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Public Enterprise Review
Halfway Through Reforms

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WEIGHTS AND MEASURES

Metric System

ABBREVIATIONS

CES	Central Energy System
CHP	Combined heat and power
CMEA	Council for Mutual Economic Assistance
GDP	Gross Domestic Product
MEGM	Ministry of Energy, Geology and Mining
MIAT	Mongolia International Airlines
MR	Mongolian Railways
MTC	Mongolian Telecommunications Co
NIC	Neft Import Concern
SPC	State Privatization Commission

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FOREWORD

The Government of Mongolia recommends the World Bank report "Mongolia Public Enterprise Review: Halfway Through Reforms" to scholars, researchers, businessmen, investors, and to all those interested in Mongolia.

The current state of the Mongolian economy, in particular the current situation of public enterprises and the challenges facing them, have been reflected in this report. We appreciate any comments on the content and design of the report, as well as any recommendation in solving problems and difficulties.

I do hope that this report will make a distinct contribution to deepen the knowledge and perception of readers about Mongolia in its transition period. I would like to express my sincere and profound thanks and appreciation to the World Bank experts and staff who have made a tremendous effort to prepare and publish this review.

PUNTSAGIIN TSAGAAN
MINISTER OF FINANCE OF MONGOLIA

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The World Bank team benefited from fruitful discussions with many government officials, who were generous with their time and knowledge. The team is especially grateful to officials from the Ministry of Finance, who helped organize meetings and served as the mission's main counterpart team.

The team would also like to acknowledge the assistance of Adelma Bowrin for her support in finalizing this report.

EXECUTIVE SUMMARY

1. The role of public enterprises has declined in Mongolia's economy, but their continued presence and deteriorating performance increasingly weakens the budget, commercial banks, and other enterprises. For further progress in stabilization and growth, the Government needs to privatize non-strategic enterprises, liquidate non-viable enterprises, and reinforce reforms that would provide public enterprises with the external and internal incentives to perform.

The Declining Role of Public Enterprises

2. The role of Mongolia's public sector has radically changed since the start of reforms in 1990. In 1989, the organization of Mongolia's economy was very similar to the other Asian republics of the Soviet Union, with which it had been closely allied. Virtually all aspects of the economy, including the large pastoral nomadic sector, were centrally planned. Public sector output was about 95 percent of GDP in 1990. By the end of 1995, only 36 percent of GDP originated from the public sector, and 44 percent of all assets were privately-owned. Government expenditures had fallen to 44 percent of GDP, down from 65 percent in the 1980s.

3. This remarkable transformation of the economy was largely the result of: (i) the Government's mass voucher privatization program that transferred 44 percent of state-owned assets to private hands between 1991 and 1994; (ii) the relaxation of restrictions on private activities that resulted in a proliferation of small shops and proprietorships; and (iii) the decline in government revenues in pace with the transition to a market economy.

4. However, public enterprises remain powerful and active in Mongolia, despite their reduced role in the economy. Public enterprises dominate various sectors, and continue to enjoy monopoly status in several, key industries. The Government maintains full ownership of enterprises in public utilities, transport and mining; majority ownership of many other enterprises; and minority shares in large parts of the privatized entities. The diffusion of ownership due to the voucher privatization gives the Government effective control, even as a minority shareholder.

The Growing Burden of Public Enterprises

5. Public enterprises are an increasing burden on the economy. Their efficiency, measured, for example, by how they adjust their wages in light of productivity, is problematic in a number of sectors. And despite retrenchment since 1990, overstaffing is

still an issue, notably in utilities and railways. However, Government has been reluctant to let non-performing public enterprises fail. This reluctance has increasing costs to the budget, the banks, and other enterprises:

- Budgetary subsidies to public enterprises are large and rising. In 1995, public enterprises received budgetary subsidies equivalent to approximately 7.4 percent of GDP, up from 5.3 percent in 1993. Whereas current subsidies declined from 2.1 percent of GDP in 1993 to 0.9 percent in 1995, capital grants increased four-fold to 2.5 percent of GDP over the same period. Subsidies implicit in the low interest on, and low repayment of, budgetary loans have been large, rising from 2.6 percent of GDP in 1993 to 4.0 percent in 1995. The subsidies exceed government spending in priority areas, such as education, health or social security and welfare. In addition, public enterprises have tax arrears to the budget that increased from 8 percent of taxes due in 1994 to 40 percent in the first half of 1995.

- Public enterprises have been the main recipients of government-directed loans from the banking system. These loans amount to over Tug 15 billion, or 3.7 percent of GDP, including interest accrued. They are mostly unrecoverable, and their repayment will become a government responsibility by the end of 1996. In addition, the repayment performance on loans made by banks on their own account is deteriorating. Loans in arrears increased from 6 percent of total loans to public enterprises at end-1994 to 11 percent six months later. An increasing share of these loans are non-performing.

- Public enterprises in energy alone had arrears to other enterprises amounting to 2.3 percent of GDP in 1995. Public enterprises in transport and food have an equally bad payment record. Tax administration received only 60 percent of the taxes due from public enterprises in the first six months of 1995, down from 92 percent in 1994.

6. Public enterprises have become a drag on growth and a major impediment to further stabilization. Without subsidies to public enterprises, Mongolia would have a budget deficit of only one-third its actual size in 1995. The dismal performance of public enterprises is therefore threatening further progress in macroeconomic stabilization. Loans from the budget and commercial banks to non-performing public enterprises crowd out private enterprises. Moreover, loan defaults have crippled the banks, and forced them to charge unsustainably high interest margins on their lending. This has virtually wiped out term lending and investment finance in the economy, and has adversely affected growth.

Public Enterprise Reform for Stability and Growth

7. Poor public enterprise performance is the result of inappropriate external and internal incentives combined with Government's reluctance to privatize or liquidate those enterprises it considers strategic. This report therefore recommends a reform agenda that would improve external and internal incentives while actively pursuing public enterprise restructuring, including privatization, reorganization, and liquidation.

External Incentives

8. *Increase Competition for Public Enterprises.* Many Mongolian public enterprises are shielded from competitive pressures. Largely as a legacy of the centralized planning system, the industrial sub-sectors in which they operate are highly concentrated. In infrastructure, most activities are carried out by public monopolies. Introducing competition in industry and infrastructure should be accorded priority in Mongolia's public enterprise reform agenda. An appropriate strategy could be to allow private entry into these activities alongside existing public enterprises. This would force public enterprises to become more efficient, while demonstrating that private enterprises are also capable of supplying most essential goods and services. The latter may reduce Government inhibitions against privatizing or liquidating inefficient public enterprises.

9. *Harden Budget Constraints.* Public enterprises receive large budgetary subsidies, obtain budget and bank loans on favorable terms, and persistently accumulate arrears on debt service and taxes. This allows weak performers to remain in production, even when technically insolvent, and thus reduces their incentives to adjust. Hardening budget constraints would require:

- Restoring credit discipline in the banking sector, which entails: (i) improving the juridical environment for loan recovery; (ii) setting up a Credit Information Bureau to generate better information on defaulting borrowers; (iii) better central bank supervision of prudential regulations, matched with credible penalties to enforce these regulations; (iv) upgrading skills of bankers, including appraising credit worthiness and working out bad debts with defaulting borrowers.

- Phasing out of budgetary subsidies. As a start, subsidies implicit in budgetary lending should be made transparent on the budget. At the same time the Government needs to establish clear criteria for subsidies, allocate subsidies through the regular budget process, and phase out the subsidies according to a schedule. For subsidies to public enterprises that are meant to benefit consumers (such as electricity and water), better target mechanisms should be developed to ensure that those who can afford to pay do, while low-income groups are subsidized. Providing direct income supplements for the intended beneficiary would not only be less costly, it

would improve resource allocation, as it would allow for completing price liberalization and cost recovery.

- Enforcing a "hard payment system." Public enterprises would only provide supplies to those customers who are willing and able to pay. This would require customers to either pay cash in advance or provide documentary evidence of ability to pay, such as certified checks or bank drafts. Public enterprises, such as utilities that are not paid for their goods or services, should be allowed to reduce/cut-off supplies to non-payers.

10. It may be difficult to sustain a universal hard budget constraint on Mongolian public enterprises because a few influential enterprises may successfully lobby for exemptions. For these enterprises, it is appropriate to isolate them from all sources of finance, except the budget, which would provide money conditional upon credible restructuring. Sound macroeconomic management requires that Government develops comprehansive accounts of the public sector as a whole. Currently, the public sector deficit and its financing cannot be established with available data. Filling this information gap on a central macroeconomic variable is a priority, and allows for better quantification of the financial burden the public sector puts on the economy.

11. *Develop the Legal Framework.* An effective and transparent legal framework is crucial for public and private enterprise performance in a market economy. Mongolia has made considerable progress in drafting and enacting new legislation, but further improvements in the laws and their enforcement. Public enterprise reform requires specific amendments to the Bankruptcy Law, the Companies Law and related provisions in the Civil Code to establish an effective legal basis for enterprise restructuring and possible liquidation. It also entails training programs for legal institutions, including the Ministry of Justice, the judiciary, the court administration and the bailiffs to enhance law enforcement.

Internal Incentives

12. *Separate Owner, Management and Regulator.* Mongolian public enterprises suffer from inadequate separation of ownership, management and regulatory functions. For example, the energy system is overseen by the Ministry of Energy, Geology and Mining, which is not only responsible for sector policy, but also intervenes considerably in the day-to-day operation of the energy companies. Lines of responsibility and accountability between the Ministry and the energy companies are therefore blurred, impeding the latter's performance. Separating ownership, management and regulation should therefore be a priority. The Law on State Property, which is currently under discussion in Parliament, would provide the appropriate legal framework. The Law could separate regulation from ownership through a State Property Commission. More effective Boards that include non-government representatives should also be introduced to separate the Government's ownership function from day-to-day management.

13. *Separate Commercial from Social Objectives.* Mongolian public enterprises are called upon to fulfill a host of social objectives through: (i) maintaining employment despite falling activity levels; (ii) protecting customers by controlling prices; (iii) providing services on a non-commercial basis to other public enterprises or budgetary organizations; and (iv) maintaining excessive inventories. These non-commercial objectives limit the viability of public enterprises, and can often be achieved with less distortive policy instruments, at less costs. Government should therefore refrain from interfering in pricing and inventory decisions of public enterprises. Where warranted, remaining regulated prices should reflect long-run marginal costs. State procurement from public enterprises should be done under transparent arrangements and on commercial terms.

14. *Accounting and Reporting.* Accurate information on enterprise performance is essential for adequate monitoring and effective management. In Mongolia, accounting standards are not yet compatible with international standards. In addition, the accounts of public enterprises are not audited by external auditors, not least because the audit profession is still nascent in Mongolia. To improve this, Government should: (i) adopt a reporting format for public enterprise reports to the Ministry of Finance compatible with international accounting standards; (ii) disseminate widely the accounting work done for some public enterprises; and (iii) support the Mongolian Organization for Accountants to develop international accounting and auditing standards.

15. Management of public enterprises needs to develop its capacity to respond adequately to external and internal incentives. Government as an owner should take an active interest in upgrading knowledge and skills of the management of public enterprises.

Enterprise Restructuring

16. Improving the external and internal environment for public enterprises will in many cases be insufficient to restore viability. Government should therefore actively pursue restructuring enterprises by privatization, reorganization, and liquidation.

17. *Privatization.* Over the past five years, Mongolia has implemented a mass voucher privatization program. The results of this program has been mixed. Governance in many privatized enterprises remains ineffective and shareholder authority is minimal, due to diffuse ownership, and residual state control. The next round of cash privatization could yield better results for governance, and yield significant revenues, provided that: (i) ownership is more concentrated and outside the hands of Government; (ii) institutional disputes between Privatization Commission and Stock Exchange are resolved; (iii) schedule and precise mechanisms of cash privatization are transparent; and (iv) the State Privatization Commission returns privatization proceeds to the budget.

18. *Reorganization and Liquidation.* Governance would improve substantially if external and internal incentives are improved. Many public enterprises may wish to initiate reorganization on their own to restore viability. They should eliminate non-viable, non-strategic lines of business, move into promising markets, cut back in ancillary services, and reduce employment.

19. The Government may contribute to reorganizing public enterprises through the provision of technical assistance to help draw up and implement reorganization plans. The Law on State Property should provide sufficient levers for the prospective State Property Commission--or any other body that will exercise the ownership rights in the future—to enforce reorganization. Non-viable enterprises that are not considered strategic should be liquidated. For those enterprises whose liquidation may be difficult (for example, enterprises with a large number of employees) the Government should take steps to ensure an orderly and pre-announced liquidation process. In the case of partially privatized enterprises, the Government should ensure the rights of minority shareholders.

20. *Dealing with "Strategic" Enterprises.* The Government considers certain enterprises to be of "strategic" importance, and neither wants to privatize nor liquidate them, irrespective of their viability. The Government's current definition of strategic is very broad, including even meat packing and carpet factories, and therefore expensive in terms of budgetary support. It is therefore recommended that Government re-examine its definition of strategic enterprises, and restrict its budgetary support to a few set of enterprises.

21. The Government should open up the "strategic" sectors to private activities. Once the goods or services are supplied by private enterprises, the existing public enterprises would undergo self-restructuring or could be privatized and/or liquidated. If private initiative is not adequately forthcoming because the activity is essentially non-viable, the Government should subsidize the goods and services it considers strategic directly, rather than subsidizing public enterprises.

22. *Mitigating the Social Impact of Reforms.* Restructuring and privatization will lead to reductions in public enterprise employment. Properly addressing social concerns related to enterprise restructuring is paramount to the success of the Government reform program. The Government should encourage labor-intensive activities, in an effort to increase employment. These should be complemented with targeted social programs to assist the most vulnerable groups of society through poverty reduction measures. Estimates of excess employment, in the range of 13,000, are relatively modest and indicate that the social impact is manageable.

23. *Building Commitment.* Political commitment is essential for successful enterprise reforms. This commitment must come from all quarters. The workers and managers that will be most affected by the transition; the policy makers and parliamentarians that will set the agenda; and the civil servants, bankers, judges and lawyers that will implement the reforms. To instill commitment from all quarters, the Government should clearly

announce the objectives of its reform program, and actively campaign to promote it to the general public. The Government could also consider piloting a few enterprises for restructuring, to show the beneficial effects of reforms.

1. INTRODUCTION

1. The role of Mongolia's public sector has radically changed since the start of reforms in 1990. In 1989, Mongolia's economy was hard to distinguish from that of an Asian Republic of the Soviet Union, with which it had been closely allied. Virtually all aspects of the economy, including the large pastoral nomadic sector, were centrally planned. Output generated by the public sector was about 95 percent of GDP. By the end of 1995, 64 percent of GDP originated from the private sector, and 44 percent of all assets were privately-owned. By end 1995, government expenditures had fallen to 43.7 percent of GDP, down from 65 percent in the eighties (see Figure 1).

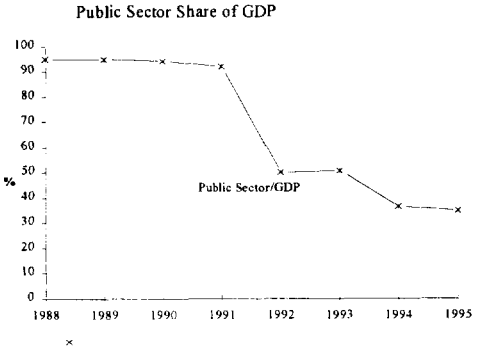
2. This remarkable transformation of the economy was largely the result of: (i) the Government's mass voucher privatization program that transferred 44 percent of state-owned assets to private hands between 1991 and 1994; (ii) the relaxation of restrictions on private activities that resulted in a proliferation of small shops and proprietorships, and created a whole class of new private enterprises; and (iii) the decline in government revenues in line with the transition to a market economy.

3. Despite the reduced role of the state in the economy, public enterprises remain powerful and active in Mongolia. They are present in numerous sectors of the economy, are the single largest importer of goods, and continue to enjoy monopoly status in a variety of mainly industrial sectors. The Government has retained full ownership of key enterprises in public utilities, transport and mining, majority ownership of many other enterprises, and minority shares in large parts of the newly privatized entities.

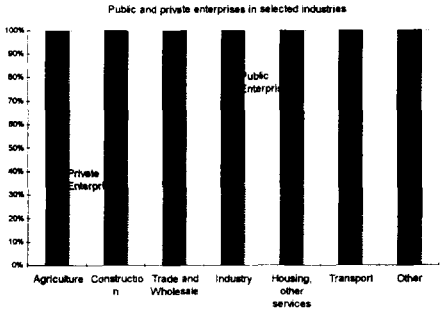
4. Enterprise reform, initiated with the privatization program in 1991-92, has been uneven. The transfer of ownership from public to private hands through the mass voucher privatization program failed to establish good governance and accountability on many occasions. In addition, government directed lending, weak banks, and government subsidies provided enterprises with a soft budget constraint. Enterprises did not have incentives to restructure and improve performance. This resulted in sub-optimal growth and increasingly undermined the Government's stabilization efforts. Inflation stubbornly hovers at an annual 50 percent.

Figure 1: Public Enterprise Performance and Reforms

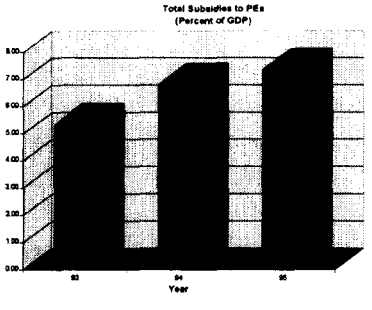
The role of public enterprises is greatly reduced...



...but they still dominate various sector...



...and they increasingly burden the budget.



Major Steps in Mongolia's Enterprise Reforms

Before 1990:	Over 96 percent of enterprises state owned
1991	Business and Entities law passed. Established new corporate structures.
1991	Privatization and Companies Law passed. Allowed private partnerships, and established State Privatization Commission.
October 1991-June 1994	Voucher Privatization. Small privatization (Pink Vouchers) and Large Privatization (Blue Vouchers) program implemented by State Privatization Commission.
1991	Stock Exchange established
February 1992	Primary trading of vouchers starts
1992	Price liberalization. Utility prices remain controlled.
1993	Foreign Direct Investment Law passed
January 1995	Securities Law passed
August 1995	Secondary share trading starts
1995	Law on Companies and Partnerships replaces Business and Entities Law
1995	Civil Code passed
1996	Draft State Property Law discussed in the Great Hural. Includes potential State Property Commission

5. The core of this problem is the weak performance of public enterprises. This report argues that the Government of Mongolia can increase growth and reduce inflation with a pragmatic program of public enterprise reforms. The program has two elements: (i) a policy framework with strong incentives for state enterprises to improve performance, by restricting access to finance for uncreditworthy companies, promoting competition, and enhancing autonomy in corporate governance; and (ii) a plan of action to restructure the state enterprise sector, including restructuring viable enterprises, privatizing non-strategic ones, and liquidating non-viable loss-making ones.

6. This report assesses the physical and financial performance of public enterprises during the adjustment period. What factors account for public enterprise performance? Are they being artificially propped up by subsidies and transfers? What is the fiscal and monetary burden of artificially supporting public enterprises? The reasons underlying the performance of public enterprises are also discussed, focusing on the policy framework governing public enterprise operations (e.g., pricing, soft budget constraints, regulatory framework, internal governance). The report concludes with recommendations on actions that can be taken to improve public enterprise performance. The report provides strategic operations for public enterprise reform, based on lessons from international experience, and summarizes its implications for Mongolia.

2. PUBLIC ENTERPRISES IN THE ECONOMY

1. Public enterprises still have a pervasive presence in Mongolia's economy, despite substantial privatization and new entry of private firms. Some sectors of the economy are completely dominated by public enterprises, which usually has a monopoly or near monopoly status. Other sectors either have a significant, if not dominant, public enterprise presence and are indirectly effected by their performance. This chapter shows that, far from withered away, public enterprises remain important in Mongolia. This means that their performance, the subject of discussions of the next chapter, has crucial implications for the rest of the economy.

Halfway Through: Privatization in Mongolia

2. Until 1991, all enterprises were regarded as budgetary units, and had no corporate status. They were managed and regulated by line ministries, municipalities or provincial authorities. The concepts of corporate structure and private ownership were introduced under the Business Entities Law in 1991, subsequently modified by the 1995 Law on Companies and Partnerships. A mass voucher privatization program was launched in 1991, in parallel with the relaxation of restrictions on private ownership and entrepreneurial activity under a newly-enacted Privatization Law. These developments also prompted a proliferation of new private entities, particularly in the trade and service sectors.

3. Two forms of corporate structure are now officially recognized: limited liability companies and joint-stock, or shareholding, companies. In both forms enterprises are governed by a meeting of shareholders, as the highest governing body, and/or a supervisory board. Day-to-day operations are managed by a director, answerable to the board and shareholders. Other newly-established economic entities include sole proprietorships and partnerships. Many of these are not officially registered, so the full extent of the enterprise sector is uncertain.

4. Under the mass privatization program, a total of Tug 5.9 billion assets of small businesses and trading companies, small agricultural entities, restaurants, small factories, shops and retail outlets, were auctioned or sold to individuals and employees under the *small privatization phase.* A further Tug 13.5 billion assets of large enterprises in construction, transport and wholesale trade were transferred under the *large privatization phase*. Ten percent of assets were reserved for employees, and the balance sold at the newly-founded Mongolian Stock Exchange.

5. Agricultural entities, including state farms, fodder and dairy farms, and herding cooperatives were divided among existing workers or herders. In the privatization process, livestock were subdivided among members of the former state herding cooperatives. Herding cooperatives could then decide whether or not to modify their organizational structure. In some cases, they corporatized themselves as shareholding or limited liability companies. In others, they continued to operate as a loose grouping of herding families. Some cooperatives chose to disband, and herders assumed full responsibility for production, management and marketing.

6. Until 1991, the crop sub-sector was dominated by state farms and cooperatives whose principal activity was wheat production. After privatization, the Government retained 51 percent majority ownership in most of these entities. Workers on state farms are now shareholders of new agricultural enterprises.

7. As a result of these reforms, there are now four basic categories of enterprises in Mongolia, based on ownership: (a) fully state-owned (100%); (b) majority state-owned (in which the state retains at least 51% of shareholdings); (c) majority private (in which the state retains up to 49% of shareholdings); and (d) fully private (100%), including newly-established private enterprises as well as former state-owned firms. Some of the largest public enterprises are joint ventures, particularly in the mining, transport and textiles sectors. Indeed, the largest public enterprise in Mongolia, Erdenet Copper Corporation, is a joint venture with Russia. There are joint ventures with foreign investors, private or public. For the purposes of this report, (a) and (b) are considered public enterprises, and (c) and (d) are treated as private enterprises.

Ownership Diffusion in Privatized Enterprises

8. Privatization of small enterprises has been largely successful, and the devolution of operational and strategic decisions appear to have resulted in effective management. Privatization of large enterprises, however, has been more problematic. The large-scale privatization program has resulted in considerable diffusion of ownership. Some enterprises have over 20,000 shareholders scattered throughout the country. Although corporate structures have been legally redefined, the roles and responsibilities of key players are not yet fully understood. As a result, governance remains ineffective, and shareholder authority nominal. For example, it is difficult to determine to what extent shareholders obtain information about enterprise performance, whether dividend payments are made, or to what extent these reflect performance. This diffused ownership structure also prevents outsiders from exercising effective control.

9. In August 1995, secondary trading of shares began at the Mongolian stock exchange. This has helped consolidate ownership somewhat, but major changes in corporate structure have not yet occurred. The Mongolian Stock Exchange was established in 1991, under the institutional control of the State Privatization Commission. From February 1992 to June 1995, privatization vouchers could be exchanged for enterprise shares at twice-monthly trading sessions. Secondary trading began officially

on August 28, 1995, and shares are now traded for one hour every day. The total market capitalization is Tug 72 billion (US$159 million). In total, 467 companies, including 247 with state participation are listed on the Stock Exchange. Only *privatized* companies are listed. No *newly-established* private entities have offered shares to the public. The Stock Exchange is regulated by the Securities Commission.

10. It is too early to detect significant consolidation of ownership through secondary trading at this stage. This is attributable largely to limited public awareness of the functions and objectives of capital markets. It is also a consequence of inadequate asset valuation, concerns over the accuracy of financial data published by listed companies, and lack of public awareness about shareholder rights and responsibilities. Most significantly, initial market trends show little investor interest in companies in which the state still has a partial share.

11. State involvement remains significant even for majority privately owned enterprises. The diffusion of private ownership enables Government to effectively control enterprises even as a minority shareholder. For many large enterprises, Government influences Board decisions through government-appointed Board members. These members do not only represent the interests of government as owner, but also as a regulator. This results in conflicts of interest, with adverse consequences for enterprise performance.

Table 1: Assets Privatized by Voucher at end-December 1994
(number of enterprises and millions of Tugriks)

Sector	Large privatization		Small privatization		All entities	
	Number	Value	Number	Value	Number	Value
Industry	199	5,487	164	195	363	5,682
Construction	157	781	185	156	342	937
Transportation	88	542	131	243	219	785
Telecommunications	2	12	1	0	3	12
Trade	138	899	1,194	947	1,332	1,846
Housing	0	0	-	20	-	20
Other services	16	193	1,050	407	1,066	600
Agriculture	325	4,045	232	1,892	557	5,937
State farms	194	1,340	39	15	233	1,355
Other	81	1,007	287	1,429	368	2,436
Total	**1,200**	**14,306**	**3,283**	**5,304**	**4,483**	**19,610**

Source: State Privatization Commission.

Public and Private Enterprises in the Economy

12. Since 1991, private participation in the economy has increased significantly, as shown in Table 2. By 1994, nearly two-thirds of GDP was produced by private entities. Private participation has increased most in trade, wholesale and retail activities, which were the biggest growth sectors in 1994-1995. Private enterprise output has also been high in the livestock and, to a lesser extent, in the construction sector. Value added of large privatized manufacturing firms remain relatively low.

13. The links between privatization and private participation in the economy are somewhat misleading. The aggregate figures masks considerable cross-sectoral variation in relative roles of private and public enterprises. Public enterprises continue to dominate many key activities in Mongolia, with a monopoly, or near-monopoly presence in several sub-sectors, particularly in energy, mining, infrastructure and utilities.

Table 2: Sectoral Composition of GDP by Ownership, 1994

(% share of GDP)		Private Enterprises	Public Enterprises
Private Enterprise Dominated			
Agriculture	(33.8%)	87.8	12.2
Construction	(2.1%)	62.0	38.0
Trade and Wholesale	(14.0%)	90.0	10.0
Public Enterprise Dominated			
Industry (incl. mining)	(32.0%)	36.0	64.0
Housing, other services	(--)	30.0	70.0
Transport	(3.1%)	35.0	65.0
Other	(15.0%)	20.0	80.0
Total		**63.7**	**36.3**

Source: State Statistics Office.

Sectors Dominated by Public Enterprises

14. In many sectors, the transfer of ownership through privatization has been partial, and in some cases minimal, particularly in energy, infrastructure and utilities. As of mid-1995, the state still had majority ownership of 62 percent of the large enterprises with some private ownership. Public enterprises continue to dominate industry, mining and energy (see Table 3).

Table 3: Value-added Share of Public and Private Enterprises, 1994
(in percent)

Sector	Public as % of sector total	Private as % of sector total
Mining	97.63	2.37
Coal mining	99.87	0.13
Food and beverage	74.26	25.74
Textiles	80.48	19.52
Garments	5.78	94.22
Leather (excl. shoes and clothes)	1.73	98.27
Shoes, excl. rubber	0.84	99.16
Wood processing (excl. furniture)	45.83	54.17
Furniture and equipment	10.00	90.00
Paper	100.00	0.00
Printing	70.05	29.95
Chemicals	100.00	0.00
Petroleum Processing	0.00	100.00
Petroleum and coal products	100.00	0.00
Ceramics	0.00	100.00
Glass	0.00	100.00
Non-ferrous metals	70.29	29.71
Iron, Steel and Alloys	100.00	0.00
Metal products	52.15	47.85
Machinery and Equipment	36.59	63.41
Industrial Machinery	29.02	70.98
Electrical equipment	76.88	23.12
Transport equipment	100.00	0.00
Science and technical equipment	43.71	56.29
Electricity, Steam	98.44	1.56
Water Supply	99.07	0.93
Total	**83.59**	**16.41**

Source: State Statistical Office, 1994 Enterprise Census of the Industry, Mining and Energy Sectors.

- **Mining**. Mining, comprising about one fifth of GDP, is almost completely publicly owned: Public enterprises accounted for 98 percent of sectoral value added in 1994. The Erdenet copper corporation, a 100 percent state-owned enterprise and 50-50 joint venture with Russia alone generates about half of Mongolia's exports revenues.

  There are 16 coal mines in Mongolia, some with minor private ownership.[1] The three largest; Baga Nuur, Shryn Gol and Shivee Oovo, are all majority state-owned. They provide all the coal used by the central

[1] Three coal mines dominate the sector: Baga Nuur (75 percent state-owned), followed by Sharyn Gol (80 percent) and Shivee Ovoo (90 percent state-owned). In 1993, these companies together produced 4.5 million tons of coal, i.e. 82 percent of the total national output of 5.5 million tons. The Baga Nuur mine is the backbone of the sector, accounting for half of all coal production in the country.

energy system, by the country's main industries, and by most of the small consumers in the main urban centers. The other, medium and small-sized, mines provide coal for local heat systems and other local consumers in the provinces.

- **Energy**. Public enterprises provide 98 percent of Mongolia's power and heat. The remaining 2 percent is generated by rural energy stations, which have limited private ownership. The fully state-owned Central Energy System controls the combined heat and power system—Mongolia's main source of power and heating—as well as the district heating systems.

- **Industry.** Public enterprises dominate industry, which generates about 30 percent of GDP.[2] The two most important sub-sectors are food and beverages and textiles and garments, accounting for 76 percent of sectoral value added. Public enterprises in these two sub-sectors were responsible for three-fourths of total production in 1994. Food processing is considered strategic in Mongolia, and flour mills, bakeries, slaughter houses and meat processing plants are all majority state-owned. In petroleum products, transport equipment and paper, public enterprises accounted for 100 percent of value-added. Private enterprises were significant in the small garments sub-sector (94 percent of garments output) as well as in leather and shoes (99 percent of value-added), and wood processing and furniture (58 percent).

- **Transport.** Public enterprises accounted for two-thirds of value-added in this sector in 1994. Mongolian Railways, a 50-50 joint venture with the Russian Ministry of Transport, has a virtual monopoly of passenger transport and carries 70 percent of the country's freight. The national air carrier, Mongolian International Air Transport (MIAT), is 100 percent state-owned, and not scheduled for privatization. MIAT is supervised by the Civil Aviation Authority, a public body, which is also responsible for operating the 20 airports and the air traffic control facilities. Urban road transport is also overwhelmingly provided by public enterprises. Although some private taxis and cars are now in operation, private buses and transport have not yet developed.

- **Telecommunications.** The Mongolian Telecommunications Company (MTC) was responsible for all telecommunications and postal services until November 1994, when the postal services were separated from the MTC. In September 1995, the Government approved the sale of 49 percent of equity in Mongol Telecom to Korea Telecom, the first major

[2] Mongolia does not publish a sectoral breakdown of GDP yet. The share is based in the Net Material Product of industry.

transaction under the cash privatization program. In March 1996, the mobile communications company Mobicom, set up by the Japanese KDD and Sumitomo last November, started communication services in Ulaanbaatar, providing Mongolia's first cellular and car phone services.

- **Services.** Municipal services (water supply, sanitation, solid waste collection) are operated by municipalities, and are fully or majority state-owned. Centralized water supply systems reach about 80 percent of the urban population, 40 percent of agricultural settlements, but only about 3 percent of the rural population. Informal systems, including private wells and tanker services supply the remaining population, including those living in informal housing, or *ger*, areas.[3] Solid waste collection, street cleaning and building maintenance services are provided by municipal contractors, funded by central or provincial budgets.

- **Petroleum Distribution**. Mongolia does not produce petroleum and has historically depended on imports of petroleum products from Russia. About 95 percent of petroleum products are imported and marketed by Neft Import Concern (NIC), which is 80 percent state-owned. At present, 8 out of the 16 filling stations in Ulaanbaatar are privately-owned, and there are plans to privatize 70 of NIC's 342 filling stations. Joint ventures are being negotiated with a Russian company for equipment, and with Shell for the marketing of lubricants.

Sectors with Active Private Participation

15. Privatization and private entry have had excellent results in some sectors of the economy. Public enterprises have all but disappeared from agriculture, and have collapsed in wholesale and trade. The following summarizes the main sectors in which private activity dominates:

- **Agriculture**. Public enterprises produced only 12 percent of value added in agriculture, which accounted for 34 percent of GDP in 1994. Both crop production and livestock herding entities were privatized in 1991. However, private initiative in the agriculture sector has been restricted by the strong presence of public enterprises in the agro-processing industries. Regardless of ownership structure, agricultural cooperatives and state farms continue to procure and sell their products as they did prior to privatization. Marketing opportunities for the farmers and herders remain limited with only a handful of procurement agents. The overall prospects

[3] In Ulaanbaatar, the water supply and sewerage system is operated by the Water Supply and Sewerage Board (USAG). USAG is a budgetary unit, but self-financing in operation and maintenance. Its tariffs are strictly regulated.

for crop production, particularly the wheat sector, are poor. However, the Government regards production of staple foods as strategically important, and subsidizes these activities from the budget, and, until recently, through directed lending.

- **Livestock** is almost entirely dominated by private herders, and new herding co-operatives. While over 90 percent of the herd was state-owned in 1990, over 90 percent was private after the completion of voucher privatization. The quality of the herd has improved substantially as a result of greater sensitivity to market signals, and more careful breeding. However, the livestock sub-sector still operates essentially within a state-run system of extension services, veterinary provision, transport services, and maintenance of essential watering points. This system has proved a major constraint to effective operation.

- **Trade and Wholesale**. The share of public enterprises in trading activities has shrunk dramatically in the past few years. This was the result of a Government decision to remove entry restrictions, and to allow enterprises to trade on their own account. The state trading companies, have experienced huge declines in business in recent years. For example, Materialimpex, which was the sole supplier of raw materials and construction materials to public enterprises, has seen a 90 percent decline in turnover in the past three years. Technikimport, which was the sole importer and domestic distributor of electrical goods for industry and household consumers, has had a 80 percent decline in business. Mongolexport and Mongolimport both have annual turnover of less than $5 million in 1995 compared to over $200 million in 1990.

- **Construction**. Until 1989, the construction sector was dominated largely by Russian and other CMEA contractors. Three large Russian firms alone accounted for 45 percent of total construction work; while the remaining balance was produced by 90 local state organizations. The sector was characterized by limited technological innovation, inefficient techniques, weak safety standards, and responded poorly to demands of maintenance, pricing and delivery. The sector shrank dramatically in 1991-93 with a slowdown in construction of public buildings and maintenance. Construction enterprises now face a significant budget constraint. The only area of growth at present is in private housing.

- **Housing**. Formal housing is almost entirely state-owned, but it serves only 25 percent of the population. There are about 125,000 government rental units in Mongolia, all in urban areas, managed by municipalities, and with heavily subsidized rents. The rest of the population relies on

informal housing, including *gers*, which are predominantly privately owned. Housing was not included in the voucher privatization program.

Trends in Public Enterprise Production

16. Measured in 1993 prices, gross industrial production in 1990 was Tug 285.7 billion; it reached its nadir in 1993 at Tug 168.8 billion; and bounced back to Tug 175.1 billion in 1994. Data for the first ten months of 1995 suggest an acceleration in growth to 15 percent, across a fairly broad range of products. Declines in outputs are across the board, with only copper production and molybdenum maintaining their output levels over the period. Public enterprises appear to have contributed to the recovery in industrial output in 1994 and 1995 in specific areas.[4] The recovery was led by copper and molybdenum production—produced by Erdenet copper mine—accompanied by significant price increases for export. Public enterprises in flour and meat production have recorded increases in output from the very low levels experienced in 1993. Nonetheless, capacity utilization remains low, due to deterioration of physical capital (as in the case of Arkhi beer and beverage company), and to shortage of working capital (as at Salkhit fur farm). In some sub-sectors, especially in garments, this has created scope for increased production by the new private businesses.

Trends in Public Enterprise Investment

17. Gross capital formation (including stocks) in the whole economy has fallen as a share of GDP from 34.2 percent in 1990 to 24.8 percent in 1994, that is, from Tug 71.4 billion to Tug 42.2 billion, measured in 1993 prices. During the same period, the share of industry in total investments has declined from 27.2 percent to 26.2 percent, and the share of machinery and equipment in overall investment has risen from 24.3 percent to 42.9 percent. Trends in investment in public enterprises are difficult to establish, but as a whole, public enterprises have experienced declines in investment in recent years. The only public enterprises that have made capital investments are those that have successfully secured investment funds from abroad. For example, Darkhan meat processing plant made a $20 million investment to replace its refrigeration equipment,[5] Gobi cashmere purchased automated equipment for its knitting plant; and Darkhan mini-mill completed its construction at a cost of some $80 million. Virtually all enterprises had plans for investments for which funding was being sought.

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[4] Separate data on production from public enterprises are not published in Mongolia, and it is possible to make only broad inferences about trends.

[5] Financed by a grant from the Japanese Government. Although the enterprise management indicated their intention to secure financing from the German Government for rehabilitation of the abattoir, there appeared to be no signs that modernization of the refrigeration plant was accompanied by more wide-spread modernization of the enterprise's facilities.

Public Enterprises in Foreign Trade

18. The dominance of public enterprises in the economy is clearly reflected in the role they play in foreign trade. The majority of export earnings are made by public enterprises. Refined copper from Erdenet copper corporation comprises more than half of total merchandise exports ($247.7 million out of $451 million in 1995). The second most important export commodity, cashmere, generates approximately $50 million in export earnings and is mostly produced by the state-owned Gobi cashmere company—although there are now a number of private producers exporting small amounts. On the imports side, the single largest import item, petroleum products ($69.6 million out of $473 million in 1995), is almost solely imported by the Neft Import Concern (NIC), the majority state-owned petroleum distribution company.

Size Distribution of Public Enterprises

19. Public enterprises usually operate in highly concentrated sectors, in which a few firms account for the bulk of production. The Erdenet copper and Gobi cashmere companies are two prominent examples. Industry, energy and mining have several hundred public enterprises, but only a handful dominate the market. Table 4 shows the relative importance of the top 10 enterprises in terms of fixed capital, operating surplus, and employment in industry, mining and energy. Clearly, there is a high degree of concentration. The top 10 enterprises in terms of fixed asset value account for 81 percent of all public enterprise fixed assets and the top 10 enterprises in terms of sales value account for a similar proportion. The degree of concentration is even greater in terms of operating surpluses. The concentration of employment is less but still high, with the 10 top employers accounting for half of aggregate employment.

Table 4: Size Distribution of Public Enterprises in Industry, Mining, and Energy 1994
(million Tugrik, percent, number of employees)

	Fixed capital	Gross sales value	Operating surplus	Employ-ment
All public enterprises	**68,984**	**173,648**	**57,562**	**54,540**
Top 10 public enterprises	56,253	139,415	52,714	27,513
Share of top 10 public enterprises	81%	80%	92%	50%
excluding Erdenet	79%	35%	28%	36%

Source: State Statistical Office and staff estimates.

The Road Ahead: Cash Privatization

20. The Government is continuing the divestiture of state-held assets, including partially privatized enterprises, and public buildings, through an ambitious program of *cash privatization*. The next stage of privatization will likely include auctions, public share offerings, tender offers, management contracts or establishment of joint ventures. Cash privatization proceeds are a considerable source of budgetary revenues. A total of 474 enterprises have been scheduled for cash privatization. As of August 1995, 119 companies from this list have been sold or partially sold for cash. The remainder are scheduled for cash sales in 1996, with anticipated revenues exceeding Tug 6 billion, or 4 percent of total revenue. These will be channeled to the government budget via the Privatization Fund administered by the State Privatization Commission.

21. The Government also plans to privatize 48,000 housing units in Ulaanbaatar, valued at over Tug 6 billion, and sell off portions of office space and unfinished buildings. Privatization of housing is expected to pave the way for development of a range of related products and services, including property insurance, real estate brokerage, housing maintenance, mortgage finance and property development organizations. For the present, however, there is no private housing market, in practical terms. This has a significant impact on the perceived social role, and hence overall performance, of public enterprises which provide subsidized housing to employees.

22. Notwithstanding further privatization plans, the Government intends to retain full ownership in about 20 large enterprises, including public utilities, transport, communications and research entities. They include: MIAT (Mongolian Airlines), Ulaanbaatar Railroad Company, Road Construction Company, Geological Survey Company, Drug Manufacturing Company, and various laboratories and research centers. This is in addition to retaining a controlling share in several large enterprises scheduled for cash privatization, including the Erdenet Copper Corporation, Gobi Cashmere factory, all the coal mines and power stations, flour mills and state farms, and other key 'strategic' industries.

3. PUBLIC ENTERPRISE PERFORMANCE

1. Public enterprises shared in the economic hardships that the entire country endured during 1990-93. Public enterprises, like their private counterparts, faced relative prices at international levels for most of their activities. High levels of inflation combined with remaining price controls squeezed financial performance of public enterprises, notably in utilities and food production. While public enterprises have undertaken some restructuring, it was not sufficient to have a real impact on efficiency. Consequently, they have increasingly become a burden on the budget and the commercial banking system. This chapter documents some of the adjustment public enterprises undertook, evaluates the technical efficiency of public enterprises across sectors, and shows the consequences of the limited adjustment and low efficiency for financial performance, the budget and the banking system.

Public Enterprise Efficiency

2. Some inference on public enterprises' efficiency can be derived from the data of the 1994 census of Industry, Mining and Energy sectors.[1] It is expected that physically efficient firms adjust their output-labor ratios according to the relative unit cost of labor. "Wage efficiency" is used as an indirect measure of this effect, and is defined as the correlation coefficient between wage rates and output per worker in a sector. Given the high variability of wage rates across firms in the data set, efficient sectors would show a positive correlation between wage rates and labor productivity.

3. Wage efficiency identifies construction, light industry and wood as the most efficient sectors (see Table 5). Worst performers are the equipment and water sectors. There is no systematic difference in performance between fully state-owned and majority

[1] This data set has, however, two main limitations: first, it does not include private sector firms, thus rendering unfeasible a comparison of efficiency between the public and private sector, and, second, it is too small to estimate meaningfully total factor productivity at the sector level. The Erdenet copper company, and the Darkhan metallurgical company have been excluded from the analysis, due to their disproportionate size.

state owned enterprises.[2] Sectors in which majority state-owned enterprises performed better than fully state-owned ones include mining, light industry, energy, construction and printing. Other sectors show no clear efficiency difference.

Table 5: Ranking of Sectors by Degree of Wage Efficiency /a

Sector	Wage Productivity Correlation
Equipment	-0.83
Water	-0.20
Metals	-0.10
Forest	0.38
Food	0.41
Energy	0.47
Printing	0.50
Medical	0.59
Mining	0.61
Wood	0.74
Light Industry	0.75
Construction	0.77

/a The equipment sector refers mainly to heavy industry; food is mainly food processing industry, while light industry is composed of textile, garments, leather and shoes industries.
Source: Staff estimates.

Employment

4. Official statistics on employment reveal a fairly stable level of employment in the economy over the past five years. Total employment was 795,700 in 1990, and after falling to 772,800 in 1993, recovered to a provisional estimate of 802,200 in 1995. Figures on total Public Enterprise employment are sketchy and inconsistent. However it is possible to draw some general inferences based on data from specific sectors.

[2] To compare the efficiency of 100 percent state-owned and majority state-owned firms within one sector, two different indicators were calculated, using data from the 1994 census on Industry, Mining, and Energy. A first indicator of technical efficiency is derived from the output/intermediate input ratio. This is a measure of technical efficiency under the assumptions that this coefficient is technically determined within each sector, and that all public enterprises in the same sector face similar output and intermediate input prices. An alternative approach is to derive efficiency indicators from sectoral Cobb-Douglas production functions. Different efficiency of fully and partially state-owned enterprises shows up as differences in the elasticities of the production functions. Since these indicators are imperfect, the results will be reported only when both of them are concordant. On the basis of these two sets of indicators, it is possible to identify a few sectors where there is a marked difference in efficiency between 100 percent state-owned and majority state-owned public enterprises. Sectors in which fully state-owned enterprises performed better than majority state-owned companies include the medical and food sub-sectors.

Employment in industry has fallen considerably in 1990-95 from 132,200 in 1990, it declined to 124,100 in 1993, and again to 101,300 in 1995. Employment in trading companies managed by the Ministry of Trade and Industry has also fallen dramatically, from 9,500 in 1993 to 2,100 in 1995.

5. A number of public enterprises have successfully downsized in recent years. The labor force reduction was done in line with the Labor Law, and required severance pay of three months salary. Some departures have been voluntary. Visits to enterprises in other sectors also revealed that current employment was frequently below past levels. The meat processing plant in Darkhan reduced employment from 1,200 employees in 1990 to 530 in late 1995[3]; and Ulaanbaatar Building Materials reduced its staff over the same period from 1,300 to 420.

6. Overstaffing is still an issue in many public enterprises. Infrastructure and utility companies under the control of Ministry of Infrastructure are especially affected. The Railway Company has 13,000 employees, with few having left despite a substantial reduction in business. Road maintenance and construction companies employ 4,500 persons despite having no projects or budget for much work; and the Telecommunications Company has more than 6,000 employees. Other enterprises have also maintained their work force despite dropping sales. The Altan Taria flour mill in Ulaanbaatar employed about 259 workers at the end of 1995, about the same level as in the past. Although annual staff turnover was about 8 percent, the result of voluntary departures, retirements and disciplinary departures, the company has kept its workers in the hope that business would improve, and skilled labor might then be hard to find. At Arkhi beverage company, there are 450 workers who have been retained despite the decline in output.

Financial Performance

7. After years of continuous decline in profits, public enterprises on aggregate returned to profitability in 1994. However, this statistic must be interpreted cautiously, given the weak accounting framework and the inadequate treatment of depreciation in

[3] The plant is open from July to December each year, and closed for the remainder of the year. During the active period, workers' wages average about Tug 20,000 per month, and for the closed period the company pays each worker Tug 7,000 per month. This off-season payment was justified by the manager on the grounds that there are no jobs available for the workers in the off-season. However, it is likely that some workers voluntarily left the plant because they were able to find full-time employment elsewhere.

most public enterprises.[4] Financial efficiency is low across all sub-sectors, and particularly low in agriculture, food processing, and mining, with the exception of copper. The financial performance of the copper sector has been strong, buoyed by strong demand and rising export prices. Public enterprises in other sub-sectors, notably public utilities, transportation, energy, agriculture and food-processing, have suffered large losses.

8. Survey data on net profit rates (net profits/gross sales) for 1994 demonstrate that most public enterprises in the sample exhibit poor financial performance, even with inadequate provision for depreciation.[5] The notable exceptions are the trading companies (Materialimpex, Raznoimpex and Technoimport), all of which performed well, and some large firms, such as Erdenet copper corporation and Gobi cashmere factory. The three trading companies all have net profits exceeding 15 percent of sales. Erdenet copper, the most important public enterprise in Mongolia, and one of the few which have converted to international accounting standards, also did well with net profit of almost 25 percent of sales. The best performance in the sample, by this criterion, is that of Gobi cashmere, which earned net profit of nearly 50 percent of gross sales revenue.

9. Most enterprises have shown poor net profits/gross sales revenue ratios, with poor performance cutting across sectors. The worst performance appears to be in the agriculture (e.g., Salkhit fur, Gonir, Sainshand wheat company) and food processing enterprises (Amtlag and Darkhan meat processing), all of which suffered losses in 1994. Mining enterprises (i.e., Shivee Ovoo coal and Khailast gold) and the flour mills (Altan Taria and Darkhan flour) managed to earn only small profit.

10. The 1994 census of public enterprises in industry, mining and energy provide a picture of the overall financial performance of these enterprises.[6] In 1994, the 239 public enterprises covered by the census had an aggregate net operating surplus of Tug 54.6 billion, or 19 percent of GDP. This figure is heavily influenced by Erdenet copper, which alone had an operating surplus of Tug 36.6 billion, or 64 percent of the total. One-third of the enterprises had operating deficits totaling Tug 3 billion. The rest of the enterprises, excluding Erdenet, had operating surpluses totaling Tug 21 billion, or 7 percent of GDP.

11. Both operating surpluses and deficits are concentrated in a few enterprises—top five profit-earners, accounting for 86 percent of the operating surpluses, and the top 10,

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[4] Accounting deficiencies render it difficult to properly analyze the financial and economic performance of Mongolian public enterprises. Treatment of depreciation in financial accounts is inadequate. Many enterprises report negligible depreciation expenses, artificially boosting their reported financial performance. Additional problems are caused by distorted prices. Despite progress toward liberalization, many prices in Mongolia do not reflect economic value, thus driving a wedge between financial and economic profitability.

[5] The Bank conducted a survey of 23 key enterprises for this report.

[6] SSO, January 1994.

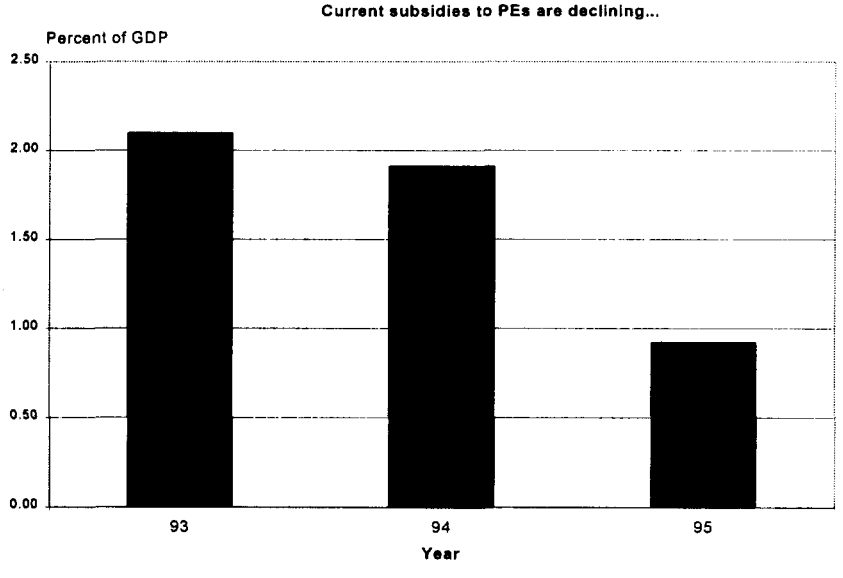
accounting for 91 percent. The bulk of operating deficits is concentrated in a few enterprises. Of the 79 enterprises that had operating deficits in 1994, the top 5 loss-makers accounted for half of the deficits, and the top 10 accounted for about 75 percent. Seven of the top 10 loss-makers are 100 percent state-owned enterprises, including five energy enterprises. The rest are majority state-owned enterprises.

12. Financial performance of many of the important public enterprises in utilities and transportation has been poor. The overall profitability of Mongolian Railways has dropped from plus 35 percent in 1991 to minus 49 percent in 1993 World Bank financial projections suggest further worsening of the situation with the absolute amount of operating deficits increasing from $3.7 million in 1993 to $20 million in 1998.[7]

Subsidies and Transfers to Public Enterprises

13. Public enterprises constitute a significant and increasing burden on the government budget and the banking sector. Aggregate subsidies to public enterprises have risen from 5.3 percent in 1993 to 7.4 percent of GDP in 1995. These subsidies were handed out directly from the budget in the form of current subsides and capital grants and were implicit in budgetary lending at below market interest rates and non-repayment of budgetary loans. The implicit subsidies to public enterprises have been larger than direct subsidies, rising both in nominal terms and as a percent of GDP in recent years.

Figure 2



14. *Current Budgetary Subsidies.* Current budgetary subsidies had traditionally been the major source of budgetary financing for public enterprises, although its relative

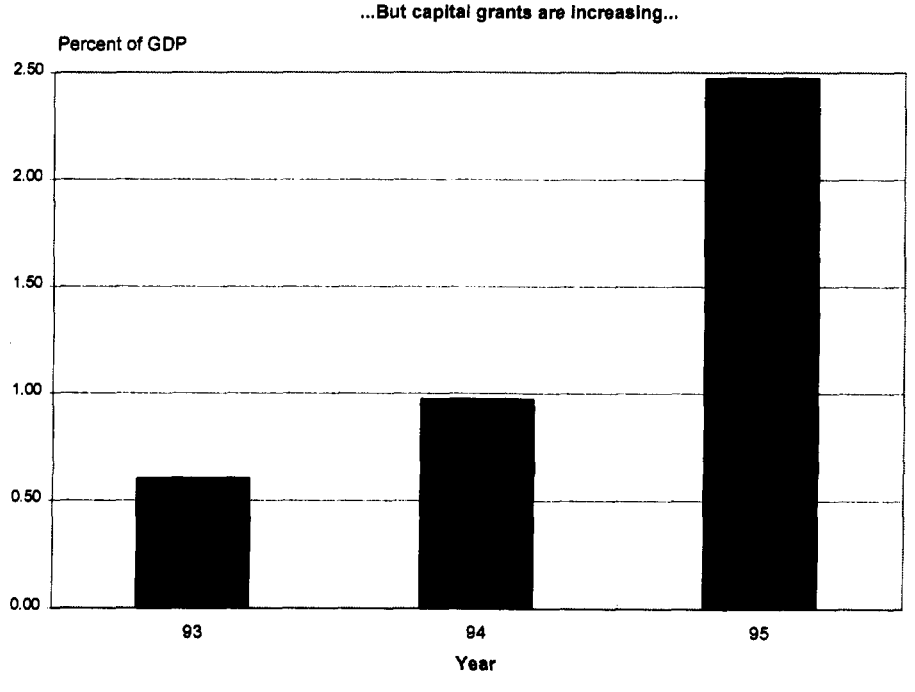
[7] *Mongolia: Country Economic Memorandum; Priorities in Macroeconomic Management,* October, 1994.

importance has declined. Current subsidies amounted to 2.1 percent of GDP in 1993. After a 33 percent increase in 1994, nominal current subsidies from the central government budget declined in 1995 to Tug 3.6 billion, or 0.9 percent of GDP (see Figure 2 and Table AI.1).

15. Current subsidies are now mainly provided to energy plants to compensate them for price controls on heating and electricity, and to some urban transport companies. They amount to an indirect subsidy to energy and urban transport consumers. The Government also subsidizes the consumption of diesel by *sums* (i.e. rural administrative sub-districts). This subsidy, which amounts to 10 percent of the price of diesel, is meant to be a temporary measure designed to mitigate the impact of 1994 increase in the price of diesel supplied by NIC.

16. *Budgetary Capital Grants.* The 1995 fall in current subsidies was more than offset by a rise in capital grants. Capital grants to public enterprises from the central budget increased in nominal terms from Tug 1.0 billion in 1993 to Tug 9.7 billion in 1995, or from 0.6 percent to 2.5 percent of GDP (see Figure 3). The Government provides capital grants under the state investment budget. Some foreign donors also supply earmarked grants to specific public enterprises, although only a few companies have benefited.

Figure 3



17. *Implicit Budgetary Subsidies.* Public enterprises have also benefited from substantial implicit subsidies. Beginning in 1993, the Government started lending to public enterprises from the budget to finance capital expenditures. The total amount of

budgetary loans disbursed during 1993-95 was Tug 16.3 billion, or on average about 2 percent of GDP annually (Table AI.2). A significant proportion of these loans has gone to a handful of enterprises.[8] Interest was extremely low by Mongolian standards: while market rates hovered around 80-120 percent per year, the budgetary loans carried an interest of 2-5 percent. In addition, loan repayment has been poor. As of November 21, 1995, Tug 3.3 million had been repaid, leaving loans of about Tug 13 billion outstanding. According to the Ministry of Finance, about half of these are in arrears.

18. Public enterprises are estimated to have received a total of about Tug 31 billion in implicit subsidies during 1993-95, or on average about 3.7 percent of GDP annually (see Table AI.3).[9] Of this, Tug 25.7 billion represents interest rate subsidization, while Tug 5.2 billion is due to non-fulfillment of debt-service obligations. These estimates indicate that *implicit subsidies to public enterprises have not only been substantial in recent years but also larger than direct subsidies and rising over time.* Implicit subsidies have increased in both nominal terms and as percent of GDP during 1993-95, from 2.6 percent of GDP in 1993 to almost 4 percent in 1995 (see Figure 4). Adding direct and implicit subsidies, total subsidies to public enterprises have averaged 6.5 percent of GDP during 1993-95, with the proportion rising from 5.3 percent in 1993 to 7.4 percent in 1995.

19. *Other subsidies.* Some public enterprises obtain financial support, either as capital grants or Government loans, through *aimags* (provincial administrations) and other non-ministerial organizations, such as the State Privatization Commission (SPC). The majority of these subsidies are, however, difficult or impossible to document.

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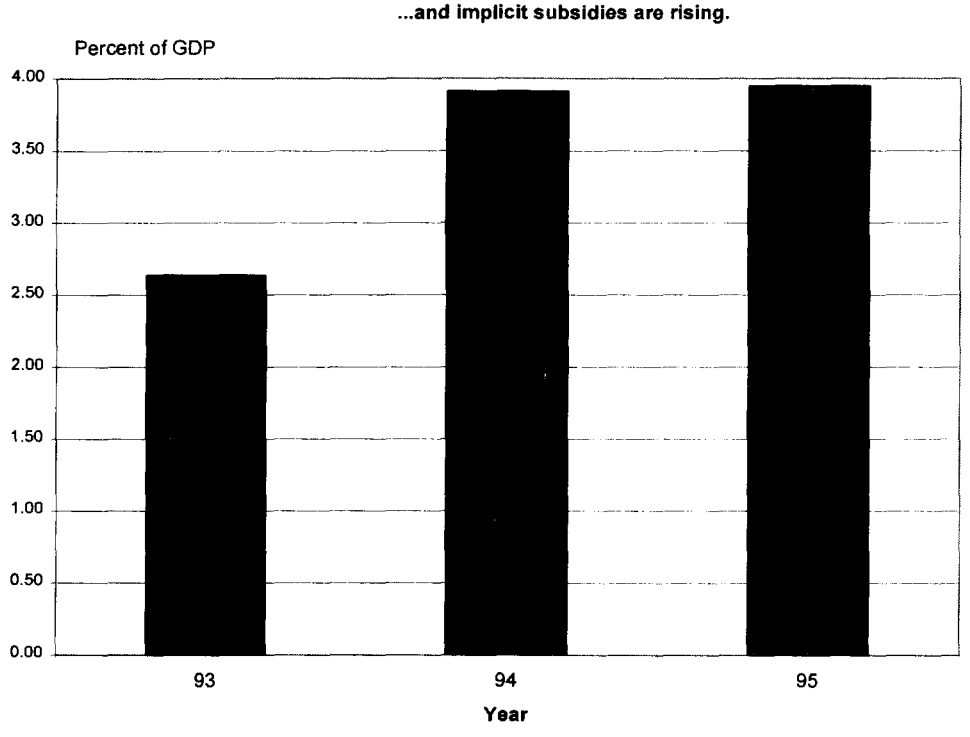
[8] Although more than 50 enterprises have received loans, almost half (43 percent) has gone to two enterprises: Neft Import Concern (Tug 5.4 billion) and Darkhan Mini-metal (Tug 1.7 billion). Another Tug 4.5 billion has gone to a group of energy plants and a group of public transport organizations. The remaining Tug 4.7 billion (29 percent of the total) has gone to roughly 40 public enterprises.

[9] As mentioned before, the interest rate on these loans to the public enterprises is very low—only 2 percent per annum. Given the high rates of inflation that has prevailed in recent years and the fact that commercial banks charge interest rates usually ranging from 80-120 percent per year, this implies a high degree of interest rate subsidization. An estimate of this subsidy was obtained by assuming a market interest rate of 100 percent and applying it to the average loans outstanding each year (i.e., the average of the beginning-of-year and end-of-year loans outstanding) to obtain an estimate of what the annual interest payment obligations would have been had the enterprises been obligated to pay the hypothetical "market" rate. The assumption of a market interest rate of 100 percent is not out of line with the fact that commercial banks are currently charging annual interest rates of 80 percent-120 percent. Since the hypothetical interest rate is 100 percent, the hypothetical interest payment obligations are in effect equal to the average loan outstanding in each year. The difference between these hypothetical payment obligations and the actual payment obligations is the estimate of the implicit subsidy to public enterprises arising from the provision of loans at subsidized interest rates. It should also be noted that data on 1995 loans are for the period through November 21 of that year.

The Burden of Public Enterprises on the Banking System

20. Public enterprises have become an increasing burden on commercial banks. They have been the main recipients of government directed loans from the banking system. These loans amount to over Tug 15 billion, or about 4 percent of GDP, including interest accrued. They are mostly unrecoverable, and will become a government responsibility by the end of 1996.

Figure 4



21. Public enterprises continue to account for a significant part of the banking sector's portfolio—about 16 percent of the total as of June 1995, but down from 43 percent at the beginning of 1993.[10] The share of public enterprises in loan disbursements has also decreased, but at a slower rate, from 46 percent in 1993 to 28 percent in the first half of 1995 (see Table 6). Yet, with one-fourth of new bank loans going to public enterprises, their debt service performance affects the viability of the banking system.

[10] The data on public enterprises actually refers to the public sector as a whole; separate data for public enterprises were not available. However, non-enterprise loan accounts for less than 4 percent of the loans to the public sector.

22. Public enterprises fall increasingly short on their debt-service obligations to the banks. While the stock of loans outstanding to public enterprises has decreased over this period, the proportion of principal arrears in total loans outstanding has increased sharply, from 6 percent at the beginning of the year to about 11 percent six months later (see Table AI.4). Even more alarming is the sharper increase in the incidence of bad loans; from 0.02 percent to 3.4 percent of loans outstanding, and from 0.4 percent to 31.3 percent of arrears.

Table 6: Bank Loans to Public Enterprises, 1993-95

	Loans outstanding at beginning	New loans disbursed during year	Loans repaid during year	Adjustments	Loans outstanding at year-end
Total					
1993	19,018	89,131	85,153	9,918	32,914
1994	32,914	114,599	100,125	8,855	56,243
1995 (first 6 months)	56,243	73,060	63,632	-2,186	63,485
Public enterprises					
1993	8,172	41,409	40,639	3,847	12,789
1994	12,789	41,746	40,109	-1,844	12,582
1995 (first 6 months)	12,582	20,441	23,192	521	10,352
Private enterprises					
1993	10,114	42,554	39,740	5,713	18,641
1994	18,641	64,290	51,944	9,365	40,352
1995 (first six months)	40,352	46,222	35,127	-2,531	48,916
Joint ventures					
1993	155	1,078	1,125	3	111
1994	111	1,562	2,004	623	292
1995 (first six months)	292	2,440	1,479	51	1,304
Others					
1993	577	4,090	3,649	355	1,373
1994	1,373	6,421	5,466	479	2,807
1995 (first six months)	2,807	3,957	3,834	-17	2,913

Source: Bank of Mongolia.

23. The figures tend to underestimate the true level of arrears and bad loans of public enterprises to the banking sector. It is common practice for public enterprises to roll-over loans, with the banks reclassifying past loans as new. A large part of the new loans to public enterprises are therefore covering the inability of those firms to repay their past loans. This partly explains why private firms, which are usually not allowed to roll-over

their debts, perform worse than public enterprises with respect to the level of arrears and bad loans to the banking system (see Table AI.4)[11].

24. The debt service record of public enterprises varies widely across sectors. Agricultural public enterprises perform the worse: they received only 12 percent of total loans outstanding as of June 1995, but accounted for 36 percent of total loans in arrears and 70 percent of arrears more than 12 months old (see Table A1.5). These are mostly inefficient state-run wheat farms that borrow without expectations of repayment. Industrial public enterprises are the largest recipients of bank loans, accounting for almost half of total loans outstanding. Their debt service record is, on average, the best, with only 3 percent of loans in arrears. Of the loans to public enterprises in infrastructure, 21 percent are in arrears, but only 3 percent of the loans was non-performing.

Inter-enterprise Arrears

25. Several enterprises have substantial arrears to other enterprises, creating a chain of loans and arrears which also stretches to the government and the commercial banking sector. These arrears weaken the performance and long-term viability of all enterprises affected, as the network of debt becomes more complicated and less manageable over time.

26. The energy sector, with the central energy system at its core, has the most serious inter-enterprise arrears. The total amount of arrears in the energy sector is estimated to exceed Tug 9 billion (i.e., 2.3 percent of 1995 GDP). They include arrears to the state budget, to energy import companies, to coal mines, to energy generating companies, to transportation companies, and others. Examples are many. During the first five months of 1995, a coal company was paid for less than one third of the product it delivered to state-owned power plants. As a result, the coal company was unable to pay Mongolian Railways for the transport of the coal to the power plants.

27. Other key areas with large arrears include the transport and food sectors. In many cases, enterprises are obliged by Government to continue selling to customers even when they do not, or cannot, receive payment. A flour mill is in considerable arrears from bakeries while having to make large interest payments on its own debt to banks. A fuel distribution company is compelled to continue fuel shipments to customers (especially in agriculture and mining) who do not pay.

28. Arrears have several detrimental effects on the economy. The problem is often passed on to the commercial banks, which, in the end, lend at higher rates to cover the arrears. Many enterprises are not able to satisfy other commitments, such as tax

[11] The poor credit record of the private sector relative to public enterprises is also misleading in that Tug 15 billion in inherited and directed loans to public enterprises, which amounts to over 30 percent of total loans outstanding, are not included in the stock of bad loans.

payments, government budget loan repayments, pension contributions, utility payments, and staff wages which are often not paid for several months. Again, the lack of the ability to pay creditors leads to the passing on of the problem to other organizations.[12]

Tax Arrears

29. Public enterprises appear to have performed better in meeting their tax payment obligations than they have been in servicing their loans from the Government. Nonetheless, tax arrears are large and appear to be rising. The tax records of 23 important public enterprises show that taxes paid as percent of taxes due fell from 92 percent in 1994 to 60 percent in the first half of 1995. Some of this decline is attributable to seasonal factors, since cash outflows usually exceed inflows in the first half of the year, with the reverse happening in the second half. However, seasonality is only one factor, and the tax-payment record of public enterprises has worsened. The decline in performance is larger for majority state-owned public enterprises than for 100 percent state-owned enterprises (see Table AI.6).[13]

30. The sample of 23 enterprises paid income, sales and excise taxes totaling Tug 23.7 billion in 1994 (7.8 percent of GDP) and Tug 13.5 billion (6.7 percent of half-year GDP) in the first six months of 1995. The bulk of these tax payments constitutes income taxes. One enterprise, Erdenet Copper Corporation, accounted for two-thirds of the income taxes paid by the large public enterprises in both 1994 and 1995. Erdenet does not pay sales or excise taxes.

The Economic Impact of Public Enterprise Performance

31. The adjustment of public enterprises to the new economic order has only been partial. Increasingly, their poor financial performance is burdening other sectors of the economy, notably the budget, but more and more the banks and other enterprises through defaults and arrears. This has large and growing costs for the Mongolian economy:

- *The opportunity costs of budgetary subsidies.* Total budgetary subsidies are a large part of total government expenditures, equal to 10.8 percent of expenditures in 1993 and 16.3 percent in 1995 (see Table AI.7). Total

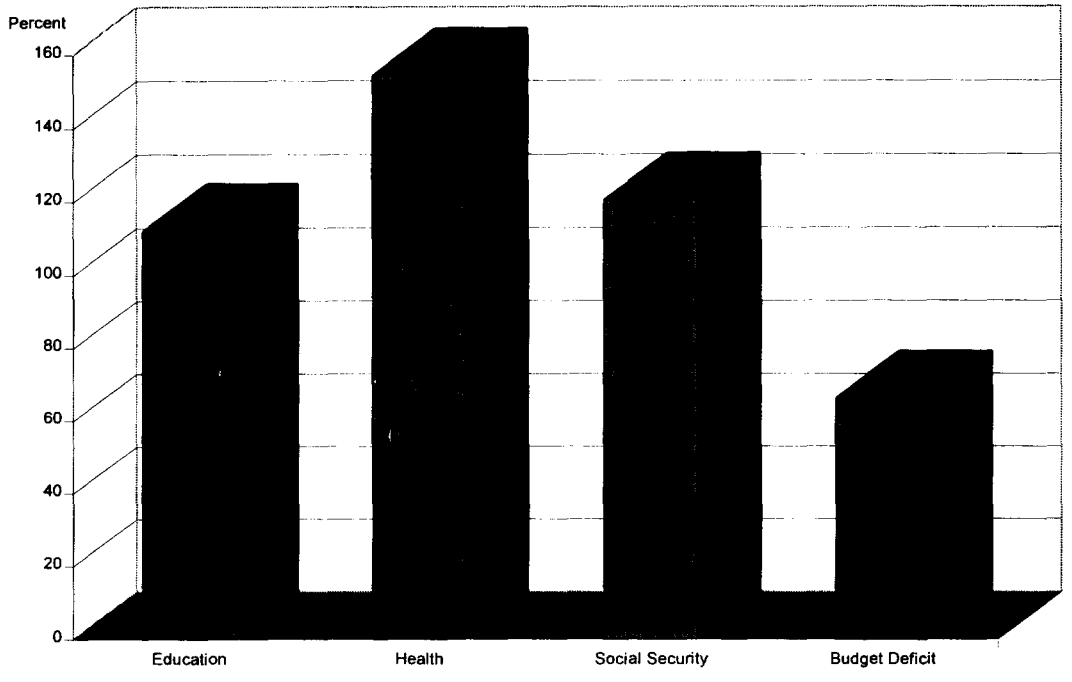
[12] A Danish government-funded World Bank study of public enterprise arrears is presently underway. Results from this study will be available in August 1996.

[13] The income, sales and excise tax payment record of 23 large public enterprises during 1994 and the first half of 1995 is summarized in Table AI.4. These 23 enterprises belong to the category of "central budget tax units" that consist of about 50 budgetary units obligated to pay taxes to the central government. Besides the 23 public enterprises, there are several banks, some government agencies and a few private enterprises in this category. Taxes payable equals tax payments outstanding at the beginning of the year plus tax payments which fell due during the year.

subsidies were two-thirds of the budget deficit in 1994.[14] The subsidies exceed government spending on individual priority areas such as education, health or social security and welfare (see Figure 5).

Figure 5

The Opportunity Costs of Subsidies to Public Enterprises
(Total subsidies as a percent of various expenditure categories and of the budget deficit, 1995)



- *Macroeconomic Stabilization.* Subsidies to public enterprises are increasingly the core of the budget deficit, and the budget deficit feeds macroeconomic instability. Without the explicit and implicit budgetary subsidies and grants to public enterprises, the deficit would have been less than a third of the 11 percent of GDP it was in 1995. In 1995, the deficit was fully foreign financed, and thus did not contribute to money growth. In fact, net credit to government fell by almost Tug 18 billion, or about 4 percent of GDP, that year. This was not the case in 1994, where the budget deficit required almost 3 percent of GDP in domestic finance, adding to the inflationary pressures that still plague Mongolia today. Reliance on foreign finance, mainly aid flows, seems

[14] Initial estimates of the public sector deficit show that this is actually smaller than the budget deficit, due to net repayment of loans and the buildup of public enterprise deposits. The stock of loans outstanding to public enterprises fell from Tug 12.8 billion, or 40 percent of total at end-1994, to Tug 8.9 billion, or 15 percent of total by end-1995. Over the same period, public enterprise deposits almost doubled to Tug 23.6 billion. This adds up to a public sector deficit of about 7.5 percent of GDP for 1995, or 3.6 percent lower than the budget deficit.

unsustainable in the longer run. Deficits of this size represent a danger to macroeconomic stability, and are incompatible with the Government stated objective of reducing the consolidated public sector deficit to a manageable level.

- *Distorted Resource Allocation.* Current policies toward public enterprises distort resource allocation on several accounts. Non-viable public enterprises are not allowed to fail, and therefore continue to use Mongolia's scarce resources inefficiently, preventing private entry and economic growth. The loans from the budget and the banks to the non-performing public enterprises crowd out private enterprises that would have a higher rate of return on their investment. Defaulting public enterprises force the banks to charge unsustainably high margins on their lending, leading to a virtual cessation of term lending and lack of new investments from any source, contributing to the progressive decapitalization of the enterprise sector.

32. Public enterprises have thus become a drag on growth, and a major cause of failure to reduce the public sector deficit and inflation. Moreover, they have crippled the banks to the point that they no longer perform their role as intermediator between savings and efficient investment. The next chapter identifies the complex set of causes of the dismal performance of public enterprises, and sets the stage for the reform program suggested in the concluding chapter of this report.

4. THE CAUSES OF DECLINE: EXTERNAL AND INTERNAL INCENTIVES OF PUBLIC ENTERPRISES

1. The poor performance of public enterprises has a multitude of causes and explanations. Some of the causes are fully external to Mongolia; others relate to the domestic policy environment in which public enterprises operate; and some causes are internal to the governance structure and management of the public enterprises. This chapter tracks the causes of poor public enterprise performance.

The External Factors

2. Mongolian GDP declined by more than 20 percent from 1990 to 1993, before resuming growth, a 2.3 percent and 6.3 percent in 1994 and 1995, respectively. The four-year period of economic decline was accelerated by a collapse in Mongolia's trading arrangements, the termination of Soviet assistance, and a deterioration in the terms of trade. External assistance, which reached about 30 percent of GDP during the 1980s, dwindled to virtually zero during the early 1990s. Trade with CMEA that amounted to over 80 percent of trade in 1989, collapsed after 1990, critically affecting enterprises that depended on this trade. The decline in external finance squeezed investment and business development. Moreover, the cancellation of Soviet projects and interruption in the supply of basic inputs, such as fuel and cement, had a formidable impact on industrial production and construction. Public Enterprises, which were the mainstay of the old system, were particularly adversely affected by these external shocks (see Box I).

The Policy Framework

3. Public enterprises have been operating in a deficient policy framework. Examples of these deficiencies include the absence of hard budget constraints, deficient pricing policy, institutional rigidities, deficient regulatory policies, and inadequate governance and autonomy. This framework results in part from Government measures introduced to counter the effects of the economic downturn and inflation. However, most of these measures backfired and hampered appropriate adjustments by public enterprises to the changing environment.

4. **Absence of Hard Budget Constraints**. As described in Chapter 3, public enterprises receive large government subsidies through both direct and indirect means, with aggregate subsidies comprising nearly 7 percent of GDP in 1995. Large subsidies have two harmful effects.

Box I: Mongolian Railways: The Impact of External Shocks

Mongolian Railways (MR) is in many respects typical for Mongolia's Public Enterprises. Its physical and financial performance have been severely affected by changing economic relations with Russia. MR, a joint venture of Mongolia and the Russian Federation, functions as a quasi-independent department under the Ministry of Infrastructure Development. It is one of the country's largest employers and a leading provider of social services. MR's main business is domestic transport of coal and construction materials, and export transport of copper ore, fluorspar, coal and meat.

MR was designed as an integral part of the former Soviet railway system. With the demise of the CMEA MR's physical performance deteriorated. While passenger transport remained stable, freight transport collapsed: by 1992, MR handled less than half the 6 billion ton-km it did in 1989, and an even smaller 2.2 billion ton-kilometer by 1994. Operational efficiency, measured in terms of freight and passenger locomotive km/day, has increased only slightly since 1992.

MR employed 16,400 staff in 1989, but over 3,000 staff were laid off between 1989 and 1994. Despite this, labor productivity fell more than 55 percent between 1989 and 1992. Over 50 percent of employees are non-operational, working in ancillary services, including track and signal maintenance, manufacturing of sleepers, construction, trading and various social services.

MR's financial performance plummeted due to the steep decline in freight traffic, and large increases in input prices. Fuel prices doubled in 1993, and these account for nearly 60 percent of working costs. Profits of 35 percent of sales in 1991 turned into losses of 49 percent of sales in 1993. Financial projections suggests a worsening trend, with operating revenues barely exceeding two-thirds of expenses in 1997.[1]

Deteriorating financial performance impeded adequate financing of operations and maintenance. More than half of essential maintenance since 1990 have been postponed. As a result, about 60 percent of locomotives were inoperative in 1993. Payments arrears, especially to the Russian railway system, have been building up, fed by customer arrears to MR. Major defaulters include the coal mines with $10 million at end-1992, and the central energy system with $2.4 million at end-1993.

Tariff adjustments have lagged behind increases in cost. Operating costs per ton-km. increased from $5.4 in 1992 to $8.5 in 1993 while operating revenues declined over the same period, from $10.1 to $8.6 per converted ton-km.[2] This pricing policy has been a major factor in the dismal financial performance of MR. Additional tariff adjustments of 10 percent and 16 percent would be required in 1996 and 1997, to deal with rising operating deficits. Larger increases are necessary to generate adequate reserves for future equipment replacements.

- First, they "crowd out" other firms from receiving credit, and thus reduce the financial resources available to bolster potentially viable companies. Many public enterprises suffer from the lack of affordable short-term working capital to operate their businesses. In addition, the complete absence of term lending, and a lack of new investment from any source, contributes to the progressive decapitalization of the enterprise sector.

- Second, subsidies permit money-losing firms to remain in business. Managers lack the incentive to adapt to market-oriented practices, such as, closure of

[1] World Bank, Mongolia: Country Economic Memorandum; Priorities in Macroeconomic Management, October, 1994.

[2] World Bank, Mongolia, Transport Rehabilitation Project, Staff Appraisal Report, 1994.

money-losing operations, and consequently, inefficiencies are perpetuated and subsidies become a recurrent feature (see Box II).

Box II: Soft and Hard Budget Constraints

Soft budget constraint

- **Darkhan Mini-Metal** carries on its books a Tug 1.7 billion loan from the budget without plans for repayment. In addition, the entire facility (US$80 million) was funded by the Government at no cost to the firm, and other loans from banks, and Russian and Japanese firms totaling Tug 4.1 billion.
- **Darkhan Flour and Feed Mill** received a loan from the budget of Tug 635 million in mid-1995; in late 1995, about half the amount was in arrears. Management *did not know* whether additional payables of Tug 580.2 million to other enterprises and Tug 235.0 million to banks were current or in arrears.

Hard budget constraint

- **Salkhit Fur**: In the face of deteriorating finances and with no prospect of receiving government funds, Salkhit Fur Farm introduced a policy of requiring customers to pay cash on delivery. This significantly reduced receivables, which declined 75 percent in nominal terms from 1993 to 1995.
- **Makhimpex Meat**, wanting to reduce high interest payments, increased production by 50 percent from 1994 to 1995, relying increasingly on internally generated resources and tightening payment terms for Russian customers.

5. The benefits of increasingly hardened budget constraint are evident in Mongolia, albeit on a small scale. Mongolian enterprises which face a hard budget constraint have taken appropriate measures to adjust to changing circumstances. These measures include significant diversification of product lines, introduction of the practice of funding operations from internally-generated resources, and demanding advance cash payment from customers. It is noted, however, that the Government cannot enforce hard budget constraints if other government policies constrain enterprise profitability, including regulations and/or price controls that keep output prices below costs, lack of enforcement of settling inter-enterprise arrears, or social burdens imposed on public enterprises.

6. **Pricing Policy**. Despite significant progress made in price reforms, pricing policy and administration continue to constrain public enterprise performance. For example, there is still a system of local "price commissions" which make prior reviews of proposed public enterprise price changes to determine whether proposed increases are justified. These often include on-site review of accounting records. These residual price controls reduces the ability of Public Enterprises to act efficiently and reduces their profitability (see Box III).

Box III: Interference in Enterprise Pricing Decisions

- **Altan Taria Flour Mill** in Ulaanbaatar announced a price increase for its flour, which it felt was fully justified, but when the Ulaanbaatar Price Commission "reviewed" the increase, it prevailed upon the firm to rescind the increase. The Director felt he had no alternative but to comply.

- Prices of the **Darkhan Meat** Enterprise are subject to review by the Darkhan Price Commission, which has kept price Tug 10-20 below management's estimate of the market level. The firm is still paying interest on debts incurred in 1993 and 1994 when it was required to sell meat to budgetary organizations at Tug 315/kilo when the market price was Tug 500.

7. In energy important prices remain substantially below costs. Electricity tariffs are currently about 50-60 percent, and heat prices about 30-33 percent of their respective estimated long-run marginal costs.[3] Although this is a marked improvement over the situation existing in 1992, when electricity tariffs were only 10 percent of long-run marginal cost, it is clear that the series of tariff adjustments made so far has been inadequate. Below-cost pricing of electricity and heating is a major source of waste and resource misallocation, and is also largely responsible for the poor financial performance of the Central Energy System. Current revenues only barely cover operating costs and are insufficient to cover basic maintenance and investment requirements.

8. Petroleum prices are currently based on international prices and, on average, are equal to or greater than costs. However, price restrictions remain. In order to encourage people to remain in rural areas, Neft Import Concern, the state fuel distribution company, is required to price all products uniformly throughout the country, regardless of distance from distribution points. This prevents the company from pricing according to cost (distribution costs are five times greater to outlying *aimags* than to ones near depots) and hinders it from competing effectively with new private suppliers. The distribution company is required to discount fuel at over 20 percent to certain public enterprises (e.g., airline, bus, and rail firms). The net result of these restrictions and cross-subsidies is a substantial reduction in the flexibility and profitability of Neft, as well as a reduction in the incentives of the users to utilize fuel efficiently.

9. Coal prices for major mines in 1994 were close to rough estimates of the economic costs of supply. However, a significant gap between tariffs and supply costs has started to develop from mid-1995. Major reforms are needed in the way in which prices are set, moving away from government-set prices to market-driven prices in long-term contracts negotiated between mines and consumers.

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[3] World Bank, *Mongolia Energy Sector Review,* November 1995.

10. In railways, as in electricity and heating, tariff adjustments have lagged behind increases in cost. A drop in transported volume coupled with a doubling of fuel prices in 1993, has led to significant increases in operating costs for Mongolian Railways, which were not matched by increases in tariffs. Operating costs per converted ton-km. increased from $5.4 in 1992 to $8.5 in 1993 while operating revenues actually declined over the same period, from $10.1 to $8.6 per converted ton-km. This pricing policy has been a major factor contributing to the serious decline in the financial performance of Mongolian Railways.

11. **Regulation and Competition.** Public enterprises are subject to various regulations and restrictions across sectors and geographic locations (see Box IV). For instance, they are frequently required by authorities to provide supplies to other public enterprises or "budgetary organizations" (e.g., schools, hospitals, the military) on a non-commercial basis, often with quantities, prices, and delivery dates specified. Public enterprises, particularly food processing companies, are sometimes asked by local governments to maintain inventories of finished or semi-finished goods greatly in excess of what market conditions might indicate. These types of regulations result in reduced flexibility and profitability of the public enterprises.

Box IV: Regulations and Constraints

- **Makhimpex Meat** is obligated by local Ulaanbaatar authorities to keep a designated quantity of meat in storage during the winter. The purpose is "to have enough meat for the people of Ulaanbaatar." The Director of Machimpex was thus denied the opportunity to sell a quantity of meat at an attractive price to Russian customers to generate additional working capital for the following year. The firm must bear the (uncompensated) cost of keeping such a high level of inventory.

- **Darkhan Meat** was required to sell meat to budgetary organizations at a price 37 percent below the prevailing market level.

12. **Entry and Exit Policies**. Policies that affect public enterprise performance also adversely impact on the ability of private firms to enter sectors dominated by public enterprises. This reduces the growth of the economy and leads to a distorted allocation of resources. The lack of private initiative in some sectors, such as public utilities, railways and mining, could be due to natural monopoly features of the sector. However, in other sectors, such as construction, heavy industry, flour mills, and ferrous metals, the absence of private involvement stems from the non-viability or depressed demand of that activity.

13. Sectors with an unexploited scope for entry by private firms include textiles, food processing, and road transport. Soft budget constraints, subsidized loans, and the

preferential access to inputs enjoyed by the public enterprises prevent private firms from competing on an equal footing. At the same time, these practices allow inefficient firms to remain in activity, consuming resources that could be better used by more efficient units. Private firms have made large inroads in some sectors where distortionary practices favoring public enterprises have been minimal, mainly in the garment, leather, shoe, wood, and furniture industries.

Governance and Management Autonomy

14. Although most public enterprises have been transformed into share-holding companies, many still lack the autonomy to adjust effectively to a rapidly changing environment.[4] Inadequate separation of the ownership, regulatory and management functions continues to plague public enterprises. In energy, the Government owns and controls almost all aspects of supply, distribution and pricing of energy sources. The major public enterprises in this sector, the Central Energy System, the Mongolian Petroleum Company, and the important coal mines (such as Baga Nuur, Sharyn Gol and Shivee Ovoo) are all accountable to the Ministry of Energy, Geology and Mines. The Ministry is responsible for both sector policy and the management of the combined heat and power (CHP) system, including the allocation of coal supplies to the CHP plants.

15. Survey results for 23 public, mostly industrial enterprises, reveal a number of weaknesses in governance:

- *The state plays an active role in the operations of enterprises.* In some enterprises the line ministry takes an active role, both through the Board of Directors, on which government representatives sit, and through the ministry's regular contacts with management. In other cases, the enterprises are seen as economically important--firms in whose continued existence the state has a political stake. Sometimes, the active Government role extends not only to technical assistance and advice but also to directed credit and funds from the budget. In other enterprises, typically smaller and economically less significant ones, the line ministry plays a passive role. The enterprise faces market prices for inputs and outputs, and management receives neither funding from the government budget nor directed loans from banks.

- *The composition and effective role of the Board of Directors varies.* In some cases, the state had fewer directors than its share-holding would permit; alternatively, the state has allowed its complement to be filled by members of enterprise management. In all cases, non-state share-holders

[4] See "Ownership and Governance the Morning After: the Initial Results of Privatization in Mongolia", Peter Murrell and Georges Korsun, October 1994.

had as many directors as their share-holding permitted (generally four out of nine).

- *Ownership diffusion in partially privatized public enterprises hinders effective governance.* The process by which very large and geographically dispersed group of share-holders nominate their representatives remains unclear, and it is likely that the selection of non-government appointed directors was made at a share-holders meeting in which a very small number of share-holders participated. All these developments seem to confirm the view that, following the creation of share-holding enterprises, effective control was taken over by management and workers.

- *The Board of Directors does not exercise significant power.* Indeed, in one case (Gobi Cashmere), the managing director explicitly stated that the board was irrelevant to decision-making, and that he made all important decisions, subject to clearance in some cases with the Ministry of Trade and Industry, with which he had a close working relationship.

- *Partial privatization has had little effect on improving the performance of enterprises--especially large enterprises.* Voucher privatization, corporatization and limited application of a hard budget constraint have apparently not produced significant improvement in the governance of enterprises in which the state maintains a significant share-holding. In particular, the Government's objective of improving enterprise performance through corporate governance by outsiders remains largely unfulfilled.

Further Development of the Securities Market

16. Secondary trading can begin to address some of these problems of corporate governance. The immediate role for secondary trading is to consolidate outside ownership and to offset the influence of insiders and government on corporate planning and operation. It will eventually foster the development of a balanced governance mechanism within enterprises.

17. As indicated earlier, there are several prerequisites for a more active secondary market in Mongolia. Priority reforms include:

- Increasing public awareness of capital market functions and objectives. For example, both the Securities Commission and the Stock Exchange have started to offer basic advice and information packages to prospective investors.

- Clarification of company registration requirements at the Securities Commission, share transaction procedures under the 1995 Securities Law, and the institutional mandates of the Securities Commission and the State Privatization Commission/State Property Agency to be established.

Management Skills and Attitude

18. Most enterprises continue to operate under the same management as they had before the privatization process began in 1991. Among public enterprise managers, there is a strong tendency to think in terms of technological and investment "fixes" for enterprise problems; relatively few firms seemed to be thinking of what to produce and how to sell and in what markets.

19. Business management in Mongolia is characterized by the goals of employment generation or retention, by traditional relationships with suppliers, customers, and employees, and by the maintenance of ancillary services. This contrasts with the goals of market-oriented management which aims at flexibility (new products and markets, divestiture of non-revenue producing activities, enterprise reorganization), profit maximization (termination of non-paying customers), cost reduction (procurement), and sales increases (via incentive compensation, innovative pricing).

20. Managers frequently have very limited information on their domestic and foreign competitors, and it is difficult for them to assess their firm's situation. Financial management is weak, in part because of accounting deficiencies. Even with improved accounting, it is questionable whether financial management in most enterprises would improve, since few managers seem to have the skills to make effective use of modern accounts in their decision-making. Currently, there is little assistance available to public enterprises managers to help in the areas of restructuring and corporate decision-making.

Ancillary Services

21. Wage levels in Mongolia have fallen in real terms by two-thirds during the past three years, and consequently, the cost of labor has also fallen. However, labor costs are influenced by the extensive supplementary services public enterprises provide to employees. The costs of these services are typically 25-35 percent of the wage bill. By international standards, these are not excessive, but they are significant because their provision and funding demand management attention. Typically, enterprises provide employees with transport to and from work, subsidized food and medical care, and housing in some cases (see Box V). For example, at Gobi, workers receive an 80 percent discount at a nearby hospital, a 90 percent discount at the staff cafeteria, free transport to and from work in company-owned buses, an 80 percent discount at the company's kindergarten, and a 60 percent discount at the company's vacation/rest and recuperation home. The firm also provides 200 apartments to its employees (at market rent). As a successful company, Gobi's social services appear to represent the most extensive coverage within the public enterprise sector, and would almost certainly amount to

considerably more than 35 percent of the wage bill. Other companies visited offer variants of the same package: Arkhi, for example, provides a 50 percent discount on its staff canteen, a 50 percent discount on transport to and from work, and some subsidy for medical care; while Darkhan flour mill provides a 40 percent food subsidy, free transport and discounts on various consumer durables that the company buys cheaply from state sources. Such packages are generally given even by companies that were in serious difficulties, but some, such as the Salkhit fur farm, has completely or partially discontinued these services.

Box V: BUK: Self-Restructuring

BUK building materials company was severely hit by the slackening demand for construction materials in the early 1990s. By 1995, the plant was operating at 10% of capacity. The Company was partially privatized through the voucher system, and is listed on the Stock Exchange; the Government has retained a 51 percent share. The Company has a 9-member Board of Directors: 2 represent employees, 5 represent shareholders, and 2 represent the Municipality of Ulaanbaatar.

Management sets sales prices, based on quarterly reviews of production costs. However, these must be officially registered and reviewed by the Social and Economic Policy Council of Ulaanbaatar Municipality. If its products are used in a building financed by the state budget, the Company may charge only the officially approved and registered prices.

The Company still provides a range of social services to employees: 66% of social insurance costs, 50% of health insurance, 50% of lunch costs, free transport to and from work in its own own bus fleet. Mothers with young children are entitled to special bonuses. The company provides low-rent apartments for 60 families. It has established an employee hardship fund, and provides financial assistance for retirees, including subsidized coal, and small gifts for Veterans' Day and Tsagan Tsaar (New Year). Management estimates social expenditures at 10% of total wage costs.

Management has taken a series of measures to keep the Company in operation, but its prospects remain uncertain. These include:

- Three-fold reduction in the Company's workforce, 1990-95; possible reduction of existing 17% overstaffing
- Diversification of product lines: reinforced concrete, renting out vehicles to private contractors, production and export of bone fertilizer to China
- Introduction of 80% advance payment requirement in all new contracts
- Full repayment of short-term loans
- Publication of financial data for prospective investors
- Solicitation of technical assistance for financial management, cost accounting and economic analysis and forecasting.

Public Enterprise Viability

20. The public enterprises have been affected by the negative shocks of the transition period more than the rest of the economy, because of its central position in the former system. With few exception, public enterprises have not reacted to the new economic environment with the dynamism and initiative which would have allowed them to exploit their full potential. This is explained in part by the persistence of an inadequate set of incentives. The lack of a hard budget constraint has been pervasive throughout the public enterprise sector and beyond. Pricing was heavily regulated until 1994, and has been

perpetuated in the energy and transport sectors. Governance of public enterprises has been weak and plagued by insider controls, and management autonomy has been lacking.

21. Thus, public enterprises are only partly responsible for their poor performance. Some enterprises may be viable in a better environment, but at present are unable to improve performance due to external constraints. For others, the incentive to adjust is suppressed by government handouts and by banks that do not, or cannot, recover their loans. Public enterprises in Mongolia can be classified into four groups depending on their current financial performance and their viability prospects. The profitable and viable enterprises, as shown in Table 7, are the ones operating in Mongolia's comparative advantage sectors and which are relatively less constrained by distortionary policies. The profitable but unviable enterprises are, by and large, the enterprises that have been obtaining assistance from the Government and banks, in the form of policy protection, loans and exemptions from taxes. The viable but non-profitable enterprises are those that have been impaired by regulatory and pricing policies, by the provision of social services to their employees, or that have suffered bad management practices.

Table 7: Public Enterprise Viability

	Viable	**Non-Viable**
Profitable	Copper Trading Companies Textiles and Garments Leather products Forestry Printing	Mini metal Steel Heavy Industry
Non-Profitable	Energy Construction Wood Meat processing Transport Mining (excluding copper)	Wheat farms Flour mills

5. REFORMING PUBLIC ENTERPRISES

A Strategy for Reforms

1. This chapter proposes a practical public enterprise reform strategy based on international experience, but shaped to meet Mongolia's specific circumstances. The strategy combines a program of reorganizing the public enterprise sector through privatization, restructuring, and/or liquidation with improvements in the external and internal incentives for public enterprises, primarily through the promotion of competition, the restriction of automatic access to finance (hard budget constraint), and the enhancement of corporate governance and management autonomy. The program aims to create a viable and dynamic enterprise sector responsive to the demands of a market economy, and conducive to efficient resource allocation and macroeconomic stability.

2. To apply this framework to Mongolia, it is necessary to assess the viability of public enterprises and their strategic importance to the Government. As discussed in the previous chapter, many public enterprises in Mongolia, including some who are currently earning profits, are inherently non-viable. Continued operation of these enterprises implies a waste of scarce resources-- a luxury that Mongolia can ill-afford. These enterprises should be liquidated and the assets, both physical and human, currently locked up in these enterprises should be freed and put to more productive uses. Most of these enterprises are in sectors, such as metal, wheat farming, flour and heavy industry, in which Mongolia does not have comparative advantage (see Box VI). These enterprises have been artificially propped up by protective pricing policies, subsidies and directed loans. In all these sectors, Mongolia could do better by importing the goods from abroad.

Box VI: Darkhan Mini-Metal

The policy dilemma involved in taking resolute action in an unviable sector is well illustrated by the **Darkhan Mini-Metal Plant**. The Darkhan plant, a 100% state-owned metallurgical plant, was built in 1994 and financed by a US$80 million Japanese commercial loan, fully guaranteed by the Mongolian Government. The firm's operations have been plagued by a scarcity of raw material (scrap metal) and by a lack of domestic demand and international competitiveness, resulting in large financial losses both in 1994 and 1995. The Government desperately wants to avert the closure of the plant, and having to repay the guaranteed loan. Far from thinking of liquidating the plant, it is presently seeking US$50-60 million in additional investments to exploit a nearby iron ore mine that would supply the plant with raw materials and keep it in operation.

3. Enterprises which are viable may be privatized. Experience the world over suggests that while public enterprises may sometimes perform well, it is difficult to sustain such performance. A change in ownership in a competitive market environment usually leads to sustained improvements in performance.

4. The design of a public enterprise reform strategy for Mongolia is, however, complicated by the fact that the Government is reluctant to privatize or liquidate some enterprises which it considers strategic for one reason or the other. Some enterprises are considered strategic either because they supply essential goods (e.g., flour mills) or services (e.g., utilities), or because they are very important for the economy (e.g., the Erdenet Copper Corporation). In some sectors, one or two large public enterprises, which dominate the sectors, have been classified as "strategic" because of their size and relative importance.

5. The Government's definition of strategic is very broad, and seems driven as much as by political influence of the enterprises as it is by public goods considerations. It is thus recommended that:

- The Government re-examines the definition of "strategic" enterprises. There are many enterprises whose strategic importance is unclear. The budget can not afford subsidies to these enterprises and the extra support they will need, once the banking system stops financing them.

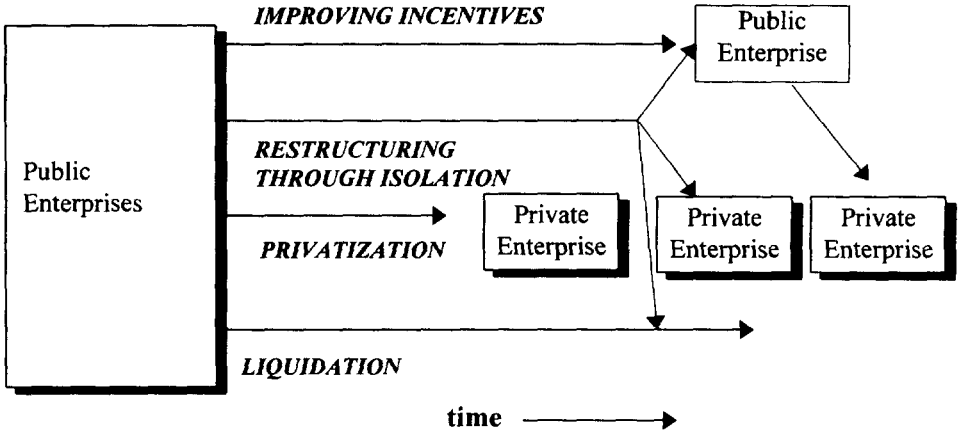
- Enterprises which continue to be classified as "strategic", and are not capable of surviving without government support, should be subsidized only through the government budget in a transparent manner.

- The Government should consider opening up "strategic" activities to the private sector. Once the private entities begin to supply these essential goods or services, existing public enterprises could be privatized and/or liquidated.

Restructuring the Public Enterprise Sector

6. The Government should pro-actively restructure the public enterprise sector. Restructuring entails privatization, enterprise reorganization, and liquidation (see Figure 6). Isolation could be considered as a combination of restructuring and cut-off from non-government finance.

Figure 6: Approaches to Public Enterprise Reforms



Privatization

7. Over the past five years, Mongolia has implemented a privatization program which, while substantial in scope, has not produced the expected results. Governance in many privatized enterprises remains ineffective and shareholder authority is minimal. This is a consequence of the diffused ownership structure which also prevents outside private investors from exercising effective control. Residual state involvement continues in many privatized enterprises.

8. The next round of privatization in Mongolia will need to address these problems. Experience elsewhere indicates that privatization strategies have proved successful when the Government has made a clear determination of what is for sale, how and when it will be sold, and has chosen, between alternative models for privatization, the ones which might be more effective in terms of sales and potentially result in a better governance regime (see Box VII). A rapid implementation of the privatization program, to reduce uncertainty associated with changing property structures, is also critical to the outcome of the program.

9. In order to ensure that the next round of privatization in Mongolia produces effective results the following specific actions need to be taken:

- The Government should now accelerate its cash privatization program to sell remaining state-owned assets and should also resolve related institutional and policy issues. The schedule and precise mechanisms of cash privatization should be established. In the nearest future, a

determination should be made of what will be for sale, how it will be sold, and when.

- The Government should consider alternative models for the privatization process which might be more effective in terms of sales and potentially result in a better governance regime.

- The Law on Companies and the Securities Law should be clarified to determine the authority of the proposed State Property Commission to sell shares in public enterprises.

- The Privatization Commission should return privatization proceeds to the budget. The Ministry of Finance should establish clear rules for the use of the Privatization Fund.

Box VII: Alternative Paths to Privatization

Privatization strategies have proved successful when the Government has clearly determined *what is for sale, how it will be sold, and when.* Crucial for the success of privatization is to chose a model that is most effective in terms of sales and governance regime. A rapid implementation the privatization program, to reduce uncertainty associated with changing property structures is also critical to the outcome of the privatization process.

In developed market economies, the preferred method of privatization has been flotation of shares on the stock exchange, although negotiated sales have also been common. Share flotation requires a well-developed, highly liquid stock market, which is lacking in most transition economies, which therefore had to consider alternatives.

Countries that privatize typically want increased efficiency, revenue for government, a fair distribution of benefits, and the separation of the state from the productive units. In general, the preferred method has been sale to "strategic" investors which can bring cash, new investment, and expertise--e.g., on markets, finance, and sources of raw material, but other methods were chosen in line with a country-specific priority of objectives.

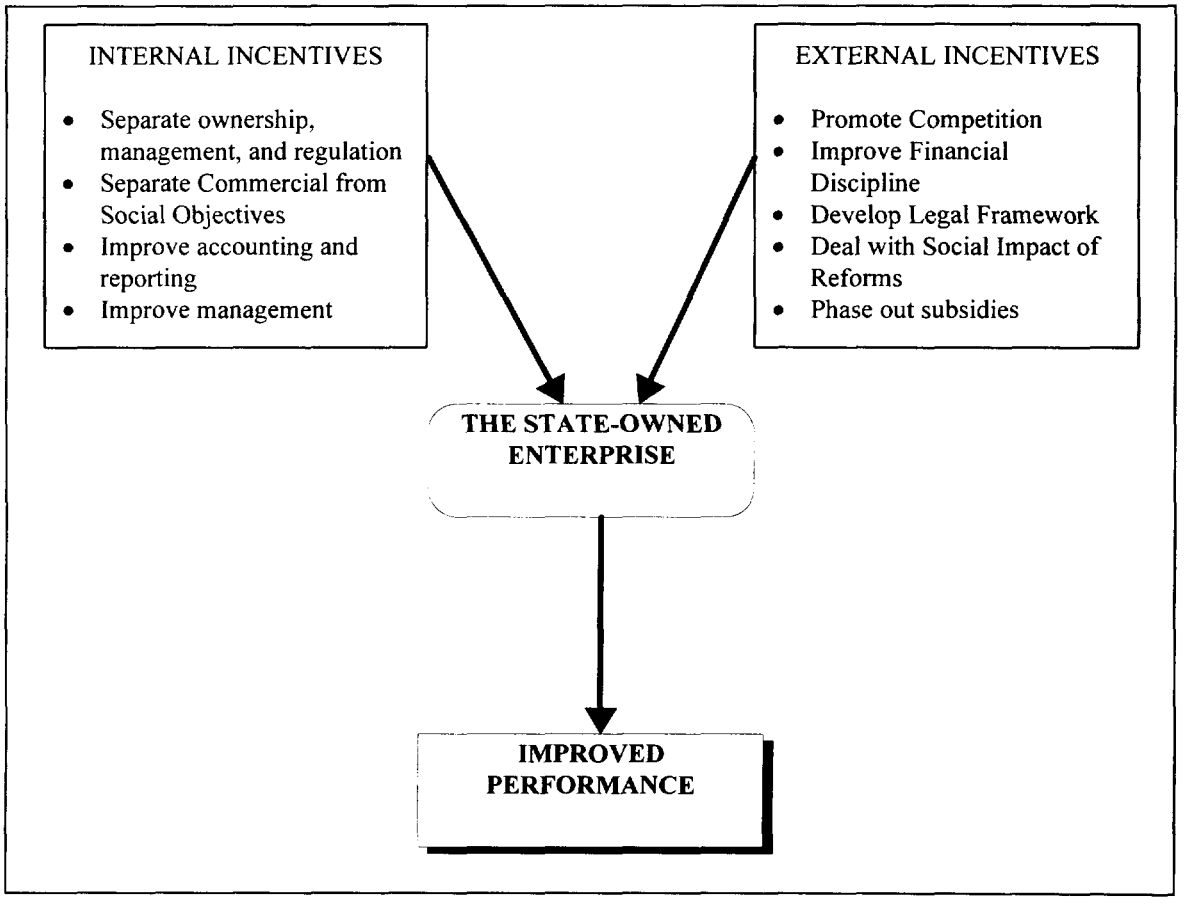
Poland has had success with share flotations, but for only a small number of firms with good prospects and strong financial positions. Hungary, with a large foreign debt, has been primarily concerned with revenue, and has emphasized sales to outside owners, but at the cost of slow implementation of the overall program. The Czech Republic, like Mongolia, wanted to remove the state from production and stimulate widespread acceptance of capitalism through voucher privatization. Unlike Mongolia, the Czech set up effective arrangements for share consolidation (mutual funds) that resulted in improved governance and efficiency. Russia wanted a speedy break with the past and was willing to confirm formally the insider control through manager/labor buyouts in the context of voucher privatization. Albania passed legislation that made restitution an important component of privatization.

In virtually all transitional economies, there have been periods when inaction on privatization has been accompanied by *spontaneous privatization*, whereby insiders have transferred assets of state firms to private companies. In some countries, governments have tried to avoid such developments by leasing state assets to private businessmen pending more permanent transfer of ownership.

Improving Incentives: Creating the Right External Incentives

10. Empirical research on public enterprises reform in transitional economies and developed economies, a number of specific lessons can be summoned to create appropriate internal and external incentives. They are summarized in Figure 7 below.

Figure 7: Internal and External Incentives



11. Improvements in the external and internal incentives will induce many public enterprises to go for restructuring on their own. They will eliminate non-viable, non-strategic lines of business, move into promising markets, cut back in ancillary services, and reduce employment. The Government may assist the process by arranging the provision of technical assistance to help draw up and implement restructuring plans. Non-viable enterprises which are not considered strategic should be immediately liquidated. In the case of partially privatized enterprises, the Government should ensure the rights of minority shareholders.

(a) Promote Competition

12. Forcing public enterprises to compete can greatly enhance their efficiency. Fierce

competition in contestable markets with negligible government interference has created highly efficient and competitive public enterprises in the UK and New Zealand. By contrast, state protection and heavy subsidies for Turkish and Indian public enterprises have perpetuated their inefficient operation.

13. Mongolia has made some progress in granting access to provide investors to business activities, such as cellular telephones, to private investors. More needs to be done in this area. The Government's hesitance to privatize "strategic" public enterprises is motivated by fear that privatization may lead to disruption of supply of essential goods and services. This fear may be understandable given the nascent stage of private sector development in Mongolia. However, the obvious drawback of this strategy is that inefficient public enterprise activities are sustained and possible efficiency gains are not realized.

14. An appropriate strategy in this context would be to allow private entry alongside existing public enterprises. This will have at least two positive effects. First, increased competition may force public enterprises to become more efficient. Second, private enterprises may demonstrate their capability to supply essential goods and services, perhaps more efficiently. In the medium to long run, this may reduce the Government's inhibitions against privatization and liquidation of existing public enterprises.

(b) Harden Budget Constraints

15. International experience shows the importance of hardening the budget constraints for public enterprises and suggests two important lessons. First, hardening budget constraints should be done across all sources of finance, i.e., finance from banks, government budget and other enterprises. A partial approach is usually ineffective and may worsen the problem. Second, competition-enhancing policies are ineffective if public enterprises have access to sources of cheap public finance.

16. Imposing hard budget constraints on large, politically influential, and economically and socially important enterprises is difficult, and may require additional efforts. These enterprises often obtain soft budget constraints. These exemptions jeopardize the entire strategy of harden budget constraints. This has led many countries, especially in transitional economies, to adopt an isolation program for a select group of enterprises whereby they receive funding only from the government budget for a specified period of time and conditional on the adoption of restructuring measures (see Box VIII).

17. In Mongolia, hardening budget constraints implies the following actions:

> *Restoring credit discipline in the banking sector.* This requires a better juridical environment which enables bank to recover their loans from defaulters. Better information on defaulters is needed, and the

Government is encouraged to accelerate establishing a Credit Information Bureau in the Mongolian Banker's Association. Supervision of prudential regulations by the central bank should be improved, matched with credible penalties to enforce these regulations. Finally, upgrading skills of bankers in appraising credit worthiness and working out bad debts with defaulting borrowers is warranted.

Box VIII: Enterprise Isolation

Several transitional economies have "isolated" politically powerful enterprises. In isolation, the government budget becomes the only, or major, source of financing. The firms are put under tight financial controls to prevent arrears to other financiers, such as banks and suppliers. Best practice shows some principles for isolation:

- *The number of enterprises to be put in isolation is limited but, together, they account for a significant proportion of the problem of the enterprise sector.* The number of firms should not be so large as to overwhelm the absorptive capacity of the isolation exercise. However, the enterprises should account for a substantial share of the enterprise sector's problems to justify the resources spent. The usual practice has been to include 20-40 important enterprises.
- *Political sensitivity is the main criterion for isolating enterprises.* In practice, there is a strong correlation between political sensitivity and the amount of problems these enterprises cause in terms of debt service and inter-enterprise arrears, and subsidies received.
- *Enterprises in the isolation exercise receive financing exclusively, or mainly, from the government budget. This financing will be transparent, time-bound and conditional.* Since financing for these enterprises is primarily a political decision, it should be done from the government budget. Budgetary financing should be time-bound, and transparent, to expose enterprises to public scrutiny, and conditional on enterprise restructuring. At the end of the program, viable enterprises will come out of isolation and may borrow from commercial banks. Non-viable enterprise would be liquidated.
- *Government only finances "passive" restructuring,* including labor retrenchment, divestment of social and other peripheral assets, transfer of social services to government agencies or the private sector, and changes in management and organizational practices. Passive restructuring will help convert enterprises to production organizations and make them better candidates for privatization. More active restructuring, involving substantial investment, is best done after the enterprise comes out of the isolation exercise, preferably under new owners.
- *Budgetary resources are not used to pay off existing creditors.* An exception to this may be made only in the context of a debt work-out whereby all important creditors take some hit.

- *Phasing out of subsidies and grants from the government budget.* As a start, clear criteria for subsidies should be established and should be budgeted for in the regular budget process. Many subsidies to enterprises are meant to benefit consumers. Subsidizing the targeted beneficiary directly would be less costly, and would improve allocation, as it would allow for price liberalization. For example, electricity prices should be liberalized so that public power companies can charge market prices and establish financial viability, while poor consumers receive directly income supplements to compensate the price increase.

- *Stopping implicit subsidies to public enterprises.* Loans from the budget at below-market interest rates, lax enforcement of debt-servicing conditions on such loans, or tolerance of non-payment or delayed payment of taxes, should be halted. If Government wishes to subsidize, it should be done in a transparent manner.

- *Enforcing a "hard payment system".* This would require customers to either pay cash in advance or provide documentary evidence of ability to pay, such as certified checks or bank drafts. Public enterprises, such as utilities that are not paid for their goods or services, should be authorized to reduce or cut off supplies to non-payers. The existing stock of inter-enterprise debts may be cleared through a once-for-all debt clearance/debt restructuring exercise along the lines of the resolution of bad debt to banks.

- *Eliminating policy distortions.* Government policies that constrain enterprise profitability, such as regulations and/or price controls that keep output prices below costs, lack of enforcement of settling inter-enterprise arrears, or social burdens imposed on public enterprises, should be eliminated as a pre-condition to enforcing hard budget constraints.

(c) Develop a Legal Framework

18. An important determinant for enterprise performance, whether public or private, is a transparent and effective legal framework. Over the past five years Mongolia has made considerable efforts in drafting and enacting new legislation to take account of changes in the enterprise sector. New laws include the Privatization and Companies Law (1991), revised in 1995, the Business Entities Law (1991) , the Bankruptcy Law (1991), the Labor Code (1991), Foreign Investment Law (1993), Land Law (1995), Securities Law (1995), new tax laws and a comprehensive Civil Code (1995). The new legislation has begun to define property rights, economic actors and their entry and exit mechanisms, transactions, fair competition and capital market activity. Some of these laws have already made a significant contribution to the functioning of Mongolia's economy.

19. Additional changes are needed to make these new laws more effective. Public enterprise reform will require specific amendments to the Bankruptcy Law, the Companies Law and related provisions in the Civil Code. It will also entail appropriate education and training programs for law enforcement institutions, including the Ministry of Justice, the judiciary, the court administration and the bailiffs. Priority areas for developing the legal framework are:

- Bankruptcy *Law Reform*: to establish an effective legal basis for enterprise restructuring and possible liquidation. This should ensure also that the provisions and implications of the law are clearly understood by

stakeholders such as creditors, managers and employees of a given enterprise.

- *Enforcing court judgments*: to establish clear lines of authority and legally-acceptable procedures for effective bankruptcy law reform, and provide institutional support to the courts and bailiffs. Court judgments, especially against defaulters, must be enforced effectively, to restore public confidence in the court system.

- *Development and enforcement of Security/Collateral Legislation*: to establish provisions governing the methods for seizure and sale of moveable or immovable property pledged as security for a loan. This process would be reinforced through creation of official property and collateral registries.

Improving Incentives: Internal Incentives for Better Governance

20. In addition to reforming the external environment in which public enterprises operate, it is necessary to introduce a clear and market-oriented incentive structure within the enterprises. This requires action on a number of fronts.

(a) Separate Ownership, Management and Regulatory Functions

21. International experience points to the need for a clear relationship between public enterprise managers and the firm's owners. Combining ownership, management and regulatory functions of individual public enterprises in a single line ministry blurs responsibilities, reduces autonomy and accountability and contributes to public enterprise inefficiency. Many Governments have recognized these problems and have separated the institutional responsibilities for carrying out these functions (see Box IX).

22. Mongolia lags behind in this respect. Inadequate separation of ownership, management and regulatory functions is a common feature of the Mongolian public enterprise sector. Many other public enterprises have boards of directors which are ineffective. A series of institutional reforms are thus required in order to improve internal incentives and governance structures:

- Ownership, management and regulatory functions of public enterprises should be separated. In the first phase, this may involve the separation of the ownership and regulatory functions from the management functions. Later, regulation may be assigned to an independent body. In the energy sector, for example, the Ministry of Energy, Geology and Mining's (MEGM) role should focus on sector policy and the design and implementation of regulations. This would include responsibilities for

sector policy and strategy, licensing of operators and the issuing and enforcement of safety and health standards.

- Boards of directors of public enterprises should be made more effective by introducing non-government specialist, such as accountants, technicians, economists, to the Boards.

Box IX: Improving Corporate Governance in Public Enterprises

International experience in countries as diverse as France, Italy, Norway, New Zealand, Korea and Indonesia suggests that effective governance for corporatized public enterprises has been achieved when the state has provided adequate *incentives to boards, managers and employees to meet commercial objectives*. The experience also indicates that *share transferability* is fundamental to successful public enterprise reform. In the case of public enterprises the risk of losses is borne by the population as a whole, which has no ready vehicle for controlling the enterprise or for divesting its ownership rights. This weakens the incentives to perform efficiently because residual gains or losses are not borne in full by the local, municipal or national authority which own the enterprise but by the population at large. Therefore, while a corporatized PE may be structured to look like a privately owned enterprise, if it lacks one significant attribute, such as transferability of shares, this deficiency will undermine the effect of reforms. Many countries have confronted this problem by diversifying PE ownership; in some cases, to secure the gains from ownership diversification, PE divestiture has been pursued.

Appoint Non-Governmental Representatives to Boards. One of the key factors which has frustrated efficient operation of public enterprises after corporatization has been the failure to separate political influence from the firm's decisions. A strong Board is important for developing the enterprise's overall strategy and for monitoring management performance. But creating a Board which facilitates undue political interference in the daily operations of the business achieves little in improved corporate governance. An effective way to ensure a Board's focus on strategy and monitoring is by appointing private sector Board members. This has proven to be useful in improving public enterprise performance in countries such as Korea and New Zealand. However, even in New Zealand, the remaining public enterprises have begun to suffer from the re-emergence of escalating interference from politicians, prompting authorities to turn to divestiture as a way of "locking in" efficiency gains.

Avoid Creation of Large Holding Companies. International experience suggests that the significant disadvantages of large holding companies outweigh any limited advantages. The examples of Italy (IRI), France (Usinor Sacilor), Turkey (Sumer Holdings) and India (HMT) as well as holdings in Algeria, Egypt and Kazakhstan demonstrate many of their drawbacks. The main disadvantages of holding structures are: the creation of additional layers of bureaucracy; a failure to shield the operating companies from undue political intervention; a propensity for cross-subsidization between operating companies; the distortion of financial signals and incentives to management; and difficulty in controlling the growth and longevity of these corporate forms once established.

(b) Separate Commercial from Social Objectives

23. Public enterprises in Mongolia are often faced with a complex agenda of pursuing a range of social and political objectives that conflict with profit maximization. The non-commercial roles of public enterprises include: (i) the maintenance of employment despite falling activity levels (construction companies and Mongolian Railway); (ii) customer protection through price control (heating and electricity; railway tariffs; de facto price controls on flour and meat); (iii) forced provision of services to other public

enterprises or budgetary organizations (schools, hospitals, the military) on a non-commercial basis; and (iv) forced maintenance of excessive inventories. Public enterprises are rarely good vehicles for pursuing social objectives, and direct government intervention supported from the budget is usually the better instrument. Phasing out the practice of using public enterprises to achieve social objectives should be an integral part of public enterprise reforms. Public enterprises should be assigned clear, unambiguous objectives in which commercial profitability features prominently. Specifically, the following should be done:

- Central and regional governments should eliminate price commissions and refrain from interfering in enterprise price setting.

- Regulated prices, desirable in certain cases such as utilities, should reflect the long-run marginal cost of production, including profits and reasonable depreciation.

- State procurement from public enterprises should be done on commercial terms.

- Decisions on inventory management should be left to the enterprises and not dictated by Government.

(c) Improve Accounting and Reporting

24. Accurate information on enterprise performance is essential for adequate monitoring. In Mongolia, accounting standards are not yet brought in line with international standards. Reporting of public enterprises to the Ministry of Finance is still done in the format inherited from the planning system. In addition, the accounts of public enterprises are not audited by external auditors, not least because the audit profession is still nascent in Mongolia. Thus, reliable information is scarce in Mongolia. To improve this situation, the Government could:

- Adopt a reporting format for public enterprises compatible with international accounting standards.

- Actively encourage the accounting profession to develop accounting standards. The Organization for Mongolian Accountants could benefit in this respect from work already undertaken for a variety of public enterprises.

- Set norms and standards for auditing of financial accounts, to result in audit regulations and an audit law in the medium run.

- Conversion to international accounting standards.

(d) Improve Management

25. The institutional reforms governing the relationships of public enterprises with their supervisory agencies, as described above, need to be complemented by reforms within public enterprises. The most important of these would be the following:

- Introduction of performance-based incentive systems.
- Training and skill development of public enterprise managers and employees.

Liquidation

26. There is, in general, great anxiety concerning liquidation in Mongolia. Liquidation is regarded as unacceptable for many reasons. Liquidation is seen as an end to an industry and in many cases a sector, especially since many of these enterprises are monopoly/oligopoly manufacturers in that sector. The loss of employment resulting from liquidation is also viewed as politically unacceptable. However, it must be recognized that liquidation is nothing more than a recognition of an already untenable situation. Jobs have already begun to disappear and production has already stopped in many cases. Very often, loss-making enterprises are just too large for the existing market, and are working at 15-30% of their full capacity. The task of liquidation is then a reallocation process so that capital and labor can be used more efficiently. It is almost always the case that delaying liquidation is more costly in the longer-term, as managers/workers strip the enterprise of valuable assets while the enterprise continues to lose money and burden the government and banks by drawing additional funds. Quickly recognizing the need for liquidation is essential, and every effort should be made to publicly announce this process. This will allow more time for workers who are most affected by the process to seek alternate forms of employment.

The Social Impact of Reforms

27. Restructuring and privatization will lead to reductions in public enterprise employment. Retrenchment in industry has already reduced employment, from 132,000 in 1990 to 101,000 in 1995, and public trading companies have greatly reduced their work force, from 9,500 in 1993 to 2,100 in 1995. However, overstaffing remains in public utilities, in the railways, and, to a lesser extent, in the construction companies under the Ministry of Infrastructure, and in coal mining. These companies also have a large share of their staff (around 20 percent) involved in the provision of ancillary services, whose position might be affected by restructuring. Retrenchment will also come from enterprises that prove to be unviable and face liquidation. In those enterprises that have prospects of becoming viable, it is unlikely that restructuring will focus primarily on labor shedding, given that wages represent a small percentage of total costs (in most cases, between 5 percent and 15 percent of total costs).

28. It is estimated that around 13,000 excess jobs exist in the public enterprises sector, and natural turnover implies that not more than 8,000 workers (equivalent to 1 percent of total employment) may have to be retrenched. The employment impact of public enterprise reform is thus likely to be modest. However, retrenched workers from public enterprises will be additional to the 30,000 employees that may be released by the civil service, to the 25,000 annual new entrants in the labor market, and to the existing 100,000 unemployed. Under these circumstances, it might prove extremely difficult for retrenched workers, especially for unskilled workers that currently represent 60 percent of the unemployed, to find a new job.

29. Properly addressing social concerns related to enterprise restructuring is paramount to the success of the Government reform program. The Government should encourage growth-oriented labor-intensive activities, in an effort to increase employment. These should be complemented with targeted social programs to assist the most vulnerable groups of society through poverty reduction measures.[1]

Speed of Reforms

30. The speed and sequencing of reforms of the Mongolian public enterprise sector will have to be carefully determined. International experience suggests a variety of approaches. The speed of reforming the external and internal incentives has varied from a "big bang" approach adopted in Poland to the more gradual and evolutionary approach adopted in China and Vietnam. Poland's choice for rapid reforms was as much driven by the internal collapse of the political structure of the command economy as it was by the collapse of the CMEA. In China, the continued political control of the communist party, combined with the huge internal market, allowed for a gradual reform based on increased internal competition and marketization. However, China—like Mongolia—is increasingly aware of the costs of retaining inefficient public enterprises, and has embarked on widespread public enterprise reforms.

31. Mongolia is likely to adopt a middle-ground between the two extremes of Poland and China. The nascent private sector and the social and economic sensitivity of several public enterprises may not allow a rapid privatization of all or most public enterprises. At the same time, the Chinese route of de-emphasizing privatization and opting for a strategy of developing new private enterprises as a means of increasing the role of the private sector is also not feasible. The speed of reforms combined with the various reform options presented in this Chapter suggest an agenda for Mongolia's reforms as presented in Table 8 below.

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[1] See World Bank, *Mongolia: Poverty Assessment.* 1996.

Political Commitment

32. Political commitment is essential to successful enterprise reforms. This commitment must come from all quarters: the workers and managers that will be most affected by the transition; from the policy makers and parliamentarians that will set the agenda; and from the civil servants, bankers, judges and lawyers that will implement the reforms. To instill commitment from all quarters, the Government should:

- clearly announce the objectives of its reform program, and actively campaign to promote it to the general public, through seminars and mass media;
- ensure sufficient social protection for retrenched workers;
- protect the legal rights of minority shareholders in restructured public enterprises; and
- consider piloting a few enterprises for restructuring, to show that reforms do not necessarily lead to liquidation.

33. With sufficient political and societal support, enterprise reform in Mongolia will yield the increased productivity and efficiency the country desperately needs.

Table 8: An Agenda for Public Enterprise Reform

	Short run (up to 1 year)	Medium run (1-3 years)	Long run (3 years plus)
Strategic; non-viable	Improve accounting systems and determine true costs of continuing operations. Adopt cost-cutting measures. Make transparent all budgetary subsidies to the enterprises. Reduce and eliminate subsidies over time, and include only explicit subsidies. Eliminate all implicit subsidies. Promote competition. Remove barriers to private entry.	Continue to cut costs. Continue to implement subsidization program. Continue to promote private entry. Liquidate as much enterprises in this category.	Privatize all remaining enterprises which have become viable. Liquidate all enterprises which continue to be non-viable. If private investors are unwilling to enter because the activity is intrinsically non-viable, subsidize the private enterprises and liquidate the public enterprise.
Strategic; viable or potentially viable after restructuring	Bring accounting systems to international standards. Separate ownership and regulatory functions from management functions for all strategic enterprises. Take steps to make Boards of Directors more effective. For natural monopolies, start process of rationalizing prices. For others, deregulate prices. Increase share of private ownership in enterprises; promote competition by removing barriers to entry for private enterprises. Impose hard budget constraints on all enterprises. Establish clear criteria for granting subsidies. Eliminate all implicit subsidies. Impose hard payment systems. Begin reducing inter-enterprise arrears.	Separate ownership from regulatory functions for all enterprises which remain under public ownership. Develop appropriate regulatory framework for various sub-sectors including natural monopoly activities. Complete process of rationalization and deregulation of prices. Initiate and complete passive restructuring of enterprises.	Privatize ownership or, at least, management.

	Short run (up to 1 year)	**Medium run (1-3 years)**	**Long run (3 years plus)**
Non-strategic; non-viable	Liquidate at least 10 enterprises.	Liquidate remaining enterprises.	
Non-strategic; viable	Establish schedule and precise mechanisms for privatization. Accelerate cash privatization.	Continue cash privatization. Develop mechanisms to facilitate secondary trading.	
All enterprises: legal reforms	Develop bankruptcy law and implementation regulations. Develop and enforce securities and collateral legislation.	Enforce court decisions. Train lawyers, judges, bailiffs to strengthen enforcement capacity.	
All enterprises: social issues	Identify social costs of enterprise restructuring. Start a pilot program to assist retrenched workers. Transfer responsibility of provision of social services to local governments.	Based on lessons of pilot exercise, develop comprehensive mechanisms to assist retrenched workers. Stop financing of social services by enterprises.	

EPILOGUE

Since the report was completed, important political changes have occurred in Mongolia. In Parliamentary elections held on June 30, 1996, the opposition coalition won by a landslide. The formerly communist Mongolian People's Revolutionary Party, which had dominated the Great Khural (Parliament) since 1992, was toppled by the Democratic Union Coalition, formed by the country's two main opposition parties, the National Democratic Party and the Social Democratic Party.

The new Government is committed to faster and deeper economic reforms, with a view to transforming Mongolia into an open, market-oriented economy. The Government's program contains plans for faster and more extended privatization of public enterprises and state assets, for a further and complete liberalization of prices, for the implementation of a serious competition policy, and for the reform and strengthening of the financial sector.

The situation of public enterprises on the ground has, however, not changed much. Governance issues are still a prevailing problem, and measures, such as consolidation of private ownership, and the establishment of greater competition, are needed. The dire state of many private enterprises call for a deeper restructuring of production facilities and management methods. The social concerns for workers of public enterprises, such as increased unemployment and re-training, will have to be dealt in the framework of tight public expenditures. The gridlock of arrears among enterprises in the energy sector threatens to become a paralyzing problem.

The Government has swiftly started implementing its program, and its actions are already reshaping the policy environment in which public enterprises operate. The ban on raw cashmere exports has been abolished, local price commissions have been eliminated, energy prices have been increased to reflect long-run marginal costs, and the privatization process has been stepped up.

Although the government is moving in the right direction, the report's description of the complex challenge of transforming Mongolia's ailing public enterprises into viable firms is still valid. Many problems, such as weak governance and inadequate physical and human capital, require long-term solutions. It is hoped that Mongolian policy makers will find the analysis and policy discussion of the report useful for the implementation of their policies toward public enterprises.

STATISTICAL TABLES

Table AI.1: Subsidies and Grants To Public Enterprises: 1993-95
(n million Tugriks)

	1993	1994	1995
Current Subsidies	3,482	5,418	3,607
Capital Grants	1,000/a	2,759	9,676
Total subsidies and grants	**4,482**	**8,177**	**13,283**
Total subsidies and grants as % of GDP	**2.7**	**2.9**	**3.5**

/a Estimate.

Note: Data for 1995 are projected totals for 1995 based on actuals for the first 10 months.

Source: Ministry of Finance.

Table AI.2: Loans to Public Enterprises from Central Government Budget: 1993-95

	(in million Tugriks)				(as % of GDP)		
	1993	1994	1995	Total	1993	1994	1995
Public enterprises							
Loans outstanding at beginning of year	0	7,252	11,349		0	2.4	2.8
Loans disbursed during the year	8,547	5,395	2,363	16,305	4.7	1.7	0.6
Loans repaid during the year	1,295	1,298	753	3,346	0.7	0.4	0.2
Loans outstanding at end of year	7,252	11,349	12,959		4	3.7	3.2
Loans repaid as % of loans outstanding at beginning of year + loans disbursed during year	15.2	10.3	5.5				
TOTAL (public enterprises + non-enterprise budgetary units)							
Loans outstanding at beginning of year	0	7,404	11,570		0	2.4	2.9
Loans disbursed during the year	8,784	5,540	2,366	16,690	4.8	1.8	0.6
Loans repaid during the year	1,380	1,374	781	3,535	0.8	0.5	0.2
Loans outstanding at end of year	7,404	11,570	13,155		4	3.7	3.3
Loans repaid as % of loans outstanding at beginning of year + loans disbursed during year	15.7	10.6	5.6				

Note: Some enterprises classified here as public enterprises are now privatized but were public when loans were made.

Source: Ministry of Finance.

Table AI.3: Calculation of Implicit Subsidies to Public Enterprises: 1993-95

	1993	1994	1995	Total
1. Average loans outstanding during the year	4,392	9,487	12,363	
2. Interest obligation at market rate of interest	4,392	9,487	12,363	26,242
3. Interest obligation at 2% annual interest rate	88	190	247	525
4. Estimated interest foregone by not charging market interest rate	4,304	9,297	12,116	25,717
5. Principal repayment obligations	1,463	3,159	4,117	8,739
6. Actual principal repayment	1,380	1,374	781	3,535
7. Estimated arrears in principal repayment	83	1,785	3,336	5,204
8. Implicit subsidies to public enterprises (=4+7)	4,387	11,082	15,452	30,921
9. Implicit subsidies as % of GDP	2.39	3.63	3.84	
10. Total subsidies as % of GDP	5.3	6.8	7.4	

Assumptions:
(a) market interest rate = 100% per annum
(b) principal repayment obligations = 33.3% of average loan outstanding during the year
(c) proportion of principal arrears which is likely to become bad loans = 100%

Source: Estimated from Table AI.2.

Table AI.4: Comparative Loan-Repayment Performance of Public Enterprises: 1995
(in million Tugriks)

	Loans outstanding	Principal arrears	of which bad loans	Principal arrears as % of loans outstanding	Bad loans as % of loans outstanding	Bad loans as % of principal arrears
Total						
January 1, 1995	52,909	7,281	153	13.8	0.3	2.1
June 30, 1995	63,485	10,498	1,402	16.5	2.2	13.4
Public enterprises						
January 1, 1995	12,495	740	3	5.9	0.02	0.4
June 30, 1995	10,352	1,118	350	10.8	3.4	31.3
Private enterprises						
January 1, 1995	37,476	5,915	114	15.8	0.3	1.9
June 30, 1995	48,916	8,697	1,018	17.8	2.1	11.7

Note: Bad loans: loans in arrears for more than a year.

Source: Bank of Mongolia.

Table AI.5: Non-Performing Loans from Banks to PEs: Sectoral Breakdown
(in million Tugriks, as of June 30, 1995)

	Total loans outstanding	Total loans in arrears	Of which arrears				Loans in arrears as % of loans outstanding	Loans in arrears for more than 12 months
			less than 3 months	3 to 6 months	6 to 12 months	more than 12 months		
Sector								
Industry	4,796	153	72	8	60	13	3.2	8.6
Agriculture	1,290	468	74	11	53	329	36.3	70.4
Construction	1,117	86	80	2	0	4	7.7	4.8
Trade	1,577	281	203	42	33	4	17.8	1.4
Infrastructure	268	56	56	0	0	0	21.0	0.0
Other	1,304	74	72	0	2	0	5.7	0.0
Total	**10,352**	**1,118**	**557**	**63**	**147**	**350**	**10.8**	**31.3**

Source: Bank of Mongolia.

Table AI.6: Tax Payment Record of Public Enterprises: 1994-95
(in million Tugriks)

	Total		Erdenet		100% state-owned PEs (minus Erdenet)		Majority state-owned PEs	
	1994	1995	1994	1995	1994	1995	1994	1995
Income Taxes								
Balance at beginning of year	885	3,958	-	2,962	668	242	217	754
Taxes which fell due during year	19,772	15,690	12,530	10,452	1,926	590	5,316	4,648
Taxes paid during the year	19,642	11,360	12,530	7,293	2,198	643	4,914	3,424
Balance at end of year	1,016	8,285	0	6,121	396	188	620	1,976
Taxes paid as % of taxes payable	95	58	100	54	85	77	89	63
Sales and excise taxes								
Balance at beginning of year	544	653	0	0	190	80	354	573
Taxes which fell due during year	4,414	2,048	0	0	482	242	3,932	1,806
Taxes paid during the year	4,031	2,154	0	0	316	146	3,715	2,008
Balance at end of year	928	546	0	0	357	175	571	371
Taxes paid as % of taxes payable	81	80			47	45	87	84
Total (income+sales+excise)								
Balance at beginning of year	1,429	4,611	0	2,962	858	322	571	1,327
Taxes which fell due during year	24,186	17,738	12,530	10,452	2,408	832	9,248	6,454
Taxes paid during the year	23,673	13,514	12,530	7,293	2,514	789	8,629	5,432
Balance at end of year	1,944	8,831	0	6,121	753	363	1,191	2,347
Taxes paid as % of taxes payable	92	60	100	54	77	68	88	70
No. of enterprises	23	23	1	1	9	9	13	13

Notes: (1) 1995 data are for the first six months of 1995. Taxes payable = Balance at beginning of year plus taxes which fell due during the year. Only one enterprise, Arkhi, pays excise taxes.
(2) All of the year-end balances (i.e., the difference between taxes payable during the year and actual payments) do not constitute arrears because enterprises have some time after the end of each tax-period to pay their dues.

Source: State Tax Office.

Table AI.7: Opportunity Costs of Direct and Indirect Subsidies to Public Enterprises

	1993	1994	1995
As percentage of GDP			
Current subsidies	2.10	1.91	0.92
Capital grants	0.60	0.97	2.47
Implicit subsidies	2.64	3.91	3.95
Total subsidies	5.34	6.80	7.35
As percentage of total expenditures			
Current subsidies	4.25	3.74	2.05
Capital grants	1.22	1.91	5.50
Implicit subsidies	5.34	7.66	8.79
Total subsidies	10.81	13.31	16.35
As percentage of total revenues			
Current subsidies	6.31	6.77	2.75
Capital grants	1.81	3.45	7.37
Implicit subsidies	7.93	13.85	11.77
Total subsidies	16.05	24.06	21.89
Total subsidies as percentage of budgetary expenditures on:			
Education	104	108	112
Health	121	153	154
Social Security	110	141	120
Total subsidies as percentage of:			
Budget Deficit	37	28	66
Public Sector Deficit	32	27	101

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