THE POWER OF PUBLIC INVESTMENT MANAGEMENT
Transforming Resources into Assets for Growth

COUNTRY CASE STUDY

Mongolia: The Politics of Public Investments

Zahid Hasnain

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This case study is one of a number of country cases in the Public Investment Management Series. The country case studies accompany the volume, “The Power of Public Investment Management: Transforming Resources into Assets for Growth”, World Bank (2014), and apply a common methodology to assess PIM systems globally.
Why do politicians distort public investments? And given that public investments are poor—because presumably that is what is politically rational—what types of reforms are likely to be both efficiency improving and compatible with the interests of politicians? This chapter explores these two questions in the context of Mongolia. It argues that Mongolian members of parliament (MPs) have an incentive to over-spend on smaller projects that bring benefits to specific geographical localities and to under-spend on large infrastructure that would bring economic benefits to Mongolia on the whole. The incentive for the former is that MPs internalize the political benefits from the provision of particular, targeted benefits to specific communities. The disincentive for the latter is that a large infrastructure investment carries a political risk because the political faction in control of that particular ministry would have access to huge rents and become politically too powerful. The identity of these “winners” is uncertain ex ante, given the relatively egalitarian and ethnically homogenous nature of Mongolia’s society and polity. Anticipating this risk, MPs are reluctant to fund these projects. Since these large infrastructure projects are crucial for national growth, neglecting them hurts all MPs. Therefore, MPs will support reforms that collectively tie their hands by safeguarding large, strategic investment projects from political interference, thereby ensuring that no political faction becomes too powerful. This protection of mega-projects would need to be part of a bargain that also allows geographical targeting of some percentage of the capital budget.
Investments are a key to economic growth, and in developing countries public investments in infrastructure, education, and health are necessary to provide public goods, address market failures, crowd-in private investments, and achieve redistributive goals. However, public investments are often the most politically visible and discretionary forms of public expenditure; therefore, they are strongly influenced by political considerations, thereby undermining their quality. These political pressures are particularly pronounced in resource-rich countries—as is often noted, the "resource curse" is primarily a political, not economic, phenomenon (Humphreys, Sachs, and Stiglitz 2007; Collier 2010; Dunning 2008).

Given these political constraints, therefore, a fundamental question is how can public investments be improved in developing countries? More specifically, given that public investments are poor because they are presumably politically rational and serve the interests of key political actors, what types of institutional and organizational reforms are likely to both improve efficiency and be compatible with the interests of these actors?

This chapter addresses these questions in the context of Mongolia, a natural resource-rich (copper and coal), rapidly transforming economy presently attempting numerous structural reforms along the length of the natural resource “value chain”—but a country that also faces many of the risks associated with the resource curse. An effective public investment system is essential for avoiding the Dutch disease and for translating natural resources underground into productive assets above ground. However, Mongolia’s public investment management (PIM) system is weak and has been unable to allocate resources well or in the most cost-effective manner. With capital expenditures increasing rapidly (from 4 percent to 14 percent of GDP from 2005 to 2013), improving this system is a central and urgent priority. Therefore, the issue of which technical solutions will be politically viable is of considerable importance to Mongolia’s development.

The approach in this chapter is to apply the lessons from the considerable academic political economy literature to attempt to answer this question. The key political actors in the analysis are Mongolia’s Members of Parliament (MPs) because in this parliamentary democracy the Parliament exercises considerable budgetary authority and the public investment system is hugely influenced by the interests of individual MPs. Drawing on the literature, the chapter identifies several perverse political incentives that need to be addressed if public investments are to improve in Mongolia.

First, many public investment projects are selected because of the perceived benefits they bring to specific localities, and not because of the economic benefits they will bring to Mongolia on the whole, and they are endorsed primarily to help the election prospects of MPs. These projects, given Mongolia’s geography (small population and low population density), tend to be uneconomic.

Second, and equally important, even those projects that are a priori economic are compromised in their implementation by poor planning and appraisal, procurement irregularities, and weak monitoring. The award of contracts to technically unqualified but politically well-connected construction companies is a major political reason for these implementation problems.
Third, political actors have little incentive to maintain capital assets, as evidenced by the chronic underfunding of capital maintenance and repairs, resulting in the deterioration of physical assets. This neglect of maintenance, resulting in a “build-neglect-rebuild” cycle for infrastructure, is common in developing countries, and reflects MPs’ short time horizons due to their election cycle.

Fourth, political actors have considerable motivation to seek off-budget financing to develop mineral resources, primarily in the form of extra-budgetary expenditures, but also public-private partnerships (PPPs). If structured well, these modalities can be an important source of infrastructure financing. However, the tendency to view these deals as “free money” that will not have fiscal repercussions until the distant future, with the benefits accruing now, is particularly pronounced in Mongolia.

The underlying motivation for these perverse outcomes is Mongolian MPs’ incentives toward “clientelism,” defined as the provision of particular, targeted benefits to either specific communities or influential individuals. These incentives are linked to political and institutional variables, in particular, to the need for Mongolian policy makers to win elections in an environment where electoral campaigns are expensive and political parties are not well-disciplined.

Mongolia shares these problems of clientelism with many developing countries. However, encouragingly, Mongolia has a number of features that suggest reform is possible. First, compared to other young democracies, Mongolia’s relatively stable two-party system and its competing parties greatly enhance electoral accountability. Second, there is little prospect of extra-constitutional intervention (for example, a military coup), providing Mongolian policy makers with longer time horizons than many of their developing country counterparts. In other words, while MPs may lose elections, they are not likely to lose their life or their freedom, thus they have the chance of winning in the future. Third, although Mongolia’s political parties are not well-disciplined, they are more programmatic—that is, they have some shared corporate policy objectives—than is the case in many other countries.

Fifth, Mongolia is not riven by ethno-linguistic cleavages, as is common, for example, in many African democracies, which is a major advantage given that in natural resource-rich countries the combination of ethnic rivalries and resource rents often proves explosive (Collier 2008). In addition, Mongolia’s vibrant and free press and numerous civil society advocacy groups can provide the necessary checks on the executive. Finally, in large part due to the legacy of communism, the population has a high education level compared to other countries at similar income levels, increasing the ability of the population to hold policy makers accountable.

These positive features suggest that Mongolian policy makers should in theory be able to cooperate to achieve reforms. This chapter argues that the following reforms can be incentive-compatible, that is, in line with the political interests of Members of Parliament:

- MPs may support reforms that collectively tie their hands by safeguarding large, strategic investment projects from political interference. Given the positive features of Mongolia’s political economy, MPs generally recognize that they are stuck in a “prisoner’s dilemma”
situation where what is individually politically rational leads to suboptimal collective outcomes. No individual MP will find it in his or her interest to forego his constituency-specific project to free up the funding needed for the large infrastructure projects to develop the Southern Gobi mines, for example. Why? Because (1) this risks hurting their reelection chances and (2) without some safeguarding of the mega-projects, a few privileged MPs—those able to secure these large contracts—will gain at the expense of a majority whose projects cannot get funded. The identity of these “winners” will be uncertain ex ante. The collective result will be that such projects will not be developed, which will hurt all MPs. Therefore, budget, planning, and procurement reforms that put in place checks and balances and collectively limit all MPs’ ability to influence these projects, and do not advantage or disadvantage any one particular faction, will be incentive-compatible.

- The corollary to the first point, given the strong public demand to see some of the benefits of natural resources, is that some constituency specific projects will be politically necessary. Indeed, protection of mega-projects would need to be part of a bargain that also allows geographical targeting of some percentage of the capital budget. These projects will most likely be uneconomic, but without them MPs cannot get reelected. The focus therefore should be to ensure that (1) these projects are properly prepared, in particular, that their cost estimations are accurate and that community consultation is institutionalized, and (2) that they cumulatively amount to a small proportion—less than 20 percent—of the annual capital budget.

- The functional form for safeguarding large, strategic national infrastructure projects will need to be incentive-compatible. In Mongolia, MPs will reject an all-powerful Ministry of Finance that combines the planning and budgeting function as this will privilege one political faction (for example, led by the Finance Minister) over others. Instead, a division of responsibilities between a central planning agency (for example, a Ministry of Planning), the Ministry of Finance, and line ministries will be incentive-compatible as it provides representation to the various political factions. The focus of reforms should then be to ensure that proper coordination mechanisms exist between the three agencies.

- A similar logic of safeguarding large projects that benefit all constituencies while allowing targeted benefits to flow from smaller projects applies to procurement arrangements. International procurement standards of competitive bidding and transparency will be incentive-compatible for the large mining infrastructure projects precisely because the stakes are so high and a particular political faction could become too powerful. However, for smaller projects, collusive practices will be difficult to prevent, particularly given that international companies are less interested in them.

This chapter is inductive in its structure. First, the broader public expenditure patterns in Mongolia are analyzed in order to identify policy makers’ priorities (that is, revealed preferences). Then the public investment management system is examined in-depth, identifying the main technical and structural weaknesses in the system. Following that is an analysis of the interests of key political actors that are served by poor investments. Given these political incentives, the final section proposes some incentive-compatible reform options.
Key Issues in Public Investment Management in Mongolia

Like many revenue-rich, former socialist countries, Mongolia has a big government, as measured by revenue collection and public expenditures. As figure x.1 shows, public expenditures have averaged 30–40 percent of GDP over the past five years. Also, like many resource-rich countries, expenditures have been highly pro-cyclical, in large part reflecting the trend in copper prices. Mongolia went through a classic boom-and-bust cycle from 2005 to 2009, with the non-mining deficit (that is, expenditures relative to non-mining revenues) increasing from a deficit of 1 percent of GDP in 2005 to over 15 percent in 2008 (Figure x.1a), which required large expenditure cuts in capital and operations (goods and services) and donor assistance to remediate.

The use of the windfall mining revenues provides a good measure of policy makers’ preferences, as it is like “manna from heaven” that can be spent without requiring an additional tax burden on citizens (Figure x.1b). The 2005–08 boom was used to finance massive increases in capital expenditures (from 3 percent of GDP in 2005 to 8 percent in 2008), across-the-board wage increases for civil servants (from 6 to 9 percent of GDP), and social transfers (from 8 to 10 percent of GDP). Within public investments, the road-and-transport and fuel-and-energy sectors received the bulk of the resources (roughly half of the capital expenditures were on these two sectors), followed by education and health. Social transfers were in general untargeted and involved significant cash handouts to all Mongolian citizens with children (The Child Money Program). The expenditure categories that were relatively neglected were operations (purchase of goods and services), which declined from 11 to 8 percent of GDP in the same time period, and, in particular, capital repair and maintenance, as described in more detail in the next section.

Figure x.1  Mongolia’s Public Expenditure Patterns, 2003–10

Source: Ministry of Finance, budget data
Therefore, unlike many other developing countries, the problem in Mongolia is not underspending on capital, but rather the poor quality of that spending. Note also that, apart from its broader macro-stability implications—the spending effect resulting in the overheating of the economy and real exchange rate appreciation, thereby hurting the non-resource tradables sector—the fiscal cycle itself compromises investment quality. The rapid increase in expenditures—in nominal terms, public capital expenditures increased 35-fold in 10 years (figure x.2)—puts a strain on the systems for planning and execution and results in the misallocation of resources. In other words, if capital expenditures grow this rapidly, then it is highly likely that they are financing many bad projects, as the systems for appraising and selecting projects cannot grow in capacity and sophistication at a similarly rapid pace. Of equal importance is the fact that the local construction sector usually cannot handle this surge in demand for public projects, resulting in myriad implementation problems. Both smoothing expenditure fluctuations to avoid the problem of many new projects that cannot be funded during the downturn, and controlling expenditure growth to preserve the quality of the capital asset portfolio are therefore imperative for a resource-dependent economy.

As is generally accepted, a good PIM system needs to accomplish both of the following objectives (World Bank 1998):

- Achieve allocative efficiency, that is, to distribute resources as per national priorities and to shift resources from less productive sectors and less effective activities to more productive and effective ones (in other words, “spending in the right areas”).

- Achieve operational efficiency, or to implement programs and deliver services at the lowest cost per unit of output, or conversely, to get the most output for a given set of inputs.

Mongolia’s system is falling short on each of these objectives, as will be detailed in the next section.

Figure x2: Growth in government capital expenditures, 2003-2011

a. Nominal capital expenditures

b. Capital expenditures

Source: Mongolia Ministry of Finance and National Statistical Office.
Low Allocative Efficiency

The problem of low allocative efficiency in Mongolia has several aspects. First, there is a gross neglect of maintenance and capital repair which leads to the “build-neglect-rebuild” scenario. Second, public investment projects are not guided by well-thought-out strategic priorities. Third, capital budgeting is not done under reasonably disciplined sector ceilings, thereby not providing any incentive for ministries to prioritize. Fourth, there is little in the form of economic appraisal in the planning and budgeting process. Fifth, there is considerable fragmentation of the capital budget, with a plethora of small projects spread across sectors and regions.

The starkest objective indicator of the misallocation of resources in Mongolia is the gross underspending on capital maintenance and repair in relation to the country’s needs. Years of neglect have left the energy and roads sectors in a state of disrepair approaching crisis proportions. The electricity sector has immediate capital repair needs estimated by the Ministry of Fuel and Energy of about US$130 million (or 2.5 percent of GDP), and 60 percent of the national paved road network is in poor condition and in need of capital repair and rehabilitation, at an estimated cost of $520 million (or roughly 10 percent of GDP).

As against these large needs, as shown in figure x.2 capital repair spending increased very little in nominal terms during the boom years—as compared to expenditures on transfers, wages and salaries, and new domestic investment—and it declined as a percentage of new investments (from 8 to 3 percent) and of lagged investments (from 21 to 6 percent) between 2008 and 2013.2

Figure x.2  Spending On Capital Repairs and Maintenance

a. Growth in capital repair and new investments

b. Capital repair portion of new investments and public capital stock
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Note: Spending on capital repairs and maintenance did not benefit from the expenditure boom and has declined as a share of new investments and capital stock.

There are both technical and political reasons for this underprioritization. The Government does not undertake any economic analysis of projects during budgeting and does not require that the future recurrent costs of projects be specified as part of the appraisal process. The deeper political reasons are discussed in the next section.

Within the capital budget, the planning and budgeting process is weak, and therefore the allocation of funds across projects has also been poor. Budgets generally, and public investments specifically, need to be guided by policies that are grounded in a strategic framework based on sound analysis. Therefore it is required that both national and sectoral planning documents be of good quality and that the public investment program be linked as much as possible to the priorities established in these documents. While there are many of these documents in Mongolia, they are usually quite weak in quality, and there is very little linkage between the documents and the annual capital budget.

Exacerbating the problem of weak strategic guidance is the failure to effectively enforce sector ceilings on line ministry budget proposals, with the result that there is little incentive for the ministries to prioritize their investment proposals, given fiscal constraints. For example, in 2008 the investment proposals submitted by all line ministries amounted to 22.6 percent of GDP, as against a ceiling of 8 percent of GDP set out in the medium term fiscal framework (Finch and Fritz, 2010). Politically, this lack of discipline implies that ministries are not forced to make tough choices and instead can “pass the buck” to the Ministry of Finance (MOF) by including numerous projects and thereby pleasing all constituencies.

No formally institutionalized process of economic appraisal of investment projects exists in Mongolia. The primary budget legislation (the Public Sector Finance and Management Law of 2003) is largely silent on the modalities for public investment planning and budgeting, and the MOF regulations on preparation and prioritization of public investment projects are skeletal. There are no project appraisal guidelines that specify what economic and financial analyses need to accompany project proposals, nor what will be the basis of appraising these projects. Without such systematic approaches, it is very difficult to determine intersectoral and intrasectoral priorities, as well as to determine which projects are feasible and which are not.

The corollary to this regulatory weakness is the lack of capacity in the line ministries to conduct economic analysis, as well as the lack of capacity in the MOF for an independent review of project proposals based on analytical criteria. The MOF Investment Division—which until the creation of the new planning agency had prime responsibility for this task—has a staff size of less than 10, and for all practical purposes, the project review process is limited to ensuring that the
proposals for new constructions have the necessary technical drawings to comply with the requirements of the Construction Law, and that the cost estimates follow the required norms.

These problems are particularly severe in projects that are inserted by Parliament during the annual budget sessions. Parliament has regularly significantly increased and altered the capital budgets submitted by the Executive. For example, in 2008 Parliament increased the capital budget approved by the cabinet from 442 to 571 billion MNT, replacing and adding numerous projects to the portfolio (figure x.4). Some of these new projects flow from the Local Development Fund, the allocation given to each parliamentarian for earmarked, or “pork-barrel,” spending in their home districts. These constituency funds were introduced in 2003, and the allocation per MP has increased hundred-fold since then from 10 million MNT per MP in 2003 to 1 billion MNT per MP in 2010. Often these schemes identified under the constituency fund are without basic technical documentation and have even more inaccurate cost estimations than the projects proposed by the line ministries.

The Local Development Fund amounts to approximately 15 percent of the capital budget. However, the total number of constituency-specific projects is much larger, as many projects proposed by line ministries also have this feature. Indeed the vast majority of projects in the Mongolia’s public investment portfolio are small and geographically targeted. This geographical targeting has resulted in considerable fragmentation of the capital budget into a large number of small projects. For example, in the 2008 capital budget, the total funding for new investments of roughly $400 million (470 billion MNT) was spread out over 758 projects, implying an average project allocation of US$520,000. However, the median project size was much lower. As figure x.5 shows, 35 percent of projects were less than 100 million MNT ($80,000) in size, and another 39 percent were between 100 and 500 million MNT ($400,000) in size. Considering 1 billion MNT ($800,000) as the threshold for a “large project,” then only 15 percent of the portfolio was made up of these large projects.

Figure x.3  Distribution of Investment Projects by Size, 2008

Source: Ministry of Finance
Such high fragmentation reduces allocative efficiency for four reasons: (1) these projects, given Mongolia’s geography (small population and low population density) tend to be uneconomic; (2) fragmentation is likely to result in duplication and wasted resources; (3) it likely increases the costs of the public investment portfolio as it foregoes some economies of scale; and (4) the large number of small projects taxes the limited human resource capacity of the line ministries that prepare and implement these projects, and of the MOF that has to screen and approve them to be financed from the budget. Therefore, it is likely that a portfolio with many smaller projects will be of poorer quality than a portfolio of the same size with fewer, larger projects.

Finally, there is considerable pressure to seek extrabudgetary sources of financing for the large infrastructure needs without the appropriate legal and regulatory structure to ensure that these projects go through appropriate appraisal and fiscal risks are adequately taken into consideration. Specifically, this off-budget financing is in the form of “build-transfer” (BT) projects in the roads and energy sectors that were financed by construction companies themselves on the condition of repayment from the budget at a later date. And this extrabudgetary financing also comes from excessive lending by the Development Bank of Mongolia (DBM), in particular for non-revenue generating public infrastructure projects.

The value of off-budget BT and DBM-financed schemes in terms of total project cost has increased from 3 percent of the total capital budget in 2008 to over 41 percent in 2012, which represents a significant fiscal liability for the Government. It is anticipated that DBM project finance for non-revenue generating projects was equivalent to 4 percent of GDP for 2012, and will likely be higher for 2013. The risks that these extra-budgetary schemes pose to both fiscal stability and the quality of capital spending are considerable, in large part due to the weaknesses in the regulatory framework of the DBM that limit its independence from parliament and provide very little oversight and control from the MoF or the central bank.

Low Operational Efficiency

The problems of allocative efficiency are compounded by problems in the project cycle. Delays in project completion are common and significant; for example, 65 percent of roads projects completed in 2005–09 had time overruns, more than doubling the original completion time in some cases, while 73 percent of ongoing projects have been extended. These delays are a result of poor planning, inaccurate cost estimation and weaknesses in the construction sector. Roughly 32 percent of these projects were delayed due to upfront problems of planning, 49 percent due to the downstream problems in implementation as a result of weak capacity of the construction companies, and 19 percent were delayed for both reasons.

Inaccurate cost estimation usually translates into time overruns, primarily because in Mongolia the capital budget is approved and appropriated on a project by project basis by the Parliament, and increasing the budgeted cost of a project requires a budget amendment. The main reasons for the poor cost estimation are: (1) use of overly simple methods to estimate costs that served as the basis for project appropriations, (2) projects inserted into the budget by Parliament that were not subjected to cost estimation to the same degree as executive-proposed capital
projects, and (3) increases in building material prices, particularly during the inflationary period of 2008–09.

Given Mongolia’s short construction season (May to October), the initial months after the capital budget is approved by Parliament in December are critical for timely implementation of a project. Procurement, however, is a major bottleneck in the process, due both to unrealistic cost estimates during project preparation and to lack of procurement capacity in the executing agencies. As the capital budget has the force of law and includes both the overall cost of the project and allocation for the particular fiscal year, no bid can be awarded that is above the approved cost of a project. Inaccurate cost estimates during project preparation imply that on many occasions the received bids do not fall beneath these cost ceilings, and on average, procurement can take six months. In the last three years this problem has been compounded by high inflation resulting in significant cost escalation during implementation. In many cases, line ministries had to seek parliamentary amendments to the capital budget to increase the cost allocation of projects to make them more in line with market rates. This problem also encourages construction companies to compromise on quality in order to avoid incurring losses. These procurement delays are particularly severe for projects added by the Parliament, as they usually have no accompanying engineering designs.

Weaknesses in the legal framework for procurement also raise questions about the quality of capital budget execution. Until 2012 procurement was decentralized in Mongolia to the line ministries and agencies, with the MOF Procurement Policy and Coordination Department setting policy and providing the regulatory and monitoring function, as well as conducting prior reviews for large contracts (above 1 billion MNT for goods and 3 billion MNT for works).

As a Government audit report at the time details, the major problem in this framework is the provision for direct contracting that was introduced in 2007 in the roads and energy sector. In 2007, 125 billion MNT, or 34 percent of all of contracts, were awarded through direct contracting, often with no accompanying technical documentation. Allegedly these construction contracts were awarded to numerous technically unqualified, and politically well connected, companies (GOM 2010). Many road construction projects were also broken down into smaller schemes to enable smaller and less qualified companies to be directly awarded the contracts. This use of direct contracting greatly expanded in 2012 and 2013 for projects funded by the DBM.

The findings from case studies of a sample of road sector projects corroborate the findings of the audit report. Of the total sample of 10 projects, 4 were executed through direct contracting, while the remainder went through the normal tendering process. As

Figure x.4 shows, 7 of the 10 projects had time overruns, with an average completion time of 3.1 years, compared to the original plan time of 1.8 years, or an overrun of 70 percent. The directly
contracted projects were the worst performers, with an average time overrun of 2.25 years (or 180 percent).

Figure x.4  Time Overruns in the 10 Sampled Projects

Source: Mongolia Department of Roads

Other reasons for the time overruns are bottlenecks in financing and the lack of implementation capacity of construction companies. The MOF exercises strict input controls in the execution of the budget; the capital budget is approved project-by-project as law by Parliament annually, even for multi-year projects. There is no multiyear appropriation, nor any provisions for carryover funding. Line ministries have no authority to reallocate funds across projects based on revised cost estimates or pace of implementation, and any unspent allocation gets re-appropriated to the MOF at the end of the fiscal year. For multi-year projects there is no prioritization process that would ensure that projects that are being implemented well would receive their necessary annual allocation.

Finally, as is common in many developing countries, monitoring in Mongolia is weak and there is no systematic ex post evaluation. One factor is the lack of data—no comprehensive central asset register exists that would enable systematic monitoring of the portfolio of publically executed capital projects. Information on key monitoring indicators—the cost and time overruns per project, completion rates, and so on—is not available in the MOF that would allow the Investment Division to inform the preparation of the Public Investment Plan.
The Politics of Public Expenditures

The discussion thus far shows a number of technical weaknesses in the public investment system in Mongolia. The assumption behind this chapter is that these technical weaknesses to a considerable extent reflect political choices, and that several perverse incentives need to be addressed if public investments are to improve in Mongolia. Clearly there are a number of important political actors in this process. This section focuses on individual members of Parliament. The reason for this focus is both that the Mongolian Parliament has considerable formal budgetary authority and that individual MPs exercise significant informal influence over the executive in project selection and execution.

Mongolia is a parliamentary democracy based on a majoritarian electoral system, with elections held regularly every four years since the transition from socialism in 1992. The two largest political parties are the Mongolian People's Revolutionary Party (MPRP) and the Democratic Party; the two have roughly alternated in power and/or formed coalition governments throughout this period. The parties are not particularly distinguished by ideology—for example, both have campaigned on broadly populist platforms of redistributing mining wealth to the people in the form of large, untargeted cash transfer programs, and of investment projects distributed across the country—and both are characterized by considerable factionalism.

The Parliament in Mongolia exercises unusual budgetary powers. As shown in figure x.7 Error! Reference source not found., Mongolia’s Parliament ranks in the top quintile in formal budgetary authority (powers of budget amendment, consequences of non-approval of the budget, and executive flexibility in budgetary appropriations). As noted, this formal authority is repeatedly used by MPs to amend the budget in general and the capital budget in particular. Equally important is the informal political interference in the execution of the overall capital budget, in particular, through influencing the contracting process. As discussed, the most egregious example of this influence was the large number of contracts awarded without competitive bidding in 2007. Anecdotal evidence suggests that a prime motivation for these contracts was to generate political support from wealthy and influential individuals ahead of the national elections in 2008. In general, political interference in the award of contracts is known to be considerable, even when competitive bidding is done de jure, given the small size of the formal sector in Mongolia and the close personal links between parliamentarians and the business community.
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Figure x.7 Index of Formal Budgetary Authority of Mongolia’s Parliament Compared to Other Democracies

Source: Calculations based on Wehner (2006).

Note: The index is a sum of three indicators normalized to range between 0 and 100: legislative powers of amendment, consequences of non-approval of the budget, and executive flexibility on budget appropriations.

These incentives of elected officials are a common feature of developing country democracies. The next few sections examine the relevant academic literature on political economic resource allocation in democratic settings, and then apply the lessons from this literature to the Mongolian context.

Lessons from the Literature

There are three relevant academic literatures to understand the politics of public investments in Mongolia. The first is the literature that has focused on the political economy of macroeconomic policy, in particular the incentives that result in fiscal indiscipline. The second is the literature that has attempted to explain why democratic governments that are ostensibly
accountable to voters would systematically under-provide public goods, thereby hurting the welfare of these voters. The third is the equally pedigreed literature on the political economy of the resource curse.

Fiscal indiscipline is usually explained in the political economy literature as a common pool resource dilemma in which the political and institutional structure of the country allows for decentralized spending determination. Specifically, policy makers have the ability to target spending to particular constituencies using general tax revenues that are shared across all the constituencies. Under these conditions, politicians have the incentive to overspend as they internalize the full benefit of the local expenditures, but they only bear a fraction of the increased costs associated with these expenditures (Weingast, Shepsle, and Johnson 1981; Velasco 2000). This negative externality generates overspending and fiscal indiscipline. These problems are likely to be exacerbated in natural-resource-rich environments in which the revenues flow from resource rents rather than taxes. The literature suggests that both centralizing fiscal authority and cooperative bargaining are conducive to overcome the inefficiency and thus are able to promote fiscal discipline. Several empirical studies have shown that budget institutions have an impact on fiscal outcomes in a variety of samples of developed and developing countries (Alesina et al. 1996).

**Clientelism Literature**

Market failures are also fundamental to explaining the under-provision of public goods in general and public investments in particular. The huge literature on clientelism attempts to explain the under-provision of public goods and over-provision of private goods, or targeted benefits to influential subsets of the population, by the relative inability of politicians to internalize the benefits of public as opposed to private goods provision. These targeted goods can be “pork-barrel” projects, or projects that benefit specific localities, or “rents” distributed to influential groups in exchange for their political support.

Bates’s (1981) classic formulation of clientelism argued that groups with shared economic interests that can organize collectively can provide politicians with political support, which creates an incentive for politicians to provide rents to these groups. Society suffers because the particular interests of these groups are inimical to broader development. Cross-country variations in development could then be attributed to either the strength and number of interest groups (Olson 1984): in pluralistic societies multiple interest groups competing for state attention may cancel each other out (North, Wallis, and Weingast 2006); whether or not these special interests were antagonistic to economic development is an important factor (for example, Acemoglu and Robinson 2002); whether or not economic activity is concentrated or dispersed is also significant (Dunning 2008).

More recent work has shown that politicians will have an incentive to provide targeted benefits to their supporters in situations where they will not receive electoral benefits from providing public goods either due to the inability to mobilize support for public goods across ethnic groups (Easterly and Levine 1997; Alesina and La Ferrara 2005; Keefer 2010); to voters lack of
information about the actions of individual politicians (Besley 2006); or to lack of credibility of national political organizations for providing these goods (Keefer 2007).

There is a widely observed empirical linkage between ethnicity and the provision of public goods. Alesina, Baqir, and Easterly (1999) found that more ethnically diverse jurisdictions in the United States spent less on a per capita basis on public goods like education and roads. Easterly and Levine (1997) reported that Africa's high level of ethno-linguistic diversity was negatively correlated with various measures of public goods, such as teledensity, percentage of paved roads, and years of schooling. Banerjee and Pande (2009) show that the greater the influence of group identity in India on the way citizens cast their votes, the poorer the quality of political representation. There are a number of possible explanations for this negative relationship between ethnicity and public good provision. One is that different ethnic groups have different preferences regarding public goods, and find it difficult to reach agreement on which public goods to provide. Another is that ethnic polarization reduces the accountability of elected politicians, as voters tend to vote for candidates based on their ethnic background, not on their public performance or policy records, and the provision of public goods suffers as a result of this lower accountability (Keefer and Khemani 2003; Bannerjee and Pande 2009).

Information can also be a key reason why democracies can produce outcomes that hurt the median voter; politicians care about getting elected, so they will focus on policies and expenditures in areas that will maximize their electoral fortunes. Getting elected is also crucially contingent on information—specifically, it requires that voters can connect improvements or deteriorations in their welfare to the actions of a particular politician. In other words, politicians must be able to take credit for these improvements. The importance of this information means that politicians are more likely to be more responsive to a more informed group of citizens, and as a result, they will focus more on private goods, or targeted benefits, as opposed to public goods that benefit the majority.

Alternatively, even if voters are informed, they may not consider as credible a politician's promises to improve public goods. A credible politician is one that can provide targeted goods to those citizens he develops a personal interaction with, typically influential people from his constituency. This incentive for targeted goods is also driven by the fact that elections are expensive and politicians usually have to raise their own campaign funds. The exchange of rents for campaign contributions as well as votes, then, is another incentive for the under-provision of public goods and the over-provision of targeted goods.

A number of institutional variables may impact clientelism. A large literature explores the impact of regime type (presidential vs. parliamentary) and electoral rules (majoritarian vs. proportional) on targeted spending (Persson and Tabellini 2000). No conclusive results have emerged, primarily because institutional arrangements vary greatly within the above stylized categories. Emerging literature covering the influence of political parties on clientelism suggests that more cohesive political parties and stronger voter attachment to political parties—or partisan voting—reduces the incentives toward clientelism and encourages a more national, programmatic orientation in individual members of Parliament (Keefer and Khemani 2003).
There are numerous refinements to the question of why clientelism should necessarily be so inefficient, manifesting either in the form of public sector employment or “white elephant” projects with negative social return (Robinson and Verdier 2013; Robinson and Torvik 2005). The answer is that clientelism is inefficient precisely because this inefficiency solves the commitment problem—that is, why would a voter honor his “contract” by voting for the politician after receiving the private good? Only by keeping that particular politician responsible for the rents in office can clients hope to keep receiving the rents. If the rents were efficient, then all politicians would have an incentive to keep supplying them and voters would have no incentive to vote for a particular politician.

To summarize this literature, public goods are under-supplied and private goods over-supplied because (1) rents can be exchanged for campaign contributions; (2) rents can be targeted, which solves the information problem and the attribution problem (the politician can take credit for them); (3) the provision of rents implies that a politician is credible; and (4) rents will only continue if voters reelect that particular politician, thereby solving the commitment problem.

Resource Curse Literature

Finally, the third relevant literature is the institutional analysis of the resource curse, which has emphasized the impact of natural resource rents on the political process. The key feature of these countries is that natural resource rents (particularly from hydrocarbon and mineral resources) tend to be large, volatile, geographically concentrated, and controlled by the government, which can create a high stakes competition among political actors to capture these rents. This incentive for control can encourage authoritarianism (Ross 2012), can result in conflict, and can encourage rent-seeking behavior. Elections per se are not enough to create the necessary accountabilities, and institutional checks and balances are seen as the key for avoiding the resource curse (Collier 2010).

Applying Lessons Learned from Literature to Mongolia

Given the numerous socioeconomic and institutional variables identified in the literature, and the public expenditure patterns and problems in the PIM system discussed here, where does Mongolia stack up in terms of policy makers’ incentives for providing sound public investments? The following negative and positive aspects of Mongolia’s PIM system and its political economy are suggestive.

Reasons policy makers do not make good public investments

- The combination of high parliamentary spending authority, large natural resource rents, the majoritarian electoral system with MPs representing specific geographical constituencies, and the need for constituency-specific spending for reelection purposes, creates a classic common pool problem that encourages over-spending by legislators and is the main political cause for the boom-and-bust cycle.
- The fragmentation of the capital budget—that is, a large number of small, often uneconomic, projects targeted to specific geographical areas—can be explained by the
absence of programmatic political parties and the need for individual members of Parliament to cultivate their own, individual-specific political support in order to win elections.

• Procurement irregularities similarly can be explained by clientelist pressures; MPs trade construction contracts for campaign finance and political support.

• Mongolia’s small population size and high concentration of natural resource rents in the Government increases the risks of elite capture and collusive practices. In particular, the pressures to enter into dubious deals for private financing of mining-related infrastructure will be considerable, which could pose serious fiscal risks to the Government.

• The election cycle encourages short time horizons for MPs’ in office, which makes them lack interest in maintaining capital assets, resulting in the “build-neglect-rebuild” project scenario.

Incentives for politicians to make good public investments

• Even though Mongolia’s political parties are factionalized, they are more programmatic than many in other developing country democracies. Programmatic parties are those in which members share common policy preferences and where citizens hold politicians from the party collectively responsible for failure to pursue policies consistent with the party’s program. The untargeted social transfer programs of both the MPRP and Democratic Party are indicative of programmatic elements.

• Even though individual MPs face considerable uncertainty regarding their reelection prospects, which encourages them to focus on “consuming now” rather than “investing for the future,” Mongolia is a relatively stable democratic system with little prospect for constitutional takeover. Therefore, there is some assurance for individual MPs that while they may lose the next election, they can eventually return to power and will not risk getting jailed through a military coup.

• Mongolia has some socioeconomic advantages that reduce clientelist pressures. First is its ethnic homogeneity and strong sense of national identity. It also has a high and growing level of urbanization (Ulaanbaatar has 40 percent of the country’s population) that will reduce incentives for pork-barrel funding to rural communities. Third, its high education level (universal literacy and over 30 percent tertiary enrollment rates) should ameliorate some of the informational roots of clientelism.

This mix of negative and positive aspects suggests that there may be an incentive-compatible set of reforms that serves to improve the PIM planning system while not seriously undermining MPs’ chances of reelection. Suggested reforms are explored in the next section.

Incentive-Compatible Reforms
Fiscal Responsibility Legislation

In June 2010 the Mongolian Parliament passed the Fiscal Stability Law (FSL) that mandates that the annual budget be based on fiscal rules that limit expenditure volatility, make expenditures countercyclical, and control expenditure growth. While the FSL is facing challenges in
implementation because of the increasing use of extra-budgetary funds, discussions with MPs revealed that the law was passed because the MPs appreciated that they were stuck in a “prisoner’s dilemma” type of problem; while it was individually politically rational for each MP to over-spend for the benefit of his or her constituency—per the “common pool” problem identified in the literature—this would lead to fiscal crises and macroeconomic instability that collectively would be irrational. The key was that the FSL collectively tied all MPs hands, thereby not conferring any advantage or disadvantage to any particular constituency or faction. It was therefore incentive-compatible.

The fact that MPs could agree on this legislation suggests that the positive features of Mongolia’s political economy listed earlier allowed for a cooperative solution to this problem. It also suggests that similar reforms which collectively tie MPs’ hands are incentive-compatible and will be the key to improving the PIM system.

**Institutional Checks on Large Infrastructure Projects**

As noted, Mongolia’s capital budget is very fragmented, with numerous small projects and very few large projects. The main political reason for this fragmentation is clientelism: numerous smaller projects allow MPs to target projects to their constituencies, as well as to exchange rents in the form of contracts for campaign financing and political support. However, the need to develop infrastructure means that considerable budgetary funding must be shifted from the smaller projects so that the composition of the public investment portfolio shifts from a large number of small projects, to fewer, and on average, larger projects.

This change in the public investment portfolio has serious political ramifications for individual MPs because (1) it risks hurting their reelection chances as constituency-specific projects are cut and (2) without some safeguarding of the mega-projects, a few privileged MPs—those able to secure these large contracts—will gain at the expense of a majority, whose projects cannot be funded. These privileged factions will then become politically dominant. Given the fluid nature of political alliances in Mongolia, helped by the fact that there are no deep and entrenched ethnic or tribal cleavages, it is likely that the identity of the “winners” is uncertain ex ante and the winners cannot credibly commit to compensate the losers. Therefore each individual MP will have an interest in opposing cutting his pet project to fund the mega projects; the collective result will be that such projects will not be developed, which will hurt all MPs.

There is anecdotal evidence to suggest that such a dynamic is at work in Mongolia. The need for a new power plant for Ulaanbaatar has long been an urgent priority, but it has repeatedly failed to be included in the budget or to secure private financing, as MPs have been unable to agree to its modalities. Since all MPs know that the planning process can be politically influenced, such a large project would privilege the faction that controls the Ministry of Fuel and Energy, at the expense of the MPs who lose out from all the smaller projects that have to be cancelled to finance it. It would therefore be opposed in Parliament.
Following the logic of the passage of the FSL, MPs should have an interest in institutional mechanisms that protect these large projects from political interference, thereby collectively tying their hands and solving this “prisoner’s dilemma.” Given Mongolia’s positive stylized facts of ethnic homogeneity and regime stability, each MP has a relatively strong interest in the improvement of infrastructure and increasing the size of the “economic pie,” as compared to their counterparts, for example, in many African countries where distributional, zero-sum conflicts among rival groups of elites, often along ethnic lines, predominate. This implies that reforms to improve project appraisal and to protect it from political influence should be incentive-compatible. These reforms, following Rajaram et al. (2010), imply an institution that serves as a “gatekeeper” to ensure that only projects that have gone through some form of cost-benefit based project appraisal are approved and funded.

### Constituency-Specific Projects

Given the above shift in the public investment portfolio, it is likely that the need for geographically targeted projects will only increase in the future as (1) constituency demands to see the results of the mineral revenues will get stronger with the development of the mines and (2) a smaller portion of the capital budget will be discretionary, given the institutional checks on the mega projects. Each MP will have an incentive to exercise control over these smaller, pork-barrel schemes in order to capture all the political benefits from them. Therefore, any reforms that try either to eliminate the Local Development Fund or to prevent MPs from exercising influence over these constituency schemes will not be incentive-compatible and will likely fail.

Instead, a better reform strategy would be to take these incentives of politicians as given and to try and improve the quality of these geographically targeted projects. In other words, local development objectives should be formalized and made explicit. This formalization can be done by explicitly including the Local Development Fund in the budget preparation process so that line ministries are responsible for preparing these schemes, as opposed to the current practice in which these schemes are introduced during the parliamentary budget debates, thereby not allowing for sufficient preparatory time. Giving line ministries responsibility early in the budget cycle should improve the cost estimation of these schemes. Some aggregate limits—for example, less than 20 percent of the capital budget—on the amount of annual funding for these schemes could also be introduced as part of this bargain. Consultation mechanisms with local level governments and local communities in identifying these projects could also be institutionalized.

Given Mongolia’s low population density, these schemes will likely remain uneconomic from a strict cost-benefit calculus. Formalizing them will serve to at least improve the cost side of the equation as well as to reduce the incentives to capture rents from the large projects that are essential for Mongolia’s development.

### Institutional Arrangements for Project Appraisal

The previous suggestion, that budget and planning legislation should specify that all projects of national importance above a certain size threshold go through a reasonably rigorous and safeguarded appraisal process, would find support among MPs, provided that it is credible and
specified in the legal framework. The next question is what form would such an institutional arrangement for a “gatekeeper” function take?

The standard textbook advice is that planning and finance functions should be unified in a powerful Ministry of Finance that would serve as the gatekeeper to appraise and budget public investment projects. To quote Weber (2007, 98–99):

Separation of responsibility for current and development expenditures between two ministries—typically the ministry of finance and the ministry of planning (or economy), respectively—is often a major obstacle to effective budget integration... Internationally, there is increasing recognition and acceptance of the principle that budget planning, presentation, management, and accounting and control functions can be conducted more effectively within one central agency: typically a ministry of finance.

The received wisdom is that separating the planning and finance functions leads to dual budgeting and therefore should be avoided, and forms the standard policy advice of the International Monetary Fund.

However, political economy factors suggest that such a powerful Ministry of Finance is not compatible with MPs’ incentives because it would also risk them losing their discretion over smaller projects. At present Mongolia’s Ministry of Finance has a staff of roughly 150, which has been grossly inadequate to enable it to perform the policy analysis, planning, and budget preparation function. However, proposals to increase the ministry’s staffing have been repeatedly rejected by Parliament, in large part because all central ministries are small, and therefore increasing the staff of MoF would create a political imbalance and would result in similar demands from all other ministries—demands that would have backing from the different political factions represented by these ministries.

Instead, Mongolia created a new planning agency in 2009, the National Development and Innovation Committee (NDIC), under the prime minister’s office, which was then elevated to a Ministry of Economic Development (MED) in 2012. Debates among policy makers preceding the creation of the NDIC included the option of strengthening the planning function in the MoF, but this option was rejected due to fears that it would result in an overmighty ministry.

A weak and relatively understaffed Ministry of Finance is in the interests of MPs as it ensures that they retain authority over the budget. Given the factionalism within the dominant political parties, MPs in general do not want any one ministry to be significantly more powerful than another because it would give undue influence to the faction that controls that ministry (that is, the faction of that particular minister). While the creation of the MED risks fragmenting planning from budgeting—and there are risks that without proper coordination between the MED and the MoF and proper distribution of responsibilities, a dual budget system would develop—separating the planning and budgeting function is incentive-compatible. And it is indeed possible that if effective technical coordination does develop between the two, then the separation of planning and budgeting functions would create the necessary checks and balances to prevent the “capture” of
one ministry by political forces. This “divide and conquer” strategy may be especially effective if the ministers of the planning agency (in this case the prime minister) and the Minister of Finance are from opposing political parties. In that case, collusion would be required to ensure that a bad project gets included in, say, a multi-year public investment plan and then also gets funded in the annual capital budget.

Therefore the incentive-compatible reform would be to give a central planning agency sufficient authority to act as the gatekeeper for large, strategically important projects, and then to ensure that the coordination between the MoF and the planning agency is strong. These mechanisms would need to be enshrined in the primary planning and budget legislation.

A second institutional form question concerns the division of responsibilities between line ministries and the central planning agency in project appraisal for these large projects. Again, the logic of incentive-compatible reform would imply that these responsibilities would need to be shared, since the central planning agency would never have enough staff to appraise all projects. Therefore, the MED would have to be limited to only large and strategically important projects, while line ministries would need to be responsible for appraising smaller projects.

**Procurement Reform**

A similar logic of safeguarding large projects that benefit all constituencies, while allowing targeted benefits to flow from smaller projects, applies to procurement arrangements. International procurement standards of competitive bidding and transparency will be incentive-compatible for the large mining infrastructure projects precisely because the stakes are so high and a particular political faction could become too powerful. However, for smaller projects, collusive practices will be difficult to prevent, particularly since international companies will be less interested.

This logic helps explain the recent thrust of procurement reform in Mongolia—which is to centralize the procurement of large projects to a recently formed (in 2012) central procurement agency (the Government Procurement Agency, GPA) while giving local governments more authority over procurement arrangements for smaller projects. These changes followed the preference of numerous MPs who wished to separate the procurement function from the contract implementation function to reduce the risk of political capture, as compared to retaining both responsibilities in line ministries, given the close links between political and business circles. The reasons are both the lower cost of monitoring the procurement process in one agency, as opposed to several ministries, as well as the increased cost to those who would wish to influence contract award for their own personal and political interest, since they would now need to effect the GPA as well as concerned line ministry staff as both will be involved in the bid evaluation committees. Retaining procurement authority with line ministries and increasing specialized procurement staff in them would not address this political economy problem since these staff would continue to be susceptible to the influence of their minister.
Conclusion

International financial institutions are recognizing that standard technical solutions for addressing public financial and sector management weaknesses in developing countries that are not sensitive to local “context” have not worked and are unlikely to work. The need for political economy analysis is repeatedly emphasized; however, there is also considerable skepticism about whether political economy work can provide a different and better, “second best” solution. In general this skepticism is valid—the academic political economy literature is excellent for showing why particular pathologies exist, but less suited to providing policy guidance for some of the questions that confront institutions like the World Bank. It is hoped that this chapter provides an example of how this political economy literature can be used to develop specific and more workable policy recommendations.
Notes

1. This section draws on World Bank (2010) and Finch and Fritz (2010).

2. The Government does not have an asset register and therefore capital stock is not measured. For the purposes of this report the public capital stock was estimated using the methodology in Harberger (2007).

3. See Rajaram et al. (2010) for the framework for key aspects of a good public investment management system.

4. In 2008 there was an exception due to significant inflationary pressures on raw material costs. Contractors were awarded MNT 4 billion for cost overruns.

5. Important recent works in this literature include Persson and Tabellini (2000) and Keefer and Khemani (2003)

References


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