)

Third, it should be noted that the reforms have **actually** been proceeding since 1984, albeit haltingly and slowly before 1990. With the fall of Tsedenbol in 1984 and his

replacement by Barmonh, genuine, if not dramatic, economic reforms were introduced. These included the decentralization of government decisions, an increasing freedom for state-owned enterprises, attempts to increase trade with convertible currency areas, some privatization of herds, and allowing the establishment of private producer cooperatives. Although developments in the Soviet Union were a necessary condition for these reforms, it is IRIS's judgment that these reforms had a distinctly Mongolian complexion and were not simply a pale imitation of Soviet perestroika. The fact that reforms have been proceeding since late 1984 shows that the transition from socialism is a representation of processes taking place deep within Mongolian society. This observation, rather than any governmental statement, might be the best indicator of the sustainability of the Mongolian commitment to reform.

These points are important because any serious program of economic policy advice in a transitional environment must take into account the political sustainability of the **transition from socialism. If that process is not evidently sustainable, then there might** be a need to advocate certain policy options that would not be advocated on strictly economic grounds, but that would help secure the transition. Extremely rapid privatization would be an example. Since we do not foresee a sustainability problem in Mongolia, we feel that there is no need to compromise good economic advice because of a fear of reversal to the old order. This is not to say that Mongolia in the long term will certainly have a stable, capitalist, democratic society -- history presents many twists and turns on the road to democratic capitalism, as evidenced by the examples of Germany and Italy in this century. Our argument is simply that a return to the old economic system is not the greatest danger now facing Mongolia. Rather, the biggest problem is likely to arise from ill-advised policies undertaken in the implementation of a market society, policies that might threaten economic failure and consequently the democracy that the Mongolians are now so eagerly creating.

2. The Progress of Reform

Economic reform in Mongolia has so far taken a number of forms including the following: reorganization and decentralization of government departments responsible for economic policy; encouragement of private-sector activity and promotion of a small business sector; revision of the tax structure; price adjustment and decontrol; restructuring **of the banking sector; transfer of some livestock to private ownership; devaluation of the tugrik;** and broadening of trade relations, especially with developed capitalist countries.

The combined effect of these reforms has, at **the** moment, had little positive effect on the economy. The basic structural reforms, such as the introduction of a modern banking sector, will certainly take a lengthy period to implement and then to affect the economy. The decentralization of government and the new pricing policies have led to a number of negative phenomena. These include a loss of monetary control, non-delivery of food products in spite of the abundance of animals in the countryside, and the absence of an allocative mechanism to replace the dismantled centrally planned supply system.

The Mongolian government has emphasized privatization to an **overwhelming degree, but the** institutions needed to support the new private sector have not yet been developed. The measures to encourage private-sector activity must be combined with measures to ensure that the new private sector has access to basic materials, facilities, and foreign markets.

Producing units are still completely dependent on the government for the supply of basic production materials and foreign exchange. This is especially critical for the new private sector because the market provides its only source of supply. Thus, while the government has encouraged the new private sector, even to the extent of offering loans at give-away interest rates, this encouragement has had little effect because of the new **concerns' inability to obtain needed materials. The government** must free up **facilities and materials** for this new sector.

3. Present Economic Situation

On the July reconnaissance trip the IRIS team did not focus on the current macroeconomic situation. The IRIS program centers on microeconomic processes and institutions. The multilateral organizations are much better placed than IRIS to assess macroeconomic problems in detail and to advise on policy options in this area. Nonetheless, some brief reflections on the macroeconomic environment and the overall economic situation are necessary as background for this report.

The IRIS team has no reason to disagree with the most gloomy assessments of the present economic situation, as for example expressed in the report to the UNDP donors conference. Simple survival of the economy requires a very large infusion of Western aid; this appears to be forthcoming. Economic catastrophe would occur this winter without it. Accurate economic statistics at the moment are so difficult to obtain that judgment on the economic situation must rely heavily on isolated pieces of information and qualitative analysis of the general predicament in which Mongolia finds itself. (As evidence of the lack of good statistical information, the IMF has found it necessary to construct its own ad hoc price index. Without reliable price indices, figures on production levels, for example, are of dubious value.)

The sheer logic of the present economic situation attests to the enormity of the present economic problems. The abrupt cutoff of Soviet aid (equal to 15% of GDP in 1990) and the demise of the CMEA trading arrangements (which led to a large decline in levels of trade, especially in industrial supplies) must have had enormous effects. One does not-need statistics to recognize this. With **even** the best policies in effect, these two events would have brought the economy to the edge of catastrophe. (A useful comparison is with Eastern Europe. The economies of Eastern Europe were much less integrated with the Soviet Union than was Mongolia; in 1990 they received virtually no Soviet aid. Further, their alternatives for trade in the short run were far better than those of Mongolia. Yet, with the collapse of the Soviet economy this year and the demise of the CMEA,

these countries have all experienced huge declines in economic activity. Industrial production in Eastern Europe is 10 to 20 percent below last year's level.)

To judge the potential for economic disaster, a few pieces of information will suffice. For example, the huge difference between the black market foreign exchange price and the official rate, even after the devaluation earlier this year, shows that an enormous price adjustment will have to occur once prices and foreign trade are liberalized. It is the experience of many other countries that such price adjustments tend **to build a self-sustaining inflationary momentum of their own. Thus, in simply removing** the backlog of price increases that have been suppressed, it is possible that the inflationary process might become embedded in the economy. Of course, the government has no choice now but to allow prices to reach their equilibrium levels.

Perhaps more ominous in the long run is the present size of monetary emission in the economy. **At present, the monetary base is increasing at 220% a year, leading to a** strong potential for hyperinflation. Western aid, in easing the budgetary situation, will no doubt give the government some time to make the adjustments that are necessary to stem **this** monetary emission. If **the** government is to have a chance of stopping **this** inflationary process, however, it will be crucial to put in place quickly a workable policy on market processes. Policies that facilitate the operations of small business and ease the process of entry and exit of business **firms** are essential. These are exactly the policy areas that the multinational organizations tend to ignore and in which IRIS has expertise.

It should be mentioned here that the **IRIS** team detected distinct differences in judgments concerning the desperateness of the macroeconomic situation, with the report to the UNDP donors conference raising more alarms than the relatively conservative comments of some IMF and World Bank **officials**. Since the **IRIS** team's visit concentrated more on microeconomic processes than on macro phenomena, we do not feel **it necessary in this report to undertake a detailed discussion of which of these points of** view is closer to reality. Our judgment is that this year the Mongolian economy has experienced as much in terms of externally imposed problems as any economy could hope to withstand. (Certainly, Mongolia's problems this year are far greater than those of any East European economy.) We therefore see no reason to stress anything other than the desperateness of the macroeconomic situation, which can only be alleviated by the aid that is forthcoming.

Apart from short-term macroeconomic problems, **there is** one further problem that needs the utmost emphasis. At the moment, there is a great contrast in the prospects of the urban and rural sectors of the economy. This contrast will loom large in the future and could potentially have enormous political consequences. It is exactly the type of economic situation that has produced the worst mix of policy measures in developing countries in the past. Where there is large potential for development in the countryside and great possibility of economic collapse in the cities, and when political control is held

by members of the urban population, policies have usually proved inimical to economic progress.

Privatization is proceeding rapidly in parts of the rural sector. It is likely that very soon there will be only private herds. Researchers at the Institute of Economics estimate that 50% of rural income comes from private sources. (This figure would surely be much higher if production for personal consumption were included.) At the same time, the lineaments of future growth in that sector are obvious -- craft-based rural industries using animal products, **food exports to complement the needs of Mongolia's large neighbors**, etc. In this scenario, the centers of the Negdals would become the basis for much new activity, in developments similar to those in China after its economic reforms. In fact, economic developments in Mongolia could mirror those of the last decade in China, where the engines of growth were new non-state industries in the rural sector and foreign investment, and where the existing urban industries were a drag on the economy.

Antithetical to such developments, government policy at the moment has the effect of favoring the cities. For example, January's Resolution No. 20 produced a large **terms-of-trade** loss for the rural sector. Moreover, the contemporaneous adjustments of the size of banking accounts showed a distinctly urban bias. At present we see no evidence that the rural sector is receiving foreign exchange proportionate to its economic status. These policies have resulted in an increasing bifurcation of the rural and urban economies. (For example, the animal population is at historically high levels at the same time as meat supply to the cities is lower than it has been for decades. Meat is rationed in Ulaan Baatar, while there are reports that overfed animals are falling dead in the countryside because their owners see no gain in slaughtering them.)

The government seems to have no intention to privatize land. This suggests that traditional methods will be relied upon for controlling grazing rights. If **traditional methods have to be used, then the decision to put the land under the control of the cooperative farms** might be a rational one. However, the cooperative farms have no incentive to absorb any of the extra labor that the cities must shed. Moreover, **economic theory and the practice of cooperatives in other countries indicate strongly that the cooperatives will have no incentive to transfer any savings through the banking system to the urban industrial sector.** In all likelihood, the cooperatives will use their surplus to create their own **small-scale** industries, with high capital-labor ratios compared to those in the cities. Given that in the short and medium term the cities themselves will not produce a large surplus that will be available for investment, **the development prospects for the urban sector and the employment prospects for urban dwellers look very bleak.**

This rural-urban problem presents a very serious political challenge for any government. Given the dominance of the urban sector in politics, there is a large probability that the policies developed will restrain economic development. (One can imagine, for example, that the government **will** continue to alter the terms of trade between city and country by intervening in agricultural export markets.) The history of

a large number of developing countries tells us that the government must be persuaded now to implement reforms that will immediately begin to reduce the structural problems that have led other countries down this disastrous policy cul-de-sac in the past.

4. Privatization

The issue of privatization deserves special emphasis in view of Mongolian policy-makers' strong focus on it. Privatization was raised as the first topic of discussion in all our interviews. The high priority that the government places on privatization was evidenced by Deputy Prime Minister Ganbold's public statement that the success of privatization is the sole criterion on which his performance should be judged.

The IRIS team views Mongolia's large program of rapidly privatizing its state enterprises as a serious problem. The effectiveness of such large-scale privatization **requires financial institutions characteristic of only the more developed countries.** The Mongolians have chosen a more complicated privatization scheme than has been implemented in any of the reforming socialist economies, and yet Mongolia has perhaps the most rudimentary understanding of market processes, and the fewest computational, and communication resources of any reforming country. In the process of rapid privatization, resources are being diverted away from the building of institutions, such as the legal structure, to support the nascent private sector. The privatization policy should not be pursued in isolation from other needs; attention to such matters as government budget balance, short term stability, and public sector accountability is essential.

There is no evidence from anywhere in the world that grandiose schemes are effective in quickly placing all enterprises in private hands nor, more importantly, that they spur rapid economic development. Western experts are generally very skeptical about the workability of the Mongolian proposal. Even advocates of very fast privatization have expressed skepticism. Indeed, the populace itself seems skeptical: worried members of the privatization commission told us that there had been little enthusiasm for purchasing the privatization vouchers in the first days that they were on sale.

The consequences of the privatization program for Mongolian private enterprise and **democracy are hard** to forecast. The best scenario is that Mongolian officials will identify the key problems as they proceed and will be able to solve them sequentially. This is the scenario endorsed by Western experts who, while advocating fast privatization, are skeptical about the workability of the present Mongolian scheme. The worst scenario -- one that is closer to the views of IRIS -- is that the privatization scheme will suffer large technical problems and that corruption and scandal will erupt in the process.- The ownership of enterprises employing thousands of people is up for grabs. Given the lack of financial expertise in the society and the inability of the government to monitor this process, an enterprise could be taken over by a small group of individuals for a song. The political ramifications of such a scandal could be enormous. Moreover, if the

government then finds itself **in an embarrassing position** and responds by reversing the privatization process, the credibility of market capitalist processes will be severely damaged.

5. Policy and the Market Process

In our conversations with top officials, we perceived little understanding of the market as a self-regulating, self-sustaining process. Despite strong statements on the commitment to the market, **officials** do not see market competition within a framework of strong governmental institutions (i.e., laws, regulations, organizational structures, and decision-making processes) as providing the necessary degree of control over economic actors **in the large majority** of cases. There was much emphasis on end products of the market process -- stock markets, privatized firms, etc. But the IRIS team saw little evidence of an understanding of the processes that brought these entities into being in capitalist societies -- **the ability to** produce and trade within a system of secure property rights. Instead, officials are impatient with market processes and wish to reach the endpoint of capitalism quickly.

This lack of sensitivity to market processes presents a large propensity for poor policies. For example, the IRIS team met almost nobody willing to countenance the thought that competitive food prices could be **just**, equitable, and efficient. Nearly every official was ready to offer a reason why the government must control food **prices in** order to achieve some outcome that he or she thought was desirable. We found nobody who was willing to say that the market and the processes of entry and exit could be relied upon to protect the interests of consumers.

Similarly, officials in charge of policies to promote small businesses have a conception of markets as comprising a predetermined number **of firms** that can be picked by the state. There was no conception that market structure should be decided ex post as a result of firm births and **firm** bankruptcies. Thus, for example, entry and exit is still controlled. Government officials rule on which **firms** may enter an industry, and the cooperative associations and private producers groups have a formal role in that process as well. Given that officials were willing to talk about these barriers to entry and exit openly **and** saw nothing wrong in them, it is likely that they **result**, at least partially, from a poor understanding rather than simply from existing producers' protecting their turf. Market processes and the accompanying virtue of competition and free entry and exit within a secure system of property rights will be stressed throughout the IRIS project,

6. Democracy and the Policy Process

The Mongolians are moving away from a policy process in which decisions were made by a narrow clique of policy-makers toward a process in which economic policy is decided within the framework of democratic institutions. Unsurprisingly, they still have a long way to go.

The difficulty experienced in integrating policy-making into the democratic process is at least partly a carryover from the previous way of doing things. Analogous problems appear in the East European countries. But there are other factors involved. Most important is the lack of economic knowledge on the part of those political leaders whose role is to monitor the government bureaucracy. Similarly, the lack of even elementary economic forecasting skills offers little chance of embodying policy planning exercises within the democratic process. In the present volatile economic environment, the inability to conduct such exercises makes it impossible for the elected officials to tie the hands of **the government, even on such matters as the size of government expenditures.**

Good policy can only arise from a good process for making policy. Policy must be politically sustainable; it must pass political muster in the formulation stage. This can occur only when there is informational feedback from the affected segments of society as the policy is formulated and enacted. The IBIS workshop approach, by involving a **wide selection of individuals from across the political and economic spectrum, will** enhance the quality of policy by broadening the cast of actors that can participate effectively in the policy-making process.

7. The Governmental Policy-Making Structure and the Makers of Policy

The division of labor in Mongolian policy-making is in **flux**. Some bodies, such as the Ministry of National Development (the descendant of the State Planning Committee), have a size incommensurate with their present powers and are looking for a new role. Others, such as the Ministry of Finance and the Central Bank, will have a much expanded role in the new market economy but do not yet have the structure and skills appropriate for that role. The fight for turf among these bodies could well be detrimental for the economy. For example, old policies might be kept in place just in order to give a role in the new economy to some politically well connected department.

Economic policy-making is at present concentrated within a narrow band of people. This concentration of policy-making power has actually been exacerbated by Western **contacts, which are very important in a society where a little knowledge of markets is a** powerful weapon. One would hope that this concentration of power is a temporary phenomenon, resulting from a governmental structure and a set of personal contacts that reflects the past rather than the market-oriented future. This situation will probably change greatly as the institutions of a market society take hold and the political actors that are relevant thereto gain power.

8. Non-State Actors

The private sector is small at the moment, but it will grow very rapidly. The formal urban private sector is estimated to employ over 30,000 people. No doubt an even larger number engages in informal activities, given the size of the black market. The most significant part of the emerging private sector, however, is virtually unrecognized

by many of the government officials discussing this element of reform. This is the rural private sector, as noted earlier in this paper.

In rural areas, the animal-husbandry sector's rapid privatization process is out of central political control. Privatization in this sector has an ambiguous status, since the biggest rural resource -- pasture land -- is still under the control of the cooperative farms. Nevertheless, the individual cooperative farms seem to be moving away from political control by the government bureaucracy. In fact, the government has determined that many of the privatization decisions on these farms will be made by democratic process on the farms themselves.

There are several groups representing the non-state sector, whose degree of independence from the government varies. The Union of Production Service Cooperatives is a good example. The chairman and driving force of this group was formerly a **high-level government official in the old regime. Paradoxically, his ability to function depends** to a large extent on the contacts he has from his previous political career. Nevertheless, his organization seems to be truly independent of the government. It is self-financing, which is probably the best measure of how much the group's leadership has to be **responsive to its members. Since its members span a broad cross-section of activities, its** purpose is to lobby government generally for policies that are in the interests of the developing private sector. It has no connection with the old state enterprises (in contrast to the Chamber of Commerce). IRIS feels that it is exactly the type of organization that could play a positive role in these early years of the transition process, when the private sector has few voices that carry its specific message to the government. Other organizations that might play a role as embryonic representatives of the nascent private sector include the Council of Agricultural Cooperatives, the Mongolian Chamber of Commerce and Industry, the Association of Private Enterprises, and the Mongolian Union of Production Service Cooperatives.

In the short term, the best hope for identifying politically significant non-governmental organizations lies in the fact that the political parties are developing the ability to conduct their own analysis and policy evaluation. The Mongolian Democratic Party, for example, has established a research institute entitled the Institute for National Development. Rival centers of independent research are vital to the process of policy formulation.

9. Approach of the World Bank and the IMF

The World Bank and the IMF will be conducting important technical assistance projects during the next few years. Because of constraints implicit in the mission of such multilateral organizations, however, they will center on a limited range of activities. The World Bank and the IMF will focus on development of the main governmental bodies in order to improve the quality of administrative input into the policy process and the efficiency of policy implementation. Their advice in the early stages will concentrate on

ensuring that **officials** can communicate in terms of Western concepts and that their informational output is consonant with the needs of the IMF.

These are laudable aims, but the limitations facing the multilateral organizations are significant. Little of what they do addresses the democratic aspects of the policy process. The World Bank and the IMF concentrate instead on bureaucracy. Their programs will not improve the abilities of parliamentarians and private-sector representatives to participate in the political process, nor will they facilitate the interaction between government officials and other policy-interested constituents. (These limitations are inherent in the organizations' terms of reference; they do not necessarily reflect how the officials of these organizations view the policy process.)

Limitations on the scope of work of these multilateral organizations arise in three additional ways. The World Bank and the **IMF** are largely constrained to work on the **existing stock of governmental organizations. Hence, they must find a role for what exists** -- e.g., the Ministry of National Development, the descendant of the planners -- even if such a role seems inappropriate for a market economy. Second, these organizations are restricted to work primarily with macroeconomic instruments of control. Third, they cannot bring non-governmental organizations into the technical advisory process in the central way in which IRIS intends.

In conclusion, even if the multilateral organizations and IRIS cover some of the same topic areas, their approaches are complementary rather overlapping. The dissimilarity of approaches ensures that duplication of activities will not be a problem.

10. Status of Existing Legislation

Although many laws aimed at implementing the transition have been passed, IRIS believes for two reasons that the legislative element of the transition has only just begun. First, given the rapidly changing situation in Mongolia and the limited experience that legislators have with markets, the laws that have been passed lack the full content necessary for the new market environment. For example, the taxation law was described to us by a top Mongolian policy-maker as "too theoretical in nature." He felt that it did not correspond to the realities of the country. The Ministry of Finance confirmed for us that even though this law was just enacted in January 1991, it is already undergoing revision because it was found not to be implementable. Similarly, the customs law, enacted in April 1991, and the foreign investment law are **being** changed.

The second reason there will be wholesale changes in the legislative package in the future is that the process of making legislation must be an ongoing one in any democratic society. As the economic environment changes, the basic laws must reflect those changes. This is especially true when the economic and political environment is adopting a wholly new complexion, as is the case in the reforming socialist economies. IRIS believes that laws passed early in the transition process are unlikely to last long. This is

especially so given that the legislative process has scarcely addressed the needs of the private sector. (One did not exist when most of the laws were passed.) The legislative calendar will be full for many years. This does not represent any failure in the reform process, but rather results from the fact that laws need to reflect the circumstances of the society in which they are to be implemented. Since the present laws have been passed in an environment that has experienced so little of the reform process, they are bound to be changed as the market economy develops.

11. Intellectual Resources for Policy-making

Research and training have traditionally been state controlled. The Institute of Law, the Economics College, and the Institute of Economics are all state organizations. The lawyers and economists have all been trained in Mongolia, the Soviet Union, or Eastern Europe. They therefore have very little training in the law and economics of market societies. The Economics College has 40,000 textbooks but not a single book on Western economics.

Knowledge about market-economy principles even at the most elementary level. Mongolia cannot wait until a new cohort has passed through the traditional educational process. For the present cohort of policy-makers, this education will have to be acquired quickly, largely by learning on the job.

B. Tonics

This section outlines the crucial institutional reform issues facing Mongolia that will be addressed by the IRIS-Mongolia project. We also justify our decision **not** to pursue two areas- that are prominent in the present policy debate. This discussion of issues must be viewed with the understanding that market-oriented policy lessons are being written on a clean slate. Even the most sophisticated Mongolians have little knowledge of democratic market processes and virtually no intuitive feel for the types of policies that are appropriate for a market environment. Hence the choice of issues is not driven by the current knowledge of the Mongolians: from this point of view, there is no area that can be ignored. Nor is the choice of issues derived from a standard recipe for upgrading the technical capacity of a policy-making elite. The transition from socialism is a very **different process from reforming a market-oriented society. Thus, the choice of issues** is based on IRIS's understanding of the pragmatic needs of Mongolia over the next year, especially the need for education in the fundamentals of the market and the democratic **policy process. The facts relevant to the choice of issues appear above and we will allude** to them here only as needed.

1. Achieving Competitive Markets: The Role of Market Institutions; the Effects of Governments; the Role of Small Business Policy

In market economies, there is a widespread, almost visceral sense that economic welfare can be protected by an open competitive process. Witness, for example, the frequent allusion to Adam Smith's invisible hand. Although this understanding is sometimes clouded by the arguments of important interest groups, it is undoubtedly an important element in maintaining the strength of the market system.

This understanding of market processes is totally absent in reforming socialist countries. In fact, almost the opposite tendency exists. There is a strong inclination to distrust markets unless their benefits are absolutely clear. Intervention is often deemed appropriate in the weakest of cases. This intervention is often prompted by the notion that some of the inevitable costs of markets -- bankruptcies, labor turnover -- are avoidable without any consequent reduction in the overall **benefits of market society**.

Clearly some of the interventionist tendencies in socialist economies are played upon by economic interests. But at the present stage of Mongolia's transition, the largest problem is the lack of understanding of market processes. In such a situation, educating policy-makers on market processes can have a large effect. Such education will make apparent the inconsistencies in the present economic program. For example, we find that while government officials are committed to markets, they are not yet encouraging the open entry and exit processes that will allow those markets to function well. Moreover, while the commitment to encouraging the formation of small businesses is strong, the resources needed to make the new businesses viable have not yet been freed up. (In the opinion of one banker, many loans that have been made to the private sector have not been economically advantageous since the private businesses have been unable to secure supplies from the state sector.)

Now is the time when a workable policy toward small business is most needed. The giant old socialist enterprises will be shedding labor for years to come. The austerity facing the government will prevent its previous employment creation policy -- the creation of large enterprises. As argued above, the countryside will not be a supplier of opportunities for the urban unemployed. The only place to expect growth is from a new private sector, and this must start with small enterprises.

Discussion of creating competitive markets must concentrate first on how to make a market environment that truly encourages the development of a small enterprise sector. Basic property rights, the trade-facilitating aspects of business law, and dispute settlement mechanisms are **essential**; they provide fertile institutional soil for the business process.

Further, this discussion must address the societal mechanisms that often confound the competitive process, especially concentrating on the role that government plays in this process. Our discussions in Mongolia indicate that policy-makers are still wedded to a

process that controls at the governmental level the entry and exit of **firms**. There are also many convoluted procedures for business licensing and registration that are likely to restrict entry. These are issues that IRIS, by its very nature, is ideally suited to explore. The multilateral organizations, in contrast, tend to ignore these issues in their approach to economic reform. The work of de **Soto** is most relevant here.

Lastly, it is important for Mongolians to develop an appropriate role for local and national government in assisting small business. This is especially crucial in a **market-oriented** society that is in transition from socialism and therefore has not **previously** experienced a viable small-business sector. The IRIS team was impressed with the eagerness of the official in charge of small business matters. Education on the reality of **what is possible, what is efficient, and what standards of accountability must be pursued** is essential. A large stock of information about how to run small-business programs is available from the market economies, especially the United States, and this information must be communicated.

2. **Budget Processes in Market Democracies**

The Mongolian budget is out of control in two fundamental senses: economically and politically. First, the level of spending in the first eight months of the year was completely inconsistent with the society's economic ability. The limits that economic realities place on the spending capacity of the government must be at the forefront of all discussions about the budget. Moreover, it is necessary to build the understanding that the allocation of budgetary expenditures has an enormous impact on the economic efficiency of the society as a whole and that there are useful economic principles that can be employed to examine these efficiency effects.

Second, the budget is not under democratic political control. The various elements of budgetary expenditures are not determined within the democratic process. Rather than falling under the purview of elected officials operating as an instrument of the society as a whole, they are controlled by a narrow group of policy-makers. The budget's potential role as a central instrument of a democratic society, both as a statement of economic policy and as a method for elected officials to control the actions of administrators, should be encouraged.

There are three aspects of this issue. First, some uncomplicated analytical concepts must be introduced. These include, for example, national income accounting and the role **of government in that schema, the alternatives for financing government expenditure** and their relationship to macroeconomic performance, particularly inflation, and elementary aspects of economic forecasting and its role in the budgetary process. This basic knowledge is not only pertinent to government officials constructing and implementing the budget but also to the elected officials responsible for passing the budget, the representatives of political parties, and interest groups looking after the needs of the private sector. In Mongolia at the moment, a little knowledge of market-economy

processes translates into considerable power. **IRIS** intends to make sure this knowledge is transmitted to a wide spectrum of participants in the democratic process.

Second, some basic questions regarding the role of government spending in a market economy should be addressed. For example, why not leave the economic task to the private sector? What economic arguments justify government spending rather than letting the market operate completely freely? How can one begin to develop an understanding within society of the appropriate division between government and private spending, and what general economic principles inform this issue? How can one begin to estimate the efficiency effects of various government programs?

Third, the legal, administrative, and political elements of the budgetary process need development. In particular, the interrelation between the procedures for passing the budget through the political process and the amount of democratic control instituted **within that budgetary process should be understood. An appropriate structure of the** interaction between the government, parliament, and the private sector is crucial here, as are control mechanisms that can help ensure that the budget is implemented in a manner that reflects the decisions of parliament.

3. Prices in a Market Society

One of the strongest paradoxes apparent from discussions with Mongolian **policy-makers** is that a need for risky schemes of rapid privatization is perceived while the need to allow economic agents extensive flexibility in choosing their own prices is not recognized. This paradox is already evident in economic events; for example, the moves toward privatization in the animal husbandry sector combined with fixed prices have led to an urban food crisis at a time of agricultural-resource abundance. The **IRIS** team believes that such contradictory policies are not simply the result of legacies of the past, nor of crass political moves for, personal gain, but rather of a widespread lack of understanding of the role that prices must play in a market economy. The same impression emerged strongly **from** the January 1991 workshop and meetings that were held by **IRIS**. There is a fundamental need for the top policy-makers to understand the way in which prices play their role in a market economy.

In addition to the role of prices, the principles appropriate for determining where to draw the line between government intervention on prices and free-pricing mechanisms must be introduced. In order to draw this line, Mongolians need a fairly comprehensive knowledge of the tools that the government can use to **achieve** its objectives without resorting to intervention on prices. Thus, the costs and benefits of price control versus alternative instruments for achieving society's objectives, including the promotion of entrepreneurship, must be explored. Policy-makers need skills and information that will enable them to take a reasoned position within the policy debate on where to draw the line on price intervention. The successes and failures of Western societies on this score can serve as examples.

Even given a well informed position on matters of price policy, it is certain the Mongolians will choose to control some prices. There is no society in the world in which all prices are free; for example, prices are usually controlled for utilities, transportation, communications, and many government services. Moreover, in the Mongolian case, it is unlikely that prices will be as decontrolled as in the typical Western society. Mineral resources, energy, and land will be possible subjects for control. Additionally, it is unlikely the government will actually free all food prices, despite the importuning of the multilateral organizations. Given these matters and the pervasive influence some of these prices will have on economic activity, there is a dire need to expose the relevant **policy-makers** to principles of price control.

The principles of price control fall into three areas. The first concerns the information that must be collected in order to make rational decisions and the ways to collect and analyze this information. The second concerns the economic principles that can be used to process this information and to decide on the level of prices that meets goals of economic efficiency and reflects the social needs the government is striving to meet. The third concerns structuring the process of price setting so that the interests of the affected members of society are represented adequately. The goal here is for price-setting arrangements to be implemented within the democratic process.

4. Property Rights Under Capitalism, with Applications to the Problem of Land

A stable and workable system of property rights is necessary for the effective functioning of a market economy. Such a system requires legal procedures to be established such that people feel secure in their property rights, obtain the fruits of these property rights, and are able to convey these rights to others. Because an essential ingredient in an effective system of property rights is the population's trust in stable government and an enforceable set of laws, this system is not easily established even under the best of circumstances. In Mongolia, where there is little history of commercial activity, the task is yet more difficult. The necessary systems of law and due process simply have not been incorporated in the society's mechanisms. Hence, there is a large task to be carried out in encouraging the top policy-makers to devise and implement active policies to develop systems of individual property rights.

The experience of Western countries provides much accumulated wisdom on the effective ways to structure legal processes and administrative procedures. It is possible that laws effective in other countries can be adapted for use in Mongolia. Thus, the Mongolians stand to learn a great deal from discussions of Western experience in establishing secure systems of property rights. The link between productivity and secure rights, and the ways these rights influence the functioning of credit markets, must be understood. For an economy that will depend on small **firms** for growth, institutional requirements and the practical ways in which property rights can be implemented quickly are of central concern. Knowledge about the role of democracy in the legal process and

the ways in which democratic decision-making can foster secure economic rights is essential.

There are many different options for the design of secure and stable economic rights. Each option has different consequences for efficiency and for the level of economic performance. Some options will be more suitable than others given the history, physical resources, and economic circumstances of the country. On the issue of land, for example, the Mongolians feel that it is important to keep some of their traditional methods and that Western practices are not necessarily appropriate given the distinctive Mongolian circumstances. While there is every reason for policy advisers to be sensitive to such views, there is also a need for Mongolians to explore the costs and benefits of the options that they choose. There has not been deep reflection in Mongolia on the characteristics of alternative land tenure systems. Indeed, the analytical and conceptual skills necessary for such reflection do not presently exist. Thus, the IRIS project can play **an important role in helping the Mongolians gain the skills that are necessary to explore** the effects of alternative systems of property rights and of alternative systems of managing the economic uses of land.

Land issues are still very much under debate in Mongolia and are likely to be debated for some time to come. The issue of land can be used to crystallize the important points about property rights systems. The experiences of different land property systems that have been adopted in a variety of countries offer valuable lessons. The appropriate role of local governments varies under differing systems of land rights. The IRIS-Mongolia project will encourage development of the conceptual skills that policy-makers need to have to understand the costs and benefits of the alternative systems of property rights in land.

One of the prime reasons for advocating attention to this issue is that IRIS believes it is important for the Mongolians to tackle some of the fundamental issues that will affect the rural-urban divide in their country. They need to determine how best to utilize the vast rural resources of their country to get the process of development underway. A system of property rights, such as the ones they have now, that restricts the movement of capital out of the countryside and of people out of the cities will impede development for a long time to come. Casting these issues in terms of the discussion of property rights in general will enable us to present the politically sensitive topic of land in a way that is palatable.

This issue is relevant in two other important areas of **policy** debate that will arise over the next few years. The ownership of mineral resources will be an extremely contentious issue, given that development of mineral resources is likely to be very much in the hands of foreign corporations. Second, the ownership of urban land is bound to become topical as the owners of new private businesses seek the security that rented property does not offer them.

5. Role of Government and Regulation in Market Economies

Defining the limits of government activity is the central political question in western societies. These limits obviously change with the ebb **and flow of** politics and society. Nevertheless, there are some well established principles that economists have developed for thinking about the determination of these limits, even if there are no hard and fast general rules on what the limits should be. Analyzing what should be left to the market and what should be done by the government entails a mode of thought that is rather alien to the reforming socialist economies. In those countries, the debate often proceeds along highly polemical lines: either the market is exploitation or government intervention is a continuation of communism.

In the practice of policy-making in Mongolia, there is still a strong tendency to intervene in direct ways in the economy. Either there is not enough faith in the ability of the market to produce desired results or there is an unwillingness to accept some of the inevitable costs of the market. When a need to affect market outcomes is perceived, intervention tends to take the form of orders and controls rather than indirect measures, **such as selective incentives, that might be more efficient. Thus, there is little recognition** that economic tools such as taxes and subsidies can be used to achieve societal objectives within the context of the market.

Discussion of this issue should focus on two themes. The first is the need for Mongolians to develop knowledge of the economic principles that democratic societies can use to draw the line between governmental and market activities. Examples of these principles in action abound in Western societies. Competition policy, income distribution, housing policy, food supply, and environmental concerns are all relevant in this context.

The second important theme is the need for learning about the various techniques of government intervention that exist in market society, such as taxes, controls, subsidies, usage fees, and regulations. The economic costs and benefits associated with these mechanisms and the efficiency with which each can be used to attain social objectives derived from a working democratic process must be considered. Western experience with regulation of public utilities, anti-trust laws, and environmental protection offer valuable examples. The ways in which governmental procurement mechanisms can either aid or **hinder small business must be analyzed given the need to create a small business sector** and the large amount of government procurement that will inevitably occur in the forthcoming years.

6. Taxes

All reforming socialist countries have faced an erosion of their tax base during the process of decentralization. This problem is exacerbated when privatization occurs. Governments find themselves with a revenue shortfall, yet they are loathe to reduce expenditures in the highly charged political atmosphere of reform politics. The early

phases of the transition from socialism are then plagued by inflation as monetary emission is used to pay for the budget shortfall. Mongolia is no exception in this regard. Moreover, it has the additional problem that one of its sources of budgetary financing -- Soviet aid -- has been eliminated.

Lack of a stable, workable tax system impedes reforms in two ways. First, arbitrary and frequent changes in the tax system, designed to raise revenues in desperate circumstances, reduce people's faith in a secure system of property rights. Second, the inflation that usually results from these budgetary problems often threatens to go out of control. The result is either complete erosion of the monetary system, as in Yugoslavia in the 1980s, or a very costly stabilization program, as in Poland in 1990. Hence, the Mongolians desperately need an efficient tax system that can be implemented within a very underdeveloped administrative system.

The present Mongolian tax laws are not workable. The customs- and income-tax laws are currently being revised only a few months after they were enacted. The taxes on the agricultural sector, being a remnant of the old system of forced deliveries (and still keeping that name), are no longer appropriate as the economy becomes marketized.

There is a need to examine the efficiency effects that various types of taxes would have within the context of Mongolia's particular features. Given the underdevelopment of the tax-collecting service, the administrative requirements of different tax systems also will be an important consideration. The way in which the tax system fits into the overall government strategy and policy process must be examined. For example, elementary procedures for forecasting tax revenues for budgetary planning purposes need to be introduced. Lastly, the interface between the tax system and the democratic process should be emphasized, particularly the procedures by which an elected parliament exerts its influence over government officials through the power of taxation.

7. Privatization

Given the prominence attached to the privatization issue by Mongolian officials, this issue must be addressed here, though IRIS has decided not pursue it to any large extent. In the following paragraphs we present our arguments on why privatization will not be **a central issue in the IRIS-Mongolia program.**

It is crucial at this juncture to be clear about terms. By privatization we mean simply the process of changing the ownership of the **existing** large state enterprises. Privatization is not the same as the creation of a private sector, since a private sector can be created, indeed is best created, by the organic growth of small new **firms**. IRIS believes the sine qua non of the transition from socialism is the creation of a dominant, viable, politically secure private sector comprising **firms** of all sizes. Since privatization of existing large **firms** and the creation of new firms compete for the same economic

resources, they are, in the short term at least, competitive means to accomplish the transition.

As described above, the Mongolian government has placed a large amount of its intellectual and political resources into the privatization process. Far less attention has been devoted to setting up the institutional requirements for capitalism and to ensuring that there is a healthy environment for new small businesses. Thus, in the interest of maintaining an appropriate balance within the mix of policies for the transition, we feel that there is no need to place further efforts into the privatization process. This is purely a question of the optimal allocation of technical assistance resources; we feel that incremental resources would be best placed outside the privatization process.

There is a further reason to eschew the issue of privatization. The Mongolians have chosen the most complicated form of privatization scheme. In the judgment of IRIS and other experts, implementation will require many ad hoc adjustments en route. These are not the types of decisions for which pre-existing theory exists or for which a plan can be created. They will need to be made pragmatically on site on a day-to-day basis. Therefore, privatization does not fit into the framework that IRIS has designed for its policy-making technical assistance.

All of the reform issues discussed previously in this report are central to the ultimate success of the privatization process. After the **firms** have been privatized, they will be beneficiaries of the institutions of the market economy and of good economic policies. Thus, to the extent that IRIS can aid in the formation of workable institutions and the creation of good policies, it will inadvertently benefit the privatization effort.

8. Macroeconomic Policy

Macroeconomic policy is another area that must be addressed for the sake of completeness. IRIS **does** not intend to pursue macroeconomic issues because the **IMF**, the World Bank, and the Sachs-Boone team hold a comparative advantage here. The comparative advantage of IRIS is on the microeconomic processes of transition and on the role and creation of the institutions of market economies.