Discussion of Mongolia's Draft Future Heritage Fund Law

Natural Resource Governance Institute

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Executive Summary and Key Recommendations

The Future Heritage Fund represents an important development in Mongolia's emergence as a mineral superpower. Designed to save a portion of mineral revenues in foreign assets for the benefit of future generations, the fund has the potential to help address macroeconomic challenges while improving the governance of mineral revenues. In terms of macroeconomic management, the fund could help mitigate Dutch disease effects, help address the perverse effects of upside revenue volatility and encourage inter-generational equity. With regard to governance improvements, the fund could draw public attention to the finite nature of mineral revenues, expand oversight of resource revenues, and make them even more transparent.

In this paper, we draw on international experiences and our understanding of Mongolia's current public financial management system to develop recommendations on how to improve the bill and better incorporate it into the Mongolian legal framework. Specifically, we highlight the need to sequence debt reduction efforts and accumulation of assets in the fund, as well as alternative processes to nominate Governing Board members, methods to reduce investment risk, and suggestions on how to improve transparency and oversight.

Success of the Future Heritage Fund will depend on establishing context-appropriate rules and broad-based acceptance of the rules governing the fund. International experience indicates that if the fund's operational rules are too constraining on public finances or if principle policymakers do not all agree to governing rules before the fund is launched, then the rules are likely to be broken. In the best case, breaking the rules undermines confidence in the public financial management system. In the worst case, it can lead to financial mismanagement, corruption or poor development outcomes.

Our recommendations are designed to help mitigate these risks, with an eye to both the short-term implications of establishing the fund and the long-term goal of generating an endowment for the citizens of Mongolia. A summary of key recommendations is below.

Recommendation 1:

We recommend consideration of a sequenced process, whereby mineral revenues are used to pay down public debt until that debt is at a sustainable level and the government can borrow at a lower interest rate than the return on Future Heritage Fund assets. Some mineral revenues could still be saved during this time as a symbolic gesture toward future generations. Options may include amendments that require:

- Using [70] percent of mineral revenues as defined in the law to pay down public debt principal until 2020, after which the percentage comes under review by the Great State Hural; or

- Using [70] percent of mineral revenues as defined in the law to pay down public debt principal until debt-to-GDP ratio reaches the debt ceiling of 40 percent (as determined by the *Fiscal Stability Law*). Once the debt-to-GDP ratio reaches 40 percent, [30] percent of mineral revenues are used to pay down the public debt.

Recommendation 2:

Consider a new withdrawal rule whereby interest is used to finance public expenditures but the fund's principal is protected. Options could include:

- Withdrawing 100 percent of the fund's net investment income (net of fund administrative costs and adjusted for inflation) using a moving 5-year average (5 years previous)
- Withdrawing 50 percent of the fund's gross investment income using a moving 5-year average (5 years previous)
- Withdrawing 4 percent of the fund annually for budgetary purposes

Recommendation 3:

Consider allowing for withdrawals to begin the year after the first deposits into the fund are made.

Recommendation 4 (new – based on revised bill):

Recommendation 4.1:

Clarify that the government will hire an internationally-recognized independent external management recruitment firm to identify candidates that meet the criteria outlined in Article 21.5 at a minimum, develop a database of pre-qualified candidates, and make recommendations to the Board selectors.

Recommendation 4.2:

Consider one of the alternatives to the Board selection process:

- That the nominating committee of citizens be chosen from a smaller group (for example 25 rather than 70) and that the qualifications for being a member of the nominating committee be changed to represent a cross-section of qualified professionals (e.g., lawyer's association, business leaders, civil society organizations) to broaden the pool of nominees. Furthermore, that the nominating committee be given 3 or 5 days to consider potential Board members, so that they may confer with each other and with the external management recruitment firm. To prevent political interference, this process could be done in secret; or

- That the Great State Hural's finance committee make recommendations on Board member appointments to the Minister for fiscal and budget affairs, based on the list of pre-qualified candidates.

Recommendation 5:

Clarify where FHF assets will be physically held, whether at the Mongolbank or with a custodian institution.

Recommendations 6.1-6.4 – additional points:

Recommendation 6.1: Article 16.4.1 requires that members of the advisory team have at least 15 years' experience in financial asset management. This may limit the pool of talent excessively and may be unnecessary for the position. It is also five years more than for Governing Board members and Supervisory Board members. 10 years' experience may be sufficient.

Recommendation 6.2: Article 18.1 allows the government to liquidate the corporation. This could lead to a situation where the government decides to empty the fund unilaterally. We would recommend an amendment that states that only the Great State Hural can liquidate the corporation.

Recommendation 6.3: Article 18.8.2 refers to the corporation's shares and share price. It is unclear why the corporation requires more than one share and why shares would be priced when the government is and will continue to be the 100 percent shareholder of the corporation. We would recommend that the article be deleted or that the FHF's ownership shares be non-transferable, meaning that the fund's shares can never be sold.

Recommendation 6.4 (new – based on revised draft): Article 9.4 prevents the corporation's operational expenses from decreasing, no matter what the rationale. It is conceivable that the corporation will find less expensive asset managers or that compensation will be found to be too high at a specific moment in time. Thus, the Board should be allowed to decrease compensation accordingly. We recommend deleting Article 9.4.

Recommendation 7:

Consider making explicit a list of assets that the FHF cannot invest in, such as low-grade securities, real estate, commodities or derivatives. Ghana and Timor-Leste provide useful models. Drawing on these examples, language such as the following could be included in the legislation:

“The Future Heritage Fund may only invest in the following financial instruments:

- A debt instrument denominated in internationally convertible currency that bears interest or a fixed amount equivalent to interest that is of an investment grade security and that is issued by or guaranteed by the International Monetary Fund or by a sovereign state other than Mongolia, if the issuer or guarantor has investment grade rating.
- An internationally convertible currency deposit or a debt instrument denominated in any internationally convertible currency that bears interest or a fixed amount equivalent to interest issued by
    - (i) the Bank for International Settlements
    - (ii) the European Central Bank
    - (iii) the central bank of a sovereign state, other than Mongolia, with a long-term investment grade rating
- A variable income security, namely listed shares, denominated in internationally convertible currency, traded on regulated financial markets.

No more than [40 percent] of the Future Heritage Fund assets will be invested in eligible investments in the form of variable income securities, namely listed shares. Participation will not exceed 5 percent of the capital issued by the issuer.

The exposure of the Future Heritage Fund to any company or the issuing entity for the eligible instruments, with the exception of sovereign states, can never exceed 3 percent of the total value of the Future Heritage Fund.

The Future Heritage Fund shall be prohibited from investing in non-investment grade or excessively volatile assets such as commodities, over-the-counter derivatives, or real estate.”

Recommendation 8:

Require that public reports listed in Article 28 include individual assets, names of board members and material transactions, and that the reports be posted online in an easy-to-read format.

Recommendation 9 (new – based on revised bill):

Consider one of the following options to ensure that independent external audits are carried out and made public:

- Amend Article 30.1.1 to require that external audits be undertaken annually and that these reports be made publicly available; or

- Amend Article 13.7 to give the Auditor-General the mandate to independently audit the accounts and activities of the corporation, rather than rely simply on corporation reports.

Recommendation 10:

Amend Article 26.1.5 to notify the Minister if the fund's total asset value decreases by 10 percent or more in a given quarter.

Introduction

Governments often exclude some revenues, expenditures or financing from their annual budget laws, instead using separate banking or institutional arrangements called 'extra-budgetary funds' to save revenues for the future or finance particular items. The most common extra-budgetary fund is a public pension fund, such as the Canada Pension Plan. Other types include development funds that earmark spending for specific purposes like roads or environmental protection (e.g., Alabama (USA)'s Forever Wild Land Trust Fund); donor funds that manage donor aid under special conditions (e.g., Liberia Health Sector Pooled Fund); and multi-year budgets that do not expire at the end of the fiscal year (e.g., Timor-Leste's Infrastructure and Human Capacity Development Funds).[1]

Extra-budgetary funds are established for different reasons. They can address a need for guaranteed multi-year financing, save government revenues for future generations, secure sources of funding for specific projects, or protect politically sensitive programs from budget cuts. Unfortunately, in many cases, they have also been used to circumvent parliamentary or citizen oversight, skirt established procurement procedures or keep certain activities of the government secret.

The Government of Mongolia currently controls about 25 extra-budgetary funds including the Budget Stabilization Fund, Human Development Fund, National Roads Fund and Culture and Art Development Fund.

The Great State Hural is now considering the creation of a new fund called the Future Heritage Fund (FHF). The FHF is proposed as a unique type of extra-budgetary fund called a sovereign wealth fund (SWF). SWFs are government-owned savings mechanisms and that invest mainly in *foreign* assets. Their overall objective is generally to address macroeconomic challenges, such as mitigating the Dutch disease by 'parking' money outside the economy, transferring financial assets from current to future generations, or helping to smooth expenditure volatility. SWFs are generally financed out of fiscal surpluses or natural resource revenues.

SWFs are usually governed by three sets of operational constraints: Deposit rules (which revenues enter the fund and when), withdrawal rules (how often transfers to the budget can be made, their size and what approvals are needed), and investment rules (what assets can the fund invest in). They are also usually subject to a clear management structure, strict transparency requirements, and strong independent oversight. General guidance on establishing a SWF can be found in our publication *Managing the Public Trust: How to make natural resource funds work for citizens* (online at www.resourcegovernance.org/nrf).

In this paper, we will analyze the proposed law on Mongolia's Future Heritage Fund, drawing on lessons learned from our research into SWF governance, experience providing technical assistance in this area, and our understanding of the Mongolian economic situation. Our ultimate aim is to suggest modifications to the bill so that the FHF improves the governance of Mongolia's natural resource wealth. First, we will

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[1] Allen, Richard and Dimitar Radev, *Extrabudgetary Funds*. IMF: Washington, D.C. (2010). http://www.imf.org/external/pubs/ft/tnm/2010/tnm1009.pdf.

discuss the Mongolian economic context today and in the future. Second, we will examine the current framework for fiscal stability and sustainability with an eye to how the FHF will fit into the current framework. Third, we will analyze the draft legislation, compare to international good practices and provide recommendations on possible amendments. Of importance, in this paper we refer to the version of the draft legislation publicly available on the Great State Hural website as of March 2015 and proposed amendments to other bills as of October 2015.

Part I: Mongolian Economic Context

Where they improve public financial management systems, SWFs are generally established in natural resource-rich countries to address a specific set of macroeconomic challenges associated with large oil, gas or mineral revenue inflows. In the short-term, resource-rich countries may experience 'Dutch disease' effects during a surge in mineral revenues. Dutch disease refers to a loss in export competitiveness caused by an exchange rate appreciation or a sharp increase in inflation in non-tradeables (e.g., taxis, housing, restaurants). In this case, real exchange rate appreciation (inflation or nominal exchange rate appreciation) is caused by a large inflow of foreign capital from the oil or mineral sector. Large revenues can also overwhelm the government's ability to spend money effectively if it does not have adequate 'absorptive capacity', leading to wasteful spending and rising costs of public infrastructure. Dutch disease effects can be mitigated by 'parking' some revenues abroad in foreign assets for a time, until the economy develops the absorptive capacity to spend the money without generating inflation or exchange rate appreciation.

In the medium-term, resource-dependent governments usually experience severe fiscal revenue volatility which translates into expenditure volatility. In resource-dependent countries, if the government spends all the revenues it receives, then expenditure oscillate up and down accordingly, causing three problems. One, when revenues increase quickly, there is an incentive to spend on 'legacy' projects like concert halls or monuments rather than social programs like health and education, in other words to make poor investment decisions. Two, when revenues decline unexpectedly, the government is forced to make painful cuts or borrow. With each up and down in spending, public debt is ratcheted up, which could eventually lead to a debt crisis. Three, unpredictable revenues makes development planning difficult, leading to overspending and, again, poor spending choices. Governments can delink expenditures from revenues by saving a portion of revenues in SWFs when they are high and draw down on these savings when revenues decline. This would mitigate harmful 'boom-bust' cycles. Mongolia's Budget Stabilization Fund was designed with this purpose in mind.

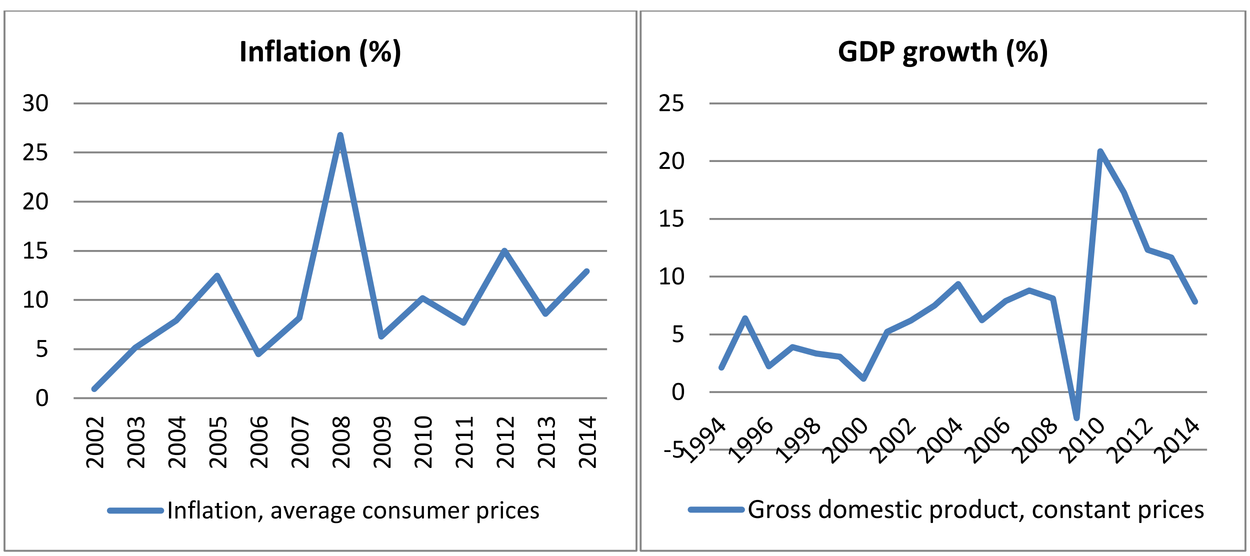
In the longer-term, oil, gas and minerals will eventually be depleted. Since these sources of revenue are finite, unless alternative tax revenues are collected or revenues are saved in a fund, the government will eventually have to cut spending or borrow unsustainably when these resources are exhausted. As a result, governments in oil-, gas- or mineral-rich regions may want to save some revenues and invest them in foreign assets for the future. There is also a moral case that revenues from natural resources belong to future generations as much as present generations. Therefore they should be saved, to be spent later (as long as the cost of public debt is not large than the interest on savings). Finally, precautionary savings are useful to have in case of environmental, social or economic crisis, such as drought.

Despite being in the nascent stages of a potentially century-long resource boom, Mongolia already experienced Dutch disease effects during the previous period of high commodity prices. Dutch disease effects and the stresses on economic absorptive capacity are evident in both the data and anecdotally. Inflation has run at above 8 percent fairly consistently since 2007 and spikes in inflation have followed spikes in government spending (and fiscal revenues) (see Figure 1). Moreover, up until the recent collapse in commodity prices, Mongolia witnessed a significant construction boom without much corresponding growth in the non-resource export sector, a typical sign of Dutch disease.

However an even bigger challenge has been the negative consequences on growth and prosperity generated by GDP, real effective exchange rate and fiscal expenditure volatility. Output volatility has been shown to generate lower growth, worse investment choices in the private and public sectors and is bad for long-term investment.[2] The poor are particularly susceptible to these negative effects.

As Figure 1 shows, Mongolia's GDP growth has been extremely volatile since 2008. GDP volatility is directly related to inflows and outflows of capital associated with mining investment and revenues. One effect has been on the real effective exchange rate—a measure of the value of the tugrik against a trade-weighted average of several foreign currencies—which has also been extremely volatile since 2008 (see Figure 2). This lack of predictability of import and export prices and costs has undoubtedly generated a large disincentive to produce tradeable goods in Mongolia, thereby harming growth and industrial prospects.

Figure 1: Inflation and GDP Growth in Mongolia

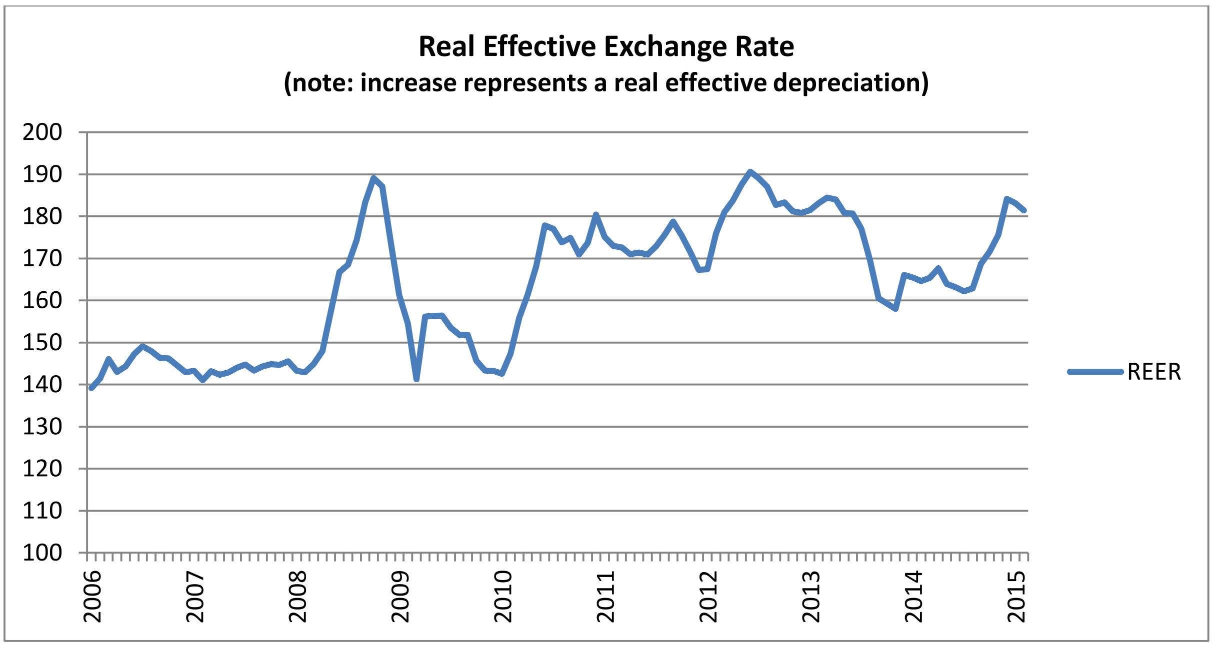


[2] For instance, see Fatas (2002), Serven (1998) and Ramey and Ramey (1995).

Data Source: IMF

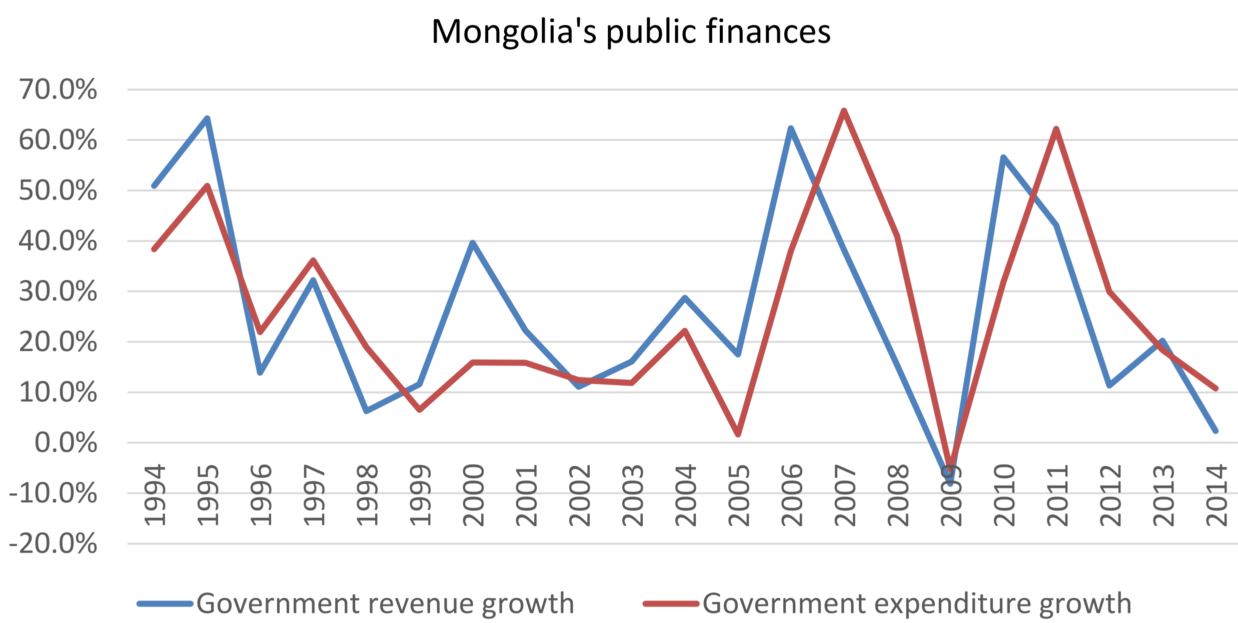
Another effect has been on the Mongolian government budget. Fiscal revenues have oscillated dramatically in reaction to commodity prices and investment in the mining sector. As is the case in many countries suffering from a version of the 'resource curse', government spending has closely followed revenues, generating significant volatility in fiscal expenditures (see Figure 3). In contrast, Chile, another copper-rich country, has delinked expenditures from revenues in order to smooth year-to-year fiscal spending (see Figure 4). Unless fiscal stability rules are enhanced and observed, this situation will only get worse as the Government of Mongolia increases its dependence on mineral revenues.

Figure 2: Real Effective Exchange Rate (REER) in Mongolia



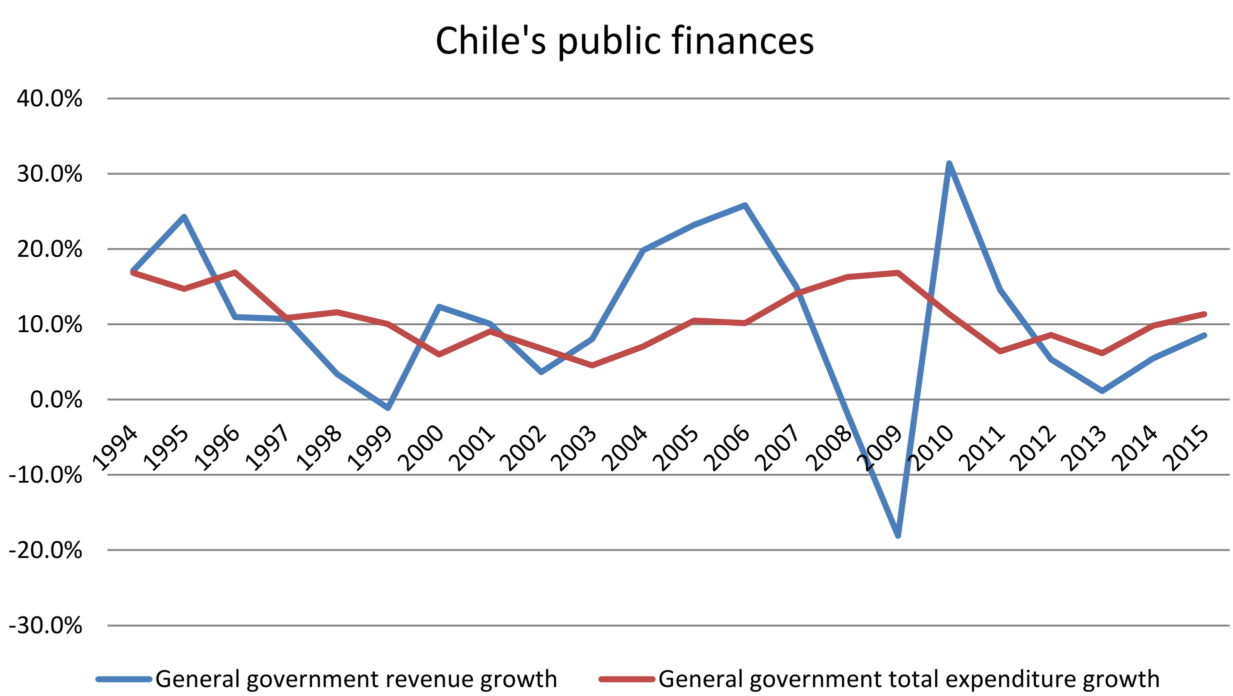
Data Source: Mongolbank

Figure 3: Revenue and Expenditure Growth Volatility in Mongolia



Data Source: IMF

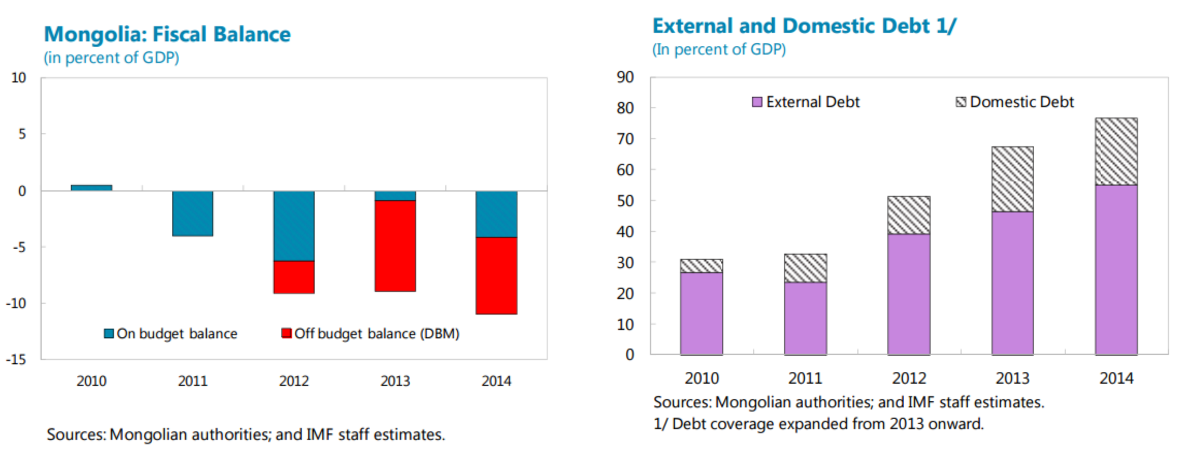
Figure 4: Revenue and Expenditure Growth Volatility in Chile



Data Source: IMF

Expenditure volatility has significantly contributed to Mongolia's current public debt challenges. With each downswing in fiscal revenues, the government has compensated by borrowing. While this policy action has helped buffer the economy from the drop in commodity prices, it has also led to a ratcheting up of public debt levels with each downswing. Mongolia's fiscal balance was already negative when the current crisis hit, however the drop in revenues has exacerbated the structural deficit and led to a sharp increase in public debt levels (see Figure 5).

Figure 5: Mongolia's Fiscal Balance and Public Debt Levels (drawn directly from IMF Article IV Consultation report)



Fiscal sustainability has become a major area of concern in Mongolia. Over the long-run, government liabilities (e.g., public pensions; public salary obligations; public debt) cannot grow faster than assets (e.g., tax obligations; expected mineral royalty streams; physical public infrastructure), otherwise the government is deemed to be in an unsustainable fiscal position. A continuation down the same path may lead to default on public debt or an inability to pay for essential public services. The consequences for the Mongolian economy and its people could include economic contraction, IMF bailout and imposition of (potentially unpopular or damaging) IMF conditionalities.

Currently the government's liabilities are growing much faster than its assets. Official public and publicly guaranteed debt reached nearly 57 percent of GDP by the end of 2014. If non-guaranteed state-owned enterprise debt and Mongolbank liabilities to the People's Bank of China (PBOC) are included, public debt reached 77 percent of GDP. With an expected fiscal deficit of nearly 10 percent of GDP in 2015 (including the Development Bank of Mongolia's fiscal balance), the overall debt burden is expected to grow substantially over the coming years.[3]

The market is reflecting this reality. On May 12th of this year, the Trade and Development Bank of Mongolia floated a 5-year government-guaranteed USD 500 million bond at over 9 percent annual interest.[4] Should the government float its own debt in US dollars, it could expect to pay similarly high interest rates.

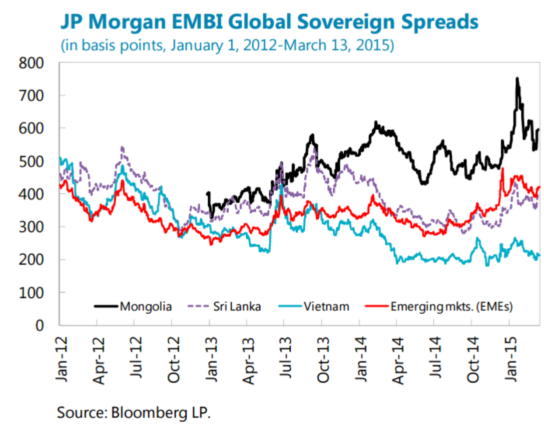
[3] IMF Article IV Consultation 2015

[4] 1-3 year tugrik-denominated government bonds were sold at over 15 percent in October 2015.

Furthermore, sovereign bond spreads on secondary markets are running at about 4 percent more than Vietnam and 2 percent more than the average emerging market economy, reflecting the market's view that Mongolia is a default risk (see Figure 6). The IMF warns that the government will face an important reckoning point in 2017 when the debt-to-GDP ratio reaches 92 percent and a set of Chinggis bonds matures. At this point the government will need to refinance its debt, likely at a much higher interest rate than it is currently paying. Another reckoning point will come in 2022. In the IMF's words, "Mongolia is thus assessed to be at high risk of debt distress."[5] The evidence points to an urgent need to pay down debt to avoid a fiscal and sovereign debt crisis.

Equally important is the inter-generational case for paying down debt. Based on IMF figures and NRGI calculations, interest payments on public debt are expected to be approximately 700 billion tugriks, or 11 percent of fiscal revenues, in 2015, and approximately 1 trillion tugriks, or 14 percent of fiscal revenues, in 2016. Is it fair for current generations to be paying 11 percent of all revenues collected—or nearly 6 percent of GDP—to Mongolia's creditors? This is nearly twice what Greece is paying its creditors in annual interest. And is it fair to saddle future generations with an even higher repayment burden?

Figure 6: Global sovereign spreads (drawn directly from IMF Article IV Consultation report)



Mongolia cannot count on GDP and fiscal revenues to increase indefinitely, or even in the medium-term. Even if mineral prices rebound over the next couple of years, the lead times on mineral projects mean that new sources of mineral revenues may be years away. Oyu Tolgoi is also unlikely to generate transformative revenues in the medium-term, as the project enters the cost recovery phase and the government must pay its equity share. These facts once more point to the need to focus on debt repayment in the short- to medium-term, until the debt-to-GDP ratio has reached a sustainable level. The alternative could find Mongolia in a debt crisis, subject to IMF conditionalities and having to cut government wages, programs and infrastructure projects.

Over the longer-term, there is a good case to be made for saving a portion of mineral revenues in the Future Heritage Fund. First, by saving a portion of revenue windfalls, the government could both help

[5] IMF Article IV Consultation 2015

mitigate Dutch disease effects during boom periods and mitigate the negative effects of an unexpected upswing in mineral revenues. Second, it could generate an endowment for the benefit of future generations. If the fund is well protected, the interest can be used to support fiscal expenditures indefinitely. That said, the priority over the next few years should be on debt repayment.

Part II: Current Legal and Fiscal Framework

Several laws form the principle framework for macroeconomic management in Mongolia. Here we will highlight some key existing provisions that determine the flow of funds from the General Department of National Taxation (under supervision of the Minister of Finance) to the budget and various funds. This list is not inclusive.

Budget Law (2011)

The *Budget Law* outlines the flow of mineral funds to different bodies and levels of government (Article 23). Among taxes and royalties derived from non-renewable resource extraction, corporate income taxes, VAT, excise taxes, customs duties, mineral resource exploitation taxes, mining and exploration license fees, state-owned enterprise dividends from non-strategic deposits, and 70 percent of royalty payments from oil are some of the main streams going to the national government. However 25 percent of VAT, 5 percent of mineral resource exploitation taxes and 30 percent of oil royalty payments are placed into a General Local Development Fund for reallocation to Ulaanbaatar, aimags, soums and districts, with mineral-producing areas receiving 10 percent more per capita than non-producing areas (Article 59).

Land fees, 20 percent of license payments from oil exploration and exploitation, and dividends from aimag-owned state-owned companies accrue to aimags and the Ulaanbaatar city. Some mineral fees and dividends from soum and district-owned state-owned companies accrue to soums and districts.

A key provision relevant to this discussion is Article 21.1 which states “the Unified Budget of Mongolia is comprised of the state budget, local budgets, the budget of the Social Insurance Fund and the budget of the Human Development Fund.” Article 18.5 states that government special funds shall be part of the state budget. And proposed a proposed amendment to the Government Law on Special Funds would ensure that the Future Heritage Fund be listed as a special fund under Article 5.4.27. Therefore the Future Heritage Fund would, in theory, be incorporated into the budget process.

Human Development Fund Law (2009)

The law states that the following revenues are to be deposited into the Human Development Fund (HDF):

- State-owned enterprise dividends from strategic mineral deposits
- 70 percent of royalty payments from companies extracting or processing strategic mineral deposits
- Prepayments and loans from strategic mineral deposits

- Returns on HDF investments

The Fund is managed by the Ministry of Finance, though its assets may be managed by external managers. Under Article 3.4, the HDF may borrow on financial markets. The HDF budget is approved through the normal budget process and the government must report to the Great State Hural and the public on fund activities. The fund is subject to National Audit Office and external audit oversight.

The law also states that a state-owned company (unnamed but actually Erdenes Mongol) can hold shares in strategic mineral deposits. These shares are distributed to citizens of Mongolia and are non-transferable. The government may distribute these shares in the form of pensions, health insurance, repayment of mortgages, child payments, cash, medical fees and education fees. In practice, this section of the law was used to distribute shares of Erdenes Tavan Tolgoi, a subsidiary of Erdenes Mongol, to each Mongolian citizen.

The state-owned company's Board of Directors consists of six members nominated by the Cabinet and three members nominated by each of the Mongolbank, central administrative body and financial regulatory commission. Board members serve six year terms. A Supervisory Board nominated by parliament reports to the Great State Hural on the company's activities.

Law on Government Special Funds (2006)

The *Law on Government Special Funds* establishes a number of extra-budgetary funds for a range of purposes. These extra-budgetary funds are earmarked accounts, approved through the budget process, not to be confused with 'off-budget' funds which are completely divorced from the budget process. Particularly relevant to this discussion, we note the following funds:

- Government reserve fund: Established to respond to environmental, engineering, or security-related emergencies, though it can be used for almost any purpose. Financing comes from the budget.
- Contingency fund: Established to respond to restrictions on agricultural exports, financial crises, unexpected increases in commodity prices or other negative shocks to domestic production. Financing comes from the budget.
- Budget stabilization fund: The objective of the fund is to finance an unexpectedly large budget deficit. Transfers to the budget can be made under four conditions: (1) If the actual budget deficit is greater than the planned budget deficit by an amount equal to 4 percent of GDP, and the cause was an unexpected drop in mineral revenues; (2) If GDP contracts in a given fiscal year; (3) If natural disaster or national emergency costs more than 5 percent of GDP; and (4) If mineral revenues unexpectedly decline due to a minimum 20 percent decrease in mineral prices or volume. The budget stabilization fund is financed out of budget surpluses, unused portions of the reserve fund and contingency fund, and its own returns. Calculations for the budget surplus are outlined in the *Fiscal Stability Law*. According to Article 16.2 of the *Fiscal Stability Law*, the value of the budget stabilization fund's assets must not be less than 5 percent of GDP starting in 2018. Also, once the fund reaches 10 percent of GDP, the excess above that amount is to be invested in foreign markets and with the Development Bank of Mongolia for investments in

railroads, oil processing, power stations, or high quality export goods and services (Article 17 of the *Fiscal Stability Law*). The Mongolbank will make investments in foreign assets on behalf of the government.

While the government must report on the activities of these and other funds, once revenues are allocated to the funds, only the Cabinet reviews and approves expenditure decisions. Most funds are held at the Treasury and subject to internal audit. Parliament may review special fund reports but is under no obligation to do so.

Fiscal Stability Law (2010)

The *Fiscal Stability Law* establishes three fiscal rules:

- Balanced budget rule: The fiscal deficit cannot exceed 2 percent of GDP (starting in 2018); 4% in 2016; 3% in 2017. The fiscal deficit target shall be reviewed every four years.

- Debt ceiling: Net present value (NPV) of public debt cannot exceed 40 percent of GDP (starting in 2018); 55% in 2016; 50% in 2017. Of note, for the purposes of this rule, the definition of NPV of public debt does not include government guarantees, Mongolbank foreign liabilities, or state-owned enterprise borrowing (e.g., Development Bank of Mongolia debt).

- Expenditure rule: Expenditure growth limited to the greater of non-mineral GDP growth or non-mineral GDP growth over a 12-year period.

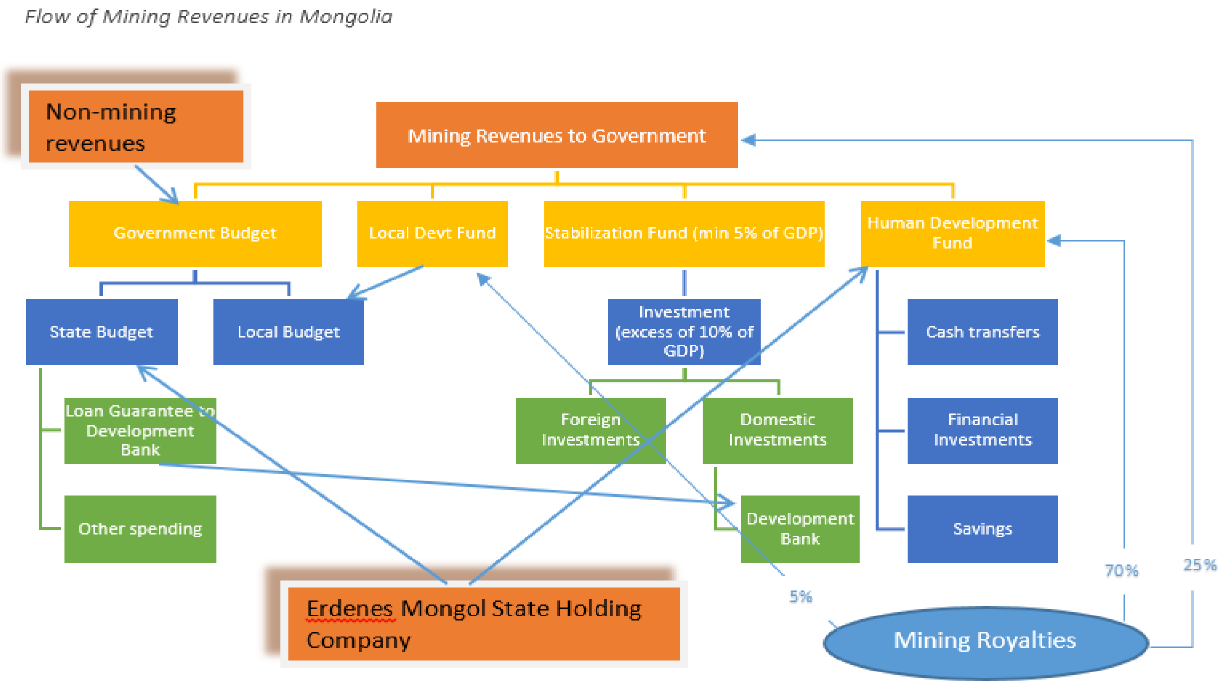
One additional rule stipulates that the fiscal revenue projections will be estimated using “structured procedures” (Article 6.1.1). According to the Ministry of Finance, this is interpreted as a revenue rule requiring savings in the budget stabilization fund in cases of mineral revenue windfall. In practice, when revenues from a single mineral exceed 3 percent of fiscal revenues, the windfall (calculated using a long-term average price) is saved in a stabilization fund. A shortfall triggers a transfer from stabilization fund under the *Law on Government Special Funds (2006)*. The *Fiscal Stability Law* allows for exceptions in case of recession, natural disaster or national emergency. Suspension of the rules requires State Great Hural approval.

At this time, only the expenditure rule acts as a constraint on public finances.

The Medium Term Fiscal Framework, Government Action Program and annual budget should reflect these fiscal rules. The government must report on compliance with the rules. The State Audit Office also oversees compliance. If the government fails to comply with the rules, the budget may be returned or the resignation of the government may be raised by the Great State Hural. If the Great State Hural does not comply with the rules, the President may veto the budget bill.

A simplified illustration of the flow of mineral revenues, based on the system just described, can be found in Figure 7.

Figure 7: Flow of mineral revenues under the current system



Part III: Analysis of the Future Heritage Fund bill

As we have seen, a significant portion of mineral and oil revenues are already earmarked for specific funds or expenditure items. According to the most recent EITI report, MNT 1,576 billion was collected in 2013, representing 26 percent of fiscal revenues. Of this, 92 percent accrued directly to the central government. However, according to the rules, approximately 5.5 percent of all oil and mineral revenues should have been deposited into the General Local Development Fund and approximately 47 percent should have been deposited into the Human Development Fund. Furthermore, slightly less than 11 percent of resource revenues was allocated to the fiscal stabilization fund. The approximately 29 percent remaining of oil and mineral revenues should have been distributed between the budget and various other funds.

While these percentages change year-to-year depending on the taxes and royalties detailed in different extractive project contracts as well as resource prices and volumes of production, the data from 2013 gives us some indication of how the current system distributed resource revenues. It also gives us a starting point for projecting the potential impact of the Future Heritage Fund bill on the flow of funds.

Deposit and Withdrawal Rules: Implications for Mongolian Public Finances and Economic Development

Article 7 of the draft FHF bill shifts deposits of mineral revenues from the Human Development Fund to the FHF. Deposits include:

- State dividends from the development mineral projects
- 65% of royalties from mineral projects, after distribution to the Stabilization Fund
- Returns on development fund investments

Additionally, the new fund plans to collect:

- 50% of additional, new mining revenue ("revenue" remains undefined, though the law specifies that amendments to existing laws qualifies as new mining revenue; unclear which of new revenues such as corporate income tax, bonus payments, windfall profits taxes, withholding taxes or service charges, for example)
- 20% of unexpected mineral revenue windfalls (not including state dividends or royalties) (as of 2018)

A proposed amendment to the *Law on Invalidation of a Law* explicitly dissolves the Human Development Fund. Unlike the Human Development Fund, the FHF will not collect bonus payments and loans from strategic mineral deposits, though, if they are newly introduced stream, 50% of these payments may be captured under bullet #4. The rest would enter the budget.

Since robust mineral revenue projections are unavailable, we are not in a position to estimate the impact on the budget. However, if we assume that all streams of mineral revenues will continue to constitute on average about 25% of fiscal revenues, as they did in 2013, and if we make a number of assumptions about royalty, state dividend and tax revenues going forward, then we can guess that approximately 25-50% of mineral revenues (not including oil) might be deposited into the FHF in an average year. In other words, under the current draft, approximately 25-50% of mineral revenues would be saved until 2030, after which 10 percent of the FHF's net investment income, or approximately 0.2-0.5 percent of the value of FHF assets would be withdrawn annually (Article 9.6).

Issue 1: Savings rules and public borrowing

Unlike most other SWFs which are financed out of fiscal surpluses (e.g., Chile, Kazakhstan, Norway, Qatar, Saudi Arabia, Timor-Leste) and/or were established in countries with low or declining public debt levels (e.g., Botswana, Russia), the FHF is being established in a context of significant budget deficits and a large and growing debt-to-GDP ratio. This has implications for the deposit and withdrawal rules governing the fund. Most importantly, it could lead to a situation whereby mineral revenues are deposited into the fund and being invested in foreign assets at 2-4 percent real return (the current average real return for low-to-moderate risk profile SWFs), at the same as the government is borrowing on international financial markets and paying 5-10 percent real interest (the current rate, which could rise).

We have witnesses this situation in other countries, most recently in Argentina, Ghana and Venezuela. In each of these cases, the interest paid on sovereign debt has been higher than the financial return on public savings over the last two years. The policy response has been the same in each: Breaking budget rules to draw down on national savings in order to finance spending or reduce the public debt burden. In Argentina, the public pension fund, ANSES, made over $14 billion in low interest loans to the government from 2013-14. In Ghana, the government raided the oil-financed Ghana Stabilization Fund using a legal loophole to cap the size of the fund and continues to borrow heavily. The IMF and the government have just agreed on a bailout package that involves public sector job cuts. In Venezuela, the government emptied the Macroeconomic Stabilization Fund which had stood at $7.1 billion in 2001. The country now faces a fiscal crisis and violent protests on the streets against economic hardship.

These policy responses may or may not be wise given the fiscal challenges each government has faced. However they highlight the dangers of borrowing at a high interest rate and attempting to save simultaneously. In Mongolia, the likely response could be to break any savings rules immediately, thereby undermining confidence in the FHF and the government's commitment to intergenerational equity. An alternative policy option would be to pass legislation that addresses the need for savings in the long-run while addressing Mongolia's acute spending and debt challenges today.

Recommendation 1:

We recommend consideration of a sequenced process, whereby mineral revenues are earmarked for public debt repayment until debt is at a sustainable level and the government can borrow at a lower interest rate than the return on FHF assets. Some mineral revenues could still be saved during this time as a symbolic gesture toward future generations. Options may include amendments that require:

- Using [70] percent of mineral revenues as defined in the law to pay down public debt principal until 2020, after which the percentage comes under review by the Great State Hural; or
- Using [70] percent of mineral revenues as defined in the law to pay down public debt principal until debt-to-GDP ratio reaches the debt ceiling of 40 percent (as determined by the *Fiscal Stability Law*). Once the debt-to-GDP ratio reaches 40 percent, [30] percent of mineral revenues are used to pay down the public debt.

Issue 2: Efficient amount of savings?

As mentioned, the current deposit rules imply saving approximately 25-50 percent of mineral revenues for future generations, or 6-13 percent of the budget in any given year. If mineral revenues increase, more of the budget is saved; if mineral revenues decrease, then less is saved. Thus the rule is mildly counter-cyclical, somewhat addressing any potential Dutch disease and volatility challenges. That said, the law does not address the consequences of a sudden drop in resource revenues. In theory, the budget stabilization fund should help compensate for this eventuality once it grows to an adequate size.

One question the Government of Mongolia and legislators may wish to consider is whether 6-13 percent of the budget is the efficient amount of savings. While it may help mitigate Dutch disease effects and upside volatility, it will significantly constrain spending. An 'efficient' level of savings would take into account the 'absorptive capacity' of the government to spend windfall revenues, meaning that if the government can transform resource revenue windfalls into productive social services or infrastructure, it should be allowed to do so. However if there are absorptive capacity constraints—which do exist in Mongolia—then saving a portion of windfall revenues may be appropriate. While there is no scientific answer, our inclination is that the proposal seems to find a reasonable balance between savings and spending.

Issue 3: Withdrawal rules

We note that Article 9.6 requires mineral revenues to be saved until 2030, after which 10 percent of the FHF's net investment income, or approximately 0.2-0.5 percent of the value of FHF assets, would be withdrawn annually. Since the average annual real return on the fund may be expected to be between 2-4 percent, the current proposal would lead to compound growth of approximately 1.8-3.5 percent of the principal. In other words, the fund would grow exponentially rather than generating returns for the government and citizens of Mongolia. Also, relying on a single year of net return would generate an unpredictable transfer of funds to the budget, especially in the fund adopts a higher-risk investment strategy. Most funds use a multi-year average of returns to determine transfers to the budget.

If the goal of the fund is to generate a sustainable flow of funds to the government to finance social services and infrastructure, we would recommend using a permanent income approach whereby transfers to the budget equal an average of the real return on assets. This is a similar approach to that used by SWFs in Alaska (USA), North Dakota (USA), Norway, Texas (USA), Timor-Leste, and Wyoming (USA).

Based on other country experiences, we would also suggest considering making withdrawals as of the second year of operations rather than waiting until 2030. Citizens are more likely to support national savings and protect their mineral revenue endowment if they see immediate and direct benefits from the FHF, as we have seen in Norway, Timor-Leste, Alberta (Canada) and most Persian Gulf countries. While making withdrawals earlier implies that the size of the fund will be smaller in the long-run, the political imperative to protect the fund from raiding may outway the financial benefits of growing the principal in the first few years of operations.

Recommendation 2:

Consider a new withdrawal rule whereby interest is used to finance public expenditures but the fund's principal is protected. Options could include:

- Withdrawing 100 percent of the fund's net investment income (net of fund administrative costs and adjusted for inflation) using a moving 5-year average (5 years previous)
- Withdrawing 50 percent of the fund's gross investment income using a moving 5-year average (5 years previous)
- Withdrawing 4 percent of the fund annually for budgetary purposes

Recommendation 3:

Consider allowing for withdrawals to begin the year after the first deposits into the fund are made.

Fund Management

In most countries, the fund's investment mandate is set by the fund manager, usually a Governing Board consisting of the Minister of Finance and others. Day-to-day operational management is usually left to a competent and independent agency, usually the central bank but sometimes a new agency. From a cost and efficiency perspective, it is generally advisable to designate an existing competent and independent institution (should one exist) with operational management duties than an unproven or inexperienced institution.

The draft legislation proposes that the Minister for fiscal and budget affairs be the manager. This is in line with international practice. It also proposes a 5-member supervisory council which provides oversight of the FHF on behalf of the Minister, as well as a 3-member advisory team to advise the Minister on the investment mandate and support the Minister's analysis of fund operations. The State Central Administrative Body would support the Minister in developing the FHF's investment mandate and support establishment of the various management bodies and operations of the fund.

Article 18 calls for the creation of a new corporation to act as operational manager. While certain countries have gone down this path— funds in Abu Dhabi (UAE), Alberta (Canada), Azerbaijan and Kuwait are managed by a state-owned corporation—others have been managed by central banks or nonpolitical departments within the government. Examples of the latter include Alaska (USA), Botswana, Chile, Ghana, Kazakhstan, Norway, Timor-Leste and Trinidad & Tobago.

Issue 4: Board pre-selection and nomination

It is proposed in Article 20 that the five-member Governing Board of the new corporation would be chosen by a nomination committee consisting of five citizens chosen at random from a pool of at least 70 citizens. The committee is then given 8 hours to select the Governing Board members. While this process may reduce the probability of politically-motivated appointments, improvements could be made with regard to pre-selection criteria and the nomination process.

According to OECD and World Bank guidelines on state-owned company board nominations, while the relevant Minister is usually involved in the nomination process, independent bodies can serve a useful purpose in encouraging political independence. Independent bodies can support both vetting potential board members and the nomination itself. In Portugal, the UK and New Zealand, an independent committee of career civil servants establishes pre-selection criteria, conducts due diligence on each candidate (including conflict of interest clearance and background checks) and makes recommendations to the government on board members. In other countries, like Chile and Finland, the government relies on independent external head-hunters or management recruitment consultants to identify suitable board members and in some cases to maintain a database of pre-qualified candidates. Russell Reynolds Associates and Inac are just two of the globally recognized executive search firms that offer these services. Thailand also uses a database of pre-qualified candidates for choosing board members.

Article 20.10 of the latest draft of the bill tasks the fiscal and budget affairs ministry with pre-selecting qualified candidates for the board "with the support of the specialized entity operating internationally".

While this article goes some way to improving the fitness of prospective Board members to serve, we are concerned that the proposed selection process may be overly bureaucratic without necessarily achieving the laudable goal of ensuring a truly independent Board. Furthermore, the phrase “with the support of the specialized entity operating internationally” does not clarify that an internationally-recognized independent external management recruitment firm will be used to identify candidates that meet the criteria.

In most countries, the board itself is involved in the process as an advisor. Equally important is that board positions and qualifications be advertised and the results of the nomination process be made public.

The FHF bill could incorporate some of these strategies. Several policy options are listed below.

Recommendation 4.1:

Clarify that the government will hire an internationally-recognized independent external management recruitment firm to identify candidates that meet the criteria outlined in Article 21.5 at a minimum, develop a database of pre-qualified candidates, and make recommendations to the Board selectors.

Recommendation 4.2:

Consider one of the alternatives to the selection process:

- That the nominating committee of citizens be chosen from a smaller group (for example 25 rather than 70) and that the qualifications for being a member of the nominating committee be changed to represent a cross-section of qualified professionals (e.g., lawyer’s association, business leaders, civil society organizations) to broaden the pool of nominees. Furthermore, that the nominating committee be given 3 or 5 days to consider potential Board members, so that they may confer with each other and with the external management recruitment firm. To prevent political interference, this process could be done in secret; or
- That the Great State Hural’s finance committee make recommendations on Board member appointments to the Minister for fiscal and budget affairs, based on the list of pre-qualified candidates.

Issue 5: Strengthening political independence of board members

Article 21.5 outlines the qualification for a board member. These are (paraphrased from the draft law):

- Have at least 10 years professional experience as a financial officer or analyst, certified accountant, auditor or lawyer with relevant experience
- Have an undergraduate degree in economics, finance or securities
- Have experience managing a large amount of assets
- A strong ethical and personal reputation, have no overdue debts, and no criminal record
- Not be a state political official, member of a political party, be a former fund asset manager, or have a personal financial interest in any fund manager

Based on the World Bank's definition of an "independent board member", additional requirements could be included in the legislation to help prevent conflict of interest in section 21.5, such as:

- A board member or immediate family of a board member cannot be an employee of, have a service contract with, or hold an ownership interest in an entity in which the corporation is an investor
- A board member cannot have been an advisor, auditor or consultant to the corporation or any entity the corporation controls
- Candidates whose immediate family was an executive officer employed by the corporation or by an entity controlled by the corporation as over the last five years are disqualified

At the same time, we recognize that the Law in Regulating Public and Private Interests and Preventing Conflict of Interests in Public Service covers the Board of any state owned corporation or entity controlled by the Ministry of Finance. While this law may not be enforceable for private entities engaged in FHF management, it should cover Board activities.

Issue 6: Clarifying the physical location of the FHF

Article 25.18 calls for the hiring of a custodian institution to physically hold FHF assets. However Article 18.3 refers to checking accounts at the Mongolbank. It may be useful to clarify where the funds will be physically held. While the governments of Botswana, Ghana, Norway, Russia and Trinidad & Tobago have each chosen to have their central banks host their respective funds, others, such as Azerbaijan, Chile, Kazakhstan, Kuwait, and North Dakota (USA), use a custodian. While custodial institutions are politically independent and can perform useful financial services, like recordkeeping, tax administration and arranging settlements, they can charge large management fees. Should one be used, it may be important to set strict guidelines on their mandate and fee structure.

Recommendation 5:

Clarify where FHF assets will be physically held, whether at the Mongolbank or with a custodian institution.

Recommendations 6.1-6.3 – additional points:

Recommendation 6.1: Article 16.4.1 requires that members of the advisory team have at least 15 years experience in financial asset management. This may limit the pool of talent excessively and may be unnecessary for the position. It is also five years more than for Governing Board members and Supervisory Board members. 10 years experience may be sufficient.

Recommendation 6.2: Article 18.1 allows the government to liquidate the corporation. This could lead to a situation where the government decides to empty the fund unilaterally. We would recommend an amendment that states that only the Great State Hural can liquidate the corporation.

Recommendation 6.3: Article 18.8.2 refers to the corporation's shares and share price. It is unclear why the corporation requires more than one share and why shares would be priced when the government is and will continue to be the 100 percent shareholder of the corporation. We would recommend that the article be deleted or that the FHF's ownership shares be non-transferable, meaning that the fund's shares can never be sold.

Recommendation 6.4 (new – based on revised draft): Article 9.4 prevents the corporation's operational expenses from decreasing, no matter what the rationale. It is conceivable that the corporation will find less expensive asset managers or that compensation will be found to be too high at a specific moment in time. Thus, the Board should be allowed to decrease compensation accordingly. We recommend deleting Article 9.4.

Investment Rules

Constraining fund investment choices is an important means of ensuring that funds are managed in the public interest. Clear investment rules, guidelines and targets guard against taking excessive risk, limit the discretionary power of fund managers and can significantly enhance the transparency and effective monitoring of fund actions and performance.

Issue 7: Limiting risk

Several countries, such as Ghana and Timor-Leste, have articulated limits on risk in petroleum or mineral revenue management legislation. For instance, they may require minimum credit ratings, restrictions on private market instruments (as opposed to publicly traded securities), restrictions on high-risk instruments like over-the-counter derivatives and real estate, and currency restrictions.

At present, Article 14.1.1 calls on the Minister in charge of fiscal and budget affairs to approve the fund's investment mandate and Article 22.1.11 calls on the Governing Board to set upper limits on investments in a single investment instrument. Article 12 sets out some guidelines, including not allowing the fund to take a controlling interest in any company and setting strong ethical restrictions.

Also, most well-governed funds prohibit investing in domestic assets, including Abu Dhabi's ADIA (UAE), Botswana, Ghana, Chile, Norway, Timor-Leste and Trinidad & Tobago. Unlike development banks which are designed to invest domestically, sovereign wealth funds are generally designed to maximize financial returns given a specific risk profile. Domestic investment by a SWF may also undermine the public financial management system and Great State Hural oversight, and could encourage patronage or corruption. The draft law successfully mitigates these risks under 12.1.5 and 12.1.7.

That said, the section could be strengthened to prohibit investments in the riskiest types of assets.

Recommendation 7:

Consider making explicit a list of assets that the FHF cannot invest in, such as low-grade securities, real estate, commodities or derivatives. Ghana and Timor-Leste provide useful models. Drawing on these examples, language such as the following could be included in the legislation:

"The Future Heritage Fund may only invest in the following financial instruments:

- A debt instrument denominated in internationally convertible currency that bears interest or a fixed amount equivalent to interest that is of an investment grade security and that is issued by or guaranteed by the International Monetary Fund or by a sovereign state other than Mongolia, if the issuer or guarantor has investment grade rating.
- An internationally convertible currency deposit or a debt instrument denominated in any internationally convertible currency that bears interest or a fixed amount equivalent to interest issued by
    - (i) the Bank for International Settlements
    - (ii) the European Central Bank
    - (iii) the central bank of a sovereign state, other than Mongolia, with a long-term investment grade rating
- A variable income security, namely listed shares, denominated in internationally convertible currency, traded on regulated financial markets.

No more than [40 percent] of the Future Heritage Fund assets will be invested in eligible investments in the form of variable income securities, namely listed shares. Participation will not exceed 5 percent of the capital issued by the issuer.

The exposure of the Future Heritage Fund to any company or the issuing entity for the eligible instruments, with the exception of sovereign states, can never exceed 3 percent of the total value of the Future Heritage Fund.

The Future Heritage Fund shall be prohibited from investing in non-investment grade or excessively volatile assets such as commodities, over-the-counter derivatives, or real estate."

Transparency and Oversight

The draft legislation is fairly comprehensive in its transparency requirements. Disclosure measures include publicly posting annual, quarterly and monthly statements of asset management activities. However several additional pieces of information—for instance a list of individual assets owned, future mineral revenue projections, names of board members and a list of material transactions of the fund—may be helpful in improving fund oversight. The Alaska Permanent Fund provides an example of full fund transparency.

Additional measures could be taken to improve oversight, for instance by tasking a committee in the Great State Hural with overseeing FHF activities or requiring that information be publicly disseminated on a website in an easy-to-access format. For instance, the Mexican government created a new website for its Petroleum Savings and Stabilization Fund that is easy to navigate. As well, the current draft only allows the Auditor-General to *review* the reports of the corporation, rather than conduct an independent assessment of the corporation's activities. This is not in line with international best practice and would need to be amended.

Recommendation 8:

Require that public reports listed in Article 28 include individual assets, names of board members and material transactions, and that the reports be posted online in an easy-to-read format.

Recommendation 9 (new – based on revised bill):

Consider one of the following options to ensure that independent external audits are carried out and made public:

- Amend Article 30.1.1 to require that external audits be undertaken annually and that these reports be made publicly available; or
- Amend Article 13.7 to give the Auditor-General the mandate to independently audit the accounts and activities of the corporation, rather than rely simply on corporation reports.

Recommendation 10:

Amend Article 26.1.5 to notify the Minister if the fund's total asset value decreases by 10 percent or more in a given quarter.