

JAPAN INTERNATIONAL COOPERATION AGENCY (JICA)
Ministry of Finance
MONGOLIA

THE STUDY ON THE SUPPORT FOR THE ECONOMIC TRANSITION AND

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FOR THE ECONOMIC TRANSITION AND
DEVELOPMENT IN MONGOLIA

FINAL REPORT
OF THE
TAX COLLECTION ENHANCEMENT

FINAL REPORT OF THE TAX COLLECTION

August 1999

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Abbreviations

JICA	Japan International Cooperation Agency
GDNT	General Department of National Taxation
IMF	International Monetary Fund
TIC	Training and Information Center
OECD	Organization for Economic Cooperation and Development
Tg	Togrog
ODA	Official Development Assistance



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August 1999	Currency Equivalent
1,030 Tg	/ USD 1.00
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PREFACE

In response to a request from the Government of Mongolia, the Government of Japan agreed to conduct a Study on Tax Collection, and entrusted the study to the Japan International Cooperation Agency (JICA), under the framework of the "Study on the Support for the Economic Transition and Development in Mongolia".

JICA sent a study team, led by Mr. Hirohiko SEKIYA of Daiwa Institute of Research Ltd., and composed of members of Daiwa Institute of Research Ltd. and other organizations, to Mongolia six times from September 1998 to July 1999. JICA organized the Steering Committee, chaired by Mr. Shinji ASANUMA. The Committee reviewed the Study Team's work from professional and technical standpoints between September 1998 to August 1999.

The team held discussions with the officials concerned in the Government of Mongolia and the General Department of National Taxation, implemented a Seminar on the reform of the tax collection system, and conducted related field surveys. After returning to Japan, the team conducted further studies and compiled the final results found in this report.

I hope this report will contribute to establishing a proper and fair taxation system and to securing stable tax revenue for the government of Mongolia, I also hope it enhances the friendly relations between our two countries.

I wish to express my sincere appreciation to the officials concerned in the Government of Mongolia and to the General Department of National Taxation for their close cooperation throughout the study.

September 1999



Kimio Fujita
President
Japan International Cooperation Agency

September 1999

Mr. Kimio Fujita
President
Japan International Cooperation Agency

Dear Mr. Fujita,

Letter of Transmittal

We, hereby, have the pleasure of submitting our report entitled "Tax Collection Enhancement" for the "Study on the Support for the Economic Transition and Development in Mongolia". The report describes the results of the Study conducted by Daiwa Institute of Research Ltd. and Nomura Research Institute, Ltd. in accordance with the contract entered into with the Japan International Cooperation Agency (JICA).

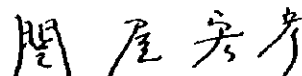
Our Study Team carried out field surveys six times within the period September 1998 and July 1999. Based on results of the field surveys in Mongolia and study activities in Japan, the Team drew up suggestions to contribute to Tax Collection Enhancement.

Regarding these suggestions, in cooperation with the Mongolian side, the Team researched subjects such as, the overall policies and practices of the Mongolian tax collection organization, and the overall condition of the legal system. And, in addition, conducted a Seminar on the reform of the tax collection system, and finally, prepared this report.

In view of the necessity of tax collection enhancement in Mongolia, and the need for socio-economic development of Mongolia as a whole, we recommend that the Mongolian government implement these suggestions as a top priority.

We wish to take this opportunity to express our sincere gratitude to your Agency, the Ministry of Foreign Affairs, the Japanese Embassy in Mongolia, and the JICA Ulaanbaatar office. We also wish to express our deep gratitude to the Government of Mongolia, the General Department of National Taxation, and other concerned organizations for the kind cooperation they extended to our Team, as well as for the warm hospitality provided during our stay in Mongolia.

Very truly yours,



Hirohiko Sekiya
Team Leader
The Study on the Support for
the Economic Transition and
Development in Mongolia

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Annex:

- 1 Mongolian Tax System and Some Suggestions**
- 2 Tax Inspection Manual**

Executive Summary

Background

The greatest problem in the current Mongolian economy is the large fiscal deficit. To deal with this issue, the Mongolian Government has asked the Japanese Government, through JICA (Japan International Cooperation Agency), to provide TA (Technical Assistance) for tax collection enhancement. In response, the Japanese Government agreed to extend TA to reinforce Mongolia's tax collection system, as part of JICA's Transition and Development Study (TRADES). The study began in October 1998, by the Joint Venture Group of Daiwa Institute of Research Ltd. and Nomura Research Institute, Ltd.

Purpose of the Study

To stabilize and increase revenues, the Mongolian Government has begun fundamental tax reform. Reform must overcome several challenges that have made revenue collection difficult. The staff of the administrative agency in charge of state revenues, GDNT, has gone from 1,600 to 1,200 during its separation from the Overall State Tax Bureau. The majority of staff members have not received unified high-level training on tax assessment and tax collection techniques. The tax-capture rate is extremely low because of organizational incompleteness and widespread tax evasion and income understatement practices of corporate and individual taxpayers in Mongolia.

The study is designed to help rectify these problems, secure stable state revenues, and support the establishment of a fair tax collection system. The study has analyzed the present tax and tax collection structures, provided recommendations for improvement – along with

implementation advice, prepared work manuals, developed personnel resources, and promoted technical transfer to the GDNT. These activities have been jointly examined with the Mongolian Government.

After launching the study in October 1998, the study team reviewed tax reform progress and analyzed the various problems inherent in the tax collection system, including tax collection methods. The team submitted recommendations for improvement of tax collection methods and, in May 1999, held a technical transfer seminar for Mongolian tax officials.

The Tax Inspection Manual was prepared as a separate report. The study team hopes that these activities will contribute for improving tax collection in Mongolia.

Content of the Report

This report is composed of 4 Chapters and an Annex. In chapter 1, "State of Tax Collection Organization -- Issues and Recommendations for Improvement," the desirable structure of the tax collection system is discussed along with proposals to strengthen current practices. In chapter 2, "Tax Collection Function," recommendations are presented with regard to the registration office, tax collection, tax inspection, the legal system, information processing and the taxpayer environment. In chapter 3, "Recommendations on the Training of Tax Collection Staff," advice is given regarding the training of tax collection officials. In chapter 4, "Taxation System," recommendations are submitted regarding the tax system, with the reinforcement of tax collection functions as a premise. In the Annex, the Mongolian tax system is described, along with suggestions.

Problems and Proposals

Issues and Proposals for the Existing Tax Collection Organization (Chapter 1)

The present tax collection framework has an organizational problem in that the lower-level structure of GDNT is the agency responsible for securing local revenues. In addition, the people-centered organizational form of tax administration results in inefficiency

Recommendations are: ① If the present tax collection structure is to be maintained, the GDNT should be reorganized in accordance with tax classifications, and the demarcation of duties should be clarified; ② if a new tax collection system is to be created, the structure should be reorganized functionally, into a taxation sector, a collection sector and other sectors. Specifically with regard to the taxation sector, organizing/execution should be implemented according to tax classifications.

Problems and Recommendations Regarding the State Registration Office (Chapter 2. 1)

The present State Registration Office has serious problems. Along with the increase of cash transaction enterprises, non-registration and the disappearance of registered taxpayers have both increased.

Recommendations are: ① If the present State Registration Office is left as it is, a system of accurate taxpayer registration, and prompt notification to the sector in charge, should be established; ② if a new taxpayer registration system is implemented, the present State Registration Office should be abolished, and a system of taxpayer registration, based on tax classifications, should be implemented at each tax office.

Present State, Problems and Recommendations Regarding the Tax Collection Sector (Chapter 2. 2)

The present tax collection sector is extremely inefficient due to its heavy duties, which includes all work regarding taxpayers, excluding only taxpayer inspection.

Recommendations include: ① Improving the legal environment through legal amendments to the Law Relating to Taxation and Tax Payment Supervision and Tax Collection, Article 24 ("Taxpayers' consent is required for seizure of assets"), the same law, Article 36 ("A taxpayer has the right to turn to the courts for any rulings by tax administration authorities"), and General Taxation Law, Article 24, Paragraph 1, Item 10 ("Tax institutions will seek compensation or take legal action in the courts to settle the problems identified below."); ② if the present collection structure is to be maintained, efforts must be made to improve taxation through corporate income tax and value-added tax, and to increase revenues from other tax items; ③ if the institution of a new tax system is desired, the sector should be reorganized as an organization dedicated only to tax collection work.

Problems and Recommendations Regarding the Tax Inspection Sector (Chapter 2. 3)

Tax inspection is extremely inefficient because, rather than being specialized within a certain field, tax inspectors are responsible for the whole range of tax items.

Recommendations are: ① If the present inspection sector is to be maintained, the structure should be reorganized according to tax classifications; inspection should be implemented for specialized tax items based on personnel disposition; tax-classification-based inspection methods should be established; and seminars for inspections should be held; ② the present inspection case selection method, based on the Dutch formula, should be improved; ③ if the institution of a new tax system is desired, the present inspection sector should be divided according to tax classifications; ④ the "Legal Receipt Method under the supervision of

GDNT," should be introduced. This is expected to have tax collection effects on cash transaction businesses, which are a hotbed for tax evasion,.

Problems and Recommendations Regarding the Legal Sector (Chapter 2. 4)

Generally speaking, court judges have insufficient knowledge of tax issues, and they tend to hand down judgments favorable to taxpayers. In particular, courts frequently turning down accusations against tax evaders.

Recommendations are: ① evidence verification capability in tax-related trials should be improved, and a suitable litigant attitude should be taken; ② unified views regarding detailed matters about tax laws should be sought and established between GDNT and legal authorities; ③ if cooperation of legal authorities cannot be obtained, institution of an armed police department should be studied.

Problems and Recommendations Regarding the Information Processing and Statistical Sector (Chapter 2. 5)

Problems within this sector include, lack of accuracy and efficiency in statistical processing and the non-availability of various information effective for tax inspection.

Recommendations are: ① The sector should be divided functionally into the "Statistical Information Division" and the " Data Inspection Information Division"; ② as for statistical information, tax imposition/revenue statistics should be calculated with information from an envisioned Taxation Division, the Investigation Division of GDNT, and revenue information from the Tax Collection Division of GDNT; ③ as for data inspection, collection of various antipodal inspection data about taxpayers should be promoted as important tasks for inspectors and tax collection officials.

Problems and Recommendations for the Training and Information Center and Taxpayer Environment Practices (Chapter 2. 6)

The taxpayer environment improvement work of the Training and Information Center is accompanied by the following problems: ① The scope of taxpayer education, in terms of the target audience and training vehicles, is excessively confined; ② the blue-return system for taxpayers has not been established, ③ improvement of the taxpaying environment for tax officials (prevention of corruption, providing motivation, etc.) has not been executed.

Recommendations are: ① school education should be introduced as part of taxpayer education; ② tax evaders should be announced publicly, etc.; ③ the blue-return system for taxpayers should be introduced; and ④ the taxpaying environment for tax officials should be improved to prevent corruption and introduce accountability.

Problems and Recommendations Regarding Training of Tax Collection Officials (Chapter 3)

The current short introductory level training course far from sufficient. While intermediate and advanced level training courses are scheduled, they have not yet been implemented. In addition, no systematization has been carried out for such training, and mutual correlations are meager, so it is not an effective training curriculum for tax officials. To improve tax administration quality, it is necessary to improve the ethics, specialized knowledge, skills, etc., of tax officials.

To implement a smooth tax administration with positive effects on tax collection, it is necessary to train tax collection officials to become excellent staff members. For this purpose, it is important to hold well-programmed "long-term training." Long-term training can help them to ① improve their character and knowledge as tax administration officials; ② learn specialized knowledge and skills and raise related application capabilities; and ③ perform high-level research on tax theory and laws.

Introductory, intermediate, and advanced long-term training programs are proposed. "Introductory level training" is designed to provide newly employed officials, not yet assigned to individual state tax offices, with the basic knowledge and skill necessary for tax officials. "Intermediate level training" aims to hold tests for those who have finished introductory level training, or who have finished similar training in the past and have 3-years of work experience. These trainees are selected as candidates for medium-class managers, based on test results, achievements of introductory level training and past work achievements. In the course of training, officials will be subject to discussion-type education designed to deepen their specialized knowledge, and strengthen their judgment capability, persuasive potential and situational adaptability. "Advanced Level Training" is designed to select core officials of the GDNT from among those who have finished intermediate level training. Selection will be based on achievements in training, work attitude, and trainees will study tax theory and tax administration problems.

Issues to Be Tackled to Increase Revenues

In the aforementioned recommendations to the Mongolian Government, the study team placed the order of priority on individual recommendations. As measures suggested to increase tax revenues, the study team recommended: ① To amend the laws with regard to the consent of taxpayers and legal actions through courts, ② to secure revenues from another tax item (Personal Income Tax), ③ for GDNT to adopt the official receipt method, ④ to institute the tax accountant system, and ⑤ to improve the training system.

The Mongolian Government Response to These Recommendations

In responding to the recommendations of this mission, the Mongolian Government issued a Cabinet Resolution indicating the following points on June 4, 1999:

- ① To seek introduction of the official receipt system among cash transaction enterprises, by 2000.
- ② To make cash transactions recorded, particularly to institute various regulations regarding activities of money changers and to put these regulations into practice by June or July 1999.
- ③ To raise business efficiency of privatized enterprises, to conduct inspection to ensure the preparation of balance sheets and audits and to introduce a continual inspection system.
- ④ To conduct inspections of enterprises, organizations, or individuals that intentionally hide taxable income, assets, products, business undertakings and service activities, based on laws. The purpose of these inspections is to compel organizations and individuals to comply with tax laws, and thereby to secure tax revenues.

Future Tasks

Important tasks, which were left “non-suggested” but which must be implemented promptly, include the following:

1. It is necessary to establish feasible measures to strengthen the self-tax return system, GDNT inspection (general inspection and investigation) and tax collection functions, in order to increase tax revenues. Specifically, the following steps should be taken:
 - ① Institute the personal income tax system and its implementation setup, in order to enforce personal income tax imposition.
 - ② Build up more advanced corporate income tax and value-added tax systems, as well as the taxation execution setup.
 - ③ Institute specific measures to attain ① and ② above (improvements in the

organizational reform, inspection information and statistical processing work, training of inspectors and various kinds of taxpaying environments).

2. It is necessary to have bookkeeping-based accounting become deep-rooted among taxpayers.

Specific steps for this purpose are as follows:

- ① Establish an authorization system regarding bookkeeping-based accounting.
- ② Institute a system to train taxpayers for the enforcement of bookkeeping-based accounting.

- GDNT's training systems (at registration and ordinary times)

- Chamber of commerce and industries' training courses

3. It is necessary to establish an asset tax imposition setup. Specific measures for this objective are as follows: Institute a tax execution setup capable of appropriately and surely executing the planned new tax system (①the inheritance tax and gift tax, ② fixed asset taxes), prepare inspection manuals, establish a real estate assessment system, form an asset registration system (Ministry of Justice) and improve distribution networks and practices, in line with institution of the new tax system (Ministry of Finance).

4. To implement these recommendations and to study future problems, GDNT has asked the Japanese Government for a second TA for tax collection enhancement. Such activities are significant for Mongolia, and a forward-looking response by the Japanese Government is hoped for.

1. State of Tax Collection Organization – Issues and Recommendations for Improvements

1.1 Issues and Proposals for Improvements in the Existing Tax Collection Organization

1.1.1. Issues in the Existing Tax Collection Organization

(I) Issues for the State Administrative Organization (Budgetary Issues and Problems Related to Authority)

Mongolia adopts a somewhat unusual tax collection system. From a functional point of view, it is determined in principle, that the General Department of National Taxation (GDNT), as well as the Ulaanbaatar tax office, aimags' tax offices and district tax offices in Ulaanbaatar, all of which are under GDNT, are in charge of revenue collection for the state budget, the municipal budget of Ulaanbaatar, budgets of aimags and budgets of each of the districts within the city of Ulaanbaatar. In brief, GDNT and all organizations below it collect taxes as revenues for their respective budgets.

State tax collection staff in all organizations below GDNT are classified as national public servants - as staff dealing with state taxes. They execute tax administration under the instruction of the Director General of GDNT, and, at the same time, they are directly in charge of securing fiscal revenues for regional fiscal budgets. As such, there is a striking unbalance between their duties and authorities given as state public servant.

Thus under the existing state tax collection system, all organizations below GDNT are revenue-securing organizations for specific local governments. This naturally results in the situation in which only local administration related to the state tax collection organizations having jurisdiction over large taxpayers can develop faster than others. This state of affairs may have a serious risk of impeding healthy state development.

Basically, the tax system for local taxes should be expanded, and local governments themselves should raise revenues for local budgets. It is considered necessary to build a tax and

subsidy system under which, if amounts of revenues raised by local governments are short of the budget framework, the shortage portion will be covered with funds from the central state budget.

(2) Problems in the Tax Administration Organization

Organizational problems in the existing Mongolian tax administration are as follows.

1. With regard to personal income taxation and asset taxation (limited to those defined under the existing tax laws), no suitable tax handling is executed at present. Under the present system, almost no taxes except the withholding portion of personal income tax are collected. For this reason, collection of other taxes is necessary from the tax administration viewpoint, and related study should be made with regard to tax administration structure.
2. The Mongolian tax administration organization is people centered, and tax collection officials and inspectors are virtually under obligatory norms for tax imposition, inspection and collection of each enterprise. Accordingly, tax administration is being performed in a confused state. There exist no integrated taxation/inspection/collection manuals that cover all categories of taxes, and tax officials are in charge of excessively many taxpayers. In view of these states, it can hardly be considered that an efficient tax administration is being executed under the present conditions of Mongolia.
If new asset taxes are imposed in accordance with the upgrading of the Mongolian economy, expansion of the underground economic sector and privatization of national land and buildings will occur. If the number of tax items increases as a result of the implementation of a personal income taxation system, it will be virtually impossible for the present people-centered tax organizations to effectively deal with the situation. A detailed examination of the tax administration structure should be made in this regard.
3. Functional responsibilities of each sector of Mongolia's tax administrations are only defined roughly, so in order to make GDNT and all of its subordinate organizations operate efficiently and at low cost, it is necessary to clarify duties of individual sector.

1.1.2 Recommendations for Improvements in the Taxation Organization

(1) Recommendations Based on Premise of Utilizing the Existing Taxation Organization

1. The entire organization of GDNT should be reorganized along tax items, while tax collection officials and inspectors should be posted in line with tax items. So, tax administration should be implemented in accordance with functions of individual tax items.
2. Individual tax organization and division of duties under the charge of individual officials should be clarified, so that a set-up free from overlapping of duties and designed for efficient implementation of tax administration should be established.

(2) Recommendations for the Buildup of a New Tax Collection Structure

Based on the premise of reinforcing tax collection functions of GDNT, it is considered necessary to reorganize its structure as explained below. The new organization is designed to be a structure of tax administration specialists to be principally operated efficiently. It is ultimately aimed at allowing efficient and appropriate implementation of tax imposition, inspection, collection and investigation of tax evaders. It is aimed at enabling detection of unjust actions by taxpayers and crackdown on tax evaders, and arranging for naturally and certainly winning in various lawsuits.

1. All organizations of GDNT should be clearly separated organizationally and operationally in implementation of tax administration along 3 functional lines of the taxation division, the tax collection division and other divisions (including investigation division; hereinafter the same).
2. The Taxation division in the existing overall tax administrative organization should be reorganized along tax items, and execution of duties should also be executed also in line with tax items.

This is designed to enable a response by the tax administration to any situation by arranging all organizations for taxation on taxpayers and execution of tax administration for specialization in accordance with tax items. Reorganization should be implemented with asset taxation, which is likely to be executed in the near future, naturally in mind.

3. Personnel management, including salary increases and promotions, must be performed in a unified and fair manner.

In order to prevent demoralizing the staff of GDNT, which will eventually lead to noticeable delays in execution of their proper function of securing fiscal revenues, it is necessary to unify personnel administration activities. Specifically, a just treatment of all staff members free from any arbitrariness must be exercised.

1) [Example of a Personnel Management Method]

Personnel management review shall be conducted on a specified date annually, and performance evaluations documents shall be prepared in accordance with results of the review. Specifically, the direct superior of a staff member shall enter in evaluation forms, his evaluation of the staff member concerned regarding the following points: ① achievements at the job, ② level of professional capabilities, ③ level of work willingness and degree of efforts expended, ④ degree of observing the superior's instructions, ⑤ leadership toward subordinates, ⑥ degree of cooperation with colleagues, ⑦ existence/non-existence of problems in dealing with taxpayers ⑧ aptitude toward the present job (whether or not the person is more suitable to other kinds of work), ⑨ other matters of special notice. Based on these entries, the superior shall assign a rating, chosen from among A (Outstanding), B(Excellent), C(Ordinary), D (Inferior) and E (Most Inferior) to individual items of ① to ⑨ of the staff member concerned. With these ratings used as a premise, the overall performance evaluation shall be given, using the "A" through "E" grade. The performance evaluation of the said staff member shall be finalized after inspection of the person's evaluation by the superior of the said superior and eventually by the top official of the related tax administration organization. In this case of personnel management regarding granting of promotions or salary increases, judgement shall not be given on a single year basis. Further, as an important element in the process of personnel management, personnel transfers should be implemented regularly at least once a year.

Finally, job classifications should be segmented according to the contents and importance of function. For example, all job functions within GDNT should be ranked as shown below, and through such arrangements, excellent staff members, including young members should be encouraged to exert efforts in their work to obtain higher ranks.

2) [Examples of Ranks of GDNT Staff]

1st class: Director General

2nd class: Deputy Director General and Director of the Ulaanbaatar Tax Office

3rd class: Ranks of the Director of GDNT General Affairs Bureau, and Directors of District Tax Offices

4th class: Rank of Directors of GDNT bureaus

5th class: Ranks of Directors of GDNT divisions and Director General of tax offices

6th class: Ranks of Managers of GDNT divisions and Directors of District Tax Office Division

7th class: Ranks of Manager of GDNT Section and Division Managers of tax offices

8th class: Ranks of Managers of District Tax Office Sections and Assistant Division Managers of tax offices

9th class: General staff of GDNT and senior inspectors and senior tax collection officials of tax offices

10th class: General staff of district tax offices and inspectors and tax collection officials of tax offices

11th class: General officials of tax offices (including new entrants)

2. Tax Collection Function

2.1 State Registration Offices

2.1.1 The Present State and Problems of State Registration Office

(1) There have been many cases in which non-existent addresses have been registered with the tax office. Poor communication between the central and district tax offices compounds the problem. Erroneous registration is often not discovered until an inspector attempts to visit the registered address, only to find it does not exist. Thus, the whereabouts of many newly established enterprises, which are subject to corporate and value-added taxes, cannot be confirmed. The tax administration officials are currently powerless to take appropriate action against enterprises that intentionally fail to report a change of address when relocating.

(2) Along with the increase in cash transactions, there is a dramatic increase in unscrupulous enterprises and individuals engaged in business without completing taxpayer registration. The State Registration Office is powerless in dealing with this situation. Normally the responsibility would fall on the inspectors but, for various reasons, they are not able to cope.

(3) Under the existing registration method, enterprises register at the State Registration Office, and then the information is passed on to district tax bureaus or tax offices. However, there are many cases in which the whereabouts of registered taxpayers are unknown, and also cases in which enterprises simply do not register (as pointed out in (1) and (2) above). This results in a substantial leakage of tax revenues and is creating a perception among society that not paying taxes is "ok," or, at least, not uncommon. This has tremendous implications for Mongolian tax administration.

(4) Taxpayer registration is a kind of "window work" in tax administration. If work is not properly implemented at this sector, tax collection cost will increase because the missing of tax revenues that would originally have been paid or the number of wicked taxpayers grows, or because efficient tax administration becomes impossible. Because waste of time and labor arises as a result of increases in meaningless or overlapped work, necessary tax administration essential for revenue procurement will be omitted in terms of both time and labor.

2.1.2 Recommendations for Improvement in the State Registration System

(1) Recommendations Based on the Assumption that the Existing State Registration Office will Be Left as Part of the Organization of GDNT

Regarding improvement steps to be implemented when the existing State Registration Office must be left as an organization under GDNT, it is necessary, in the case of registration at the State Registration Office, to ensure the same or higher level of registration accuracy as that at conventional tax offices (desirably registration of taxpayers should be completed after various conditions of taxpayers are confirmed). It is also necessary to arrange for the institution of a system in which registered information will be promptly sent to the tax offices concerned.

In instituting the system, the following content must be ensured, based on the premise of efficient and sure execution of registration work.

1. All responsibilities associated with the registered information shall rest with the State Registration Office.
2. Jurisdictional tax offices that have received information shall extend various kinds of guidance to registered taxpayers and confirm their state some time after the communications.
3. If the State Registration Office receives notification from jurisdictional tax offices about unavailability of addresses or whereabouts, the Office must take prompt actions based on its own responsibility.
4. Various kinds of communications from the State Registration Office to Jurisdictional tax offices and vice versa, as well as any follow-up communications, shall be implemented at an early date and in the stabilized manner.
5. All of documents and actions regarding the above steps shall be converted into manuals.

(2) Recommendations for the Establishment of a New Taxpayer Registration System, Based on the Premise of Tax Collection Reinforcement

If the present State Registration Office is left as an organization within GDNT, a problem

may remain as to its efficiency in taxpayer registration work, even if its systematization is enforced. (For instance, communications to jurisdictional tax bureaus are necessary by all means.)

Accordingly, if reinforcement of tax collection functions is mandatory, the State Registration Office should be abolished. Registration of taxpayers should be implemented according to tax items at tax administration organizations that have jurisdictions over the head office locations or personal addresses of taxpayers. Needless to say, if taxpayer registration is carried out according to tax items, it is naturally necessary to organize tax administration organizations based on tax items. An example of taxpayer registration document is described below.

[Example of Taxpayer Registration Document]

1. Taxpayer name
2. Location of head office / telephone number / rough map of the head office location
3. Name of tax office or the national tax bureau to which the taxpayer will file a return and pay taxes
4. Name of the representative, address, age, passport number / if an enterprise, the name of the business and location of business conducted prior to the establishment / details of other business in which the taxpayer is involved
5. Detailed description of the business and purpose (product name / store name)
6. Date of establishment
7. Accounting period (from Year Month Day to Year Month Day)
8. Amount of capital or amount invested (amount invested by an investor, name and address)/ details on the application of capital funds (acquisition of fixed assets / procurement of merchandise or materials / deposits (name of bank and account name))
9. Name / location / business details of branches / offices / factories / representative and the address / telephone number of the representative / number of employees / whether ownership of the location is with the enterprise or with a third party (the purchase price or the rent paid) / size of the building / number of vehicles owned and type / details of principal equipment / existence of independent enterprises / name of tax institution to which withholding taxes are paid / name and address of the responsible tax accountant
10. Organization of the business (name / title of the person responsible for accounting / sales / procurement and the number of employees in each function).
11. Accounting status
Accounting function (name and address of the person responsible for accounting and the

number of employees dealing with accounting and cash administration)

12. Accounting status

Bookkeeping (ledger to which entries are entered / name and address of the bookkeeper / time of bookkeeping entry / the basis of the entries)

13. Name of the tax accountant (Name / office location / address / telephone number / details of qualifications / compensation details)

14. The balance sheet at the time of establishment and itemized chart of accounts

15. Major customers and suppliers and names and addresses.

2.2 Tax Collection Sector

2.2.1 The State of the Tax Collection Sector

The current tax collection sector is not an organization specialized exclusively for the collection of taxes. It is in charge of all activities toward taxpayers with the exception of inspection on taxpayers (receipt of tax returns, study of their content, preparation of tax collection plans, tax imposition work and tax collection). In other words, functions of the sector are greatly surpass the general concept of tax collection.

2.2.2 Issues in Tax Collection Sector

The tax collection sector has the problem of being extremely inefficient as an organization to collect tax from taxpayers, as explained in reasons for presenting the following recommendations. In submitting improvement recommendations, therefore, those based on the premise of maintaining the present work responsibilities for the sector and recommendations based on the premise of changing the organization into the desirable tax collection sector are described side by side.

2.2.3 Improvement Recommendations Regarding the Tax Collection Sector

(1) Recommendations for Improvement of the Tax Collection Sector Common for Two Scenarios - Retaining the Existing Status and Changing It to Be in the Desirable Condition.

Laws must be amended to enable compulsory collection of taxes.

[[Legal Reforms Relating to "Consent of Taxpayers"]

*** Article 24 of the Law Relating to Taxation and Tax Payment Supervision and Tax Collection must be amended.**

The greatest problem with the tax administration of Mongolia is that the authority given to tax collection officials is extremely limited. If a tax collection official is to seize taxpayer assets (including income; hereinafter the same) because of tax payment default, the consent of the taxpayer concerned is required, in principle (Article 24 of the Law Relating to Taxation and Tax Payment Supervision and Tax Collection). All asset seizure that a tax collection official can implement without any legal restrictions is to attach the balance and subsequent input amounts in the bank account of the taxpayer concerned (Article 23 of the

Law Relating to Taxation and Tax Payment Supervision and Tax Collection). If the taxpayer refuses to give his (or her) consent, the tax administrative organization is to bring a lawsuit to a court to seek tax payment. In such a lawsuit, it is extremely difficult under the present situation for the tax administrative organization to win, because of bribes offered to a judge by the taxpayer concerned or the judge's shortage of taxation-related knowledge. Even if the tax administrative organization wins a lawsuit, much time has passed until then. The procedure to seize assets of the taxpayer is then started, with a related revenue ultimately obtained through a public auction. Many cases in which taxpayers consciously and skillfully utilized the related time lag have been confirmed so far. Therefore, the article requiring the consent of taxpayers must be amended by all means, in consideration of fair balance with taxpayers who diligently continue to pay taxes and also for the purpose of infusing the fear of compulsory tax collection in the case of sabotaging submission of tax returns or tax payment.

*** Article 24, Paragraph 1, Item 10, of the General Taxation Law Must Be Nullified**

The provision of Article 24, Paragraph 1, Item 10, of the General Taxation Law ("Tax administrative organization will seek compensation or take legal action in the courts to settle problems identified below") allows Mongolian tax administrative organization to exercise powers that should have originally been acknowledged only after they obtain permission of the country's legal authorities. This provision must be nullified to strengthen tax collection functions.

If tax administrative authorities can seize taxpayer assets and obtain revenue through public auctions freely when a taxpayer defaults the payment of a fixed amount of tax, fiscal revenues of Mongolia are expected to increase dramatically.

[Amendments Relating to "Legal Action in the Court"]

*** Article 36 of the Law Relating to Taxation and Tax Payment Supervision and Tax Collection should be amended.**

In Mongolia, taxpayers have rights to bring lawsuits to courts against any decision by tax administrative organization (Article 36 of the Law Relating to Taxation and Tax Payment Supervision and Tax Collection). Unless this provision is corrected, Mongolia will become a country where tax evasion will be rampant. Namely, if a taxpayer is wicked, he can raise a lawsuit against any decision by tax administrative organization and stage a court battle. If a taxpayer submits tax returns or tax payment after their individual deadlines set by the tax law, and if tax administration decides to impose a penalty on him, the taxpayer can start a lawsuit

against the penalty. Recognition of such rights is going too far, and it is advisable to adopt a legal system under which the taxpayer cannot file a lawsuit for the portion of his inability to abide by the law based on his responsibility. The term "any decision" is highly problematic, so legal amendment should be promptly implemented in this regard.

*** Article 13, Paragraph 1, Item 4, of the General Taxation Law should be amended.**

Regarding the General Taxation Law, Article 13, Paragraph 1, Item 4 ("In the case that taxes are not paid within the due date, a daily interest of 0.5% on the amount owed shall be levied"), a new provision disabling the taxpayer from filing a lawsuit with a court in regard to the taxpayer's obligation arising there from, should be added

(2) Recommendations for Improvement with the Retention of the Present Status as a Premise

1) It Is Necessary to Strive to Expand the Taxation Base According to Tax Items.

Efforts should be made to improve taxation related to the corporate income tax and value-added tax.

a) Grasping of non-filers of tax returns in connection with corporate income tax and value-added tax, and imposing taxes on these tax evaders

Taxation on those who sabotage submission of tax returns is a serious issue on which the survival of the Mongolian taxation system is dependent. If these non-filers are left unchecked, similar persons will grow, just like the case of a disease. Further, it is certain that taxpayers who have faithfully paid taxes become unwilling to observe the tax laws. Eventually, it will become extremely difficult to secure the nation's revenues. These serious issues -- how to grasp these non-filers and how to impose taxes on them -- can be solved by integrally settling the following issues:

*** A setup capable of grasping antipodal inspection data about taxpayers should be established, and the information collection system should be expanded.**

*** Expansion of the taxpayer registration system**

Steps should be taken against persons who have once registered but subsequently moved their addresses secretly, thereby becoming non-filers.

*** Reorganization of the taxation structure, resultant personnel disposition of inspectors and**

tax collection officials and grasping of taxpayers should be executed, according to tax items.

***Improvement of the taxpayer inspection method**

It is necessary to work out an inspection method for non-filers.

b) The bookkeeping-based accounting system should be established among taxpayers.

Generally speaking, the tax system (particularly regarding the corporate income tax and value-added tax) is based on the premise that bookkeeping-based accounting is deep-rooted among taxpayers. Under the current situation of Mongolia, however, this form of accounting has not yet been rooted. It is necessary, therefore, to take steps to spread bookkeeping-based accounting practices at an early date.

***The certification test system for bookkeeping-based accounting should be established.**

***It is necessary to continually hold lecture courses for taxpayers, and punishment should be strengthened if taxpayers do not engage in bookkeeping-based accounting.**

***The tax accountant system should be promptly introduced.**

2) Revenues from other tax items should also be increased.

a) Personal income tax should be fully imposed. (Taxation on personal income taxes other than withholding portion of income taxes should be promoted).

***Reorganization of the taxation structure and clear demarcation of business duties between inspectors and tax collection officials should be pushed for, based on tax items.**

***The setup capable of grasping antipodal inspection data should be established, and the information collection system should be expanded.**

***Efforts should be made to work out a personal income tax inspection method that is accurate and suitable for the current state of Mongolia.**

b) Tax imposition on assets (income) should be studied

*Tax should be imposed on interest on bank deposits.

*Tax should be imposed on profits from the sale of securities.

*Tax should be imposed in a suitable manner on profits from the sale of buildings

*A local tax system for ordinary fixed assets should be established.

(3) Recommendations for Improvements Based on the Premise of a Desired State of the Tax Collection Sector

The desired state of the tax collection sector will be that sector to be formed when GDNT and all of its subsidiary organizations are divided, based on their functions, into three sectors: the taxation sector, tax collection sector and other sector, with all of inspectors, tax collection officials and investigators separated in accordance with the sectors to which they belong. Compared with the present tax collection sector, the envisioned sector should be completely specialized in tax collection work. The tax collection sector should be divided into the regular collection group related to the progressing fiscal year and the special collection group concerned with tax arrears.

2.3 Tax Inspection

2.3.1 State of Tax Inspection

The tax inspection area of Mongolia is specialized in tax inspection functions, and each inspector is responsible for inspection across all categories of taxes related to the taxpayer. GDNT and each tax office divide the responsibilities for inspection of the corporations over which they have jurisdiction. At present, there are no quotas placed on inspectors in GDNT, but in the Ulaanbaatar city tax office, each inspector is assigned a quota of 4 inspections per month and a monthly tax revenue increase of over 4 million Tg., while inspectors in the other tax offices are given a quota of inspecting 60 corporations per year and quarterly tax revenue increases of over 3 million Tg.

2.3.2 Issues in the Tax Inspection

As explained in the explanation and reasons in the following recommendations, the tax collection area in Mongolia is beset with gross inefficiencies as a department charged with the inspection of the propriety of the tax return information and this relates to the following set of recommendations. It is necessary to separate the recommendations into those assuming the existing set of functional responsibilities, and those based on the tax inspection department as it should be structured.

2.3.3 Recommendations for Improvements in Tax Inspection

(I) Assuming Retention of the Existing Specialization in Tax Inspection

***Organize the taxation by tax categories, and assign tax inspectors and tax collection officers according to tax categories. Tax inspectors should function in a specialist environment and be responsible only for inspections related to specified tax categories.**

***Establish inspection methodologies and implement frequent training seminars for each tax classification for the inspectors.**

(2) Recommendation for Improvement in Selection Procedures for Inspection Targets

If the Dutch method (a method to divide taxpayers into 5 categories from A(greatly reliable) to E(unreliable), based on tax amounts, characteristics of industry concerned (operational policy), existence/non-existence of non-compliance cases found in the past inspection, internal accounting control situation and occurrence of tax defaults in the past) continues to be used, it should be reviewed by each tax classification in a more sophisticated light, and modified into a method to that appropriately suits the conditions in Mongolia, and the modified method should be used for a manual and conduct selection based on the manual. In this case, a detailed review using the same common assumptions in target selection methods that prevail across all tax categories, should be conducted.

Recommendation of an improved methodology for a target selection method other than the Dutch method is outlined below.

[Recommendation for Improvement in Selection Procedure for Inspection Targets]

1) Purpose of Selection of Inspection Targets

The most important objective in the selection of inspection targets is, in principle, selection of inspection targets that can be predicted, with a sufficient degree of probability, to contain errors and evidence of illegal practices in the income filings and based on the value. Another important objective is to carry out the selection so as to increase tax collection amounts and raise inspection cost efficiency.

2) Implementing the Selection

1. Person Implementing the Selection

The selection should be done by a senior inspector or one who is well experienced in inspecting taxpayers in the particular tax category.

2. Explanation and Approval After the Selection

Issues regarding the target company selected by senior inspectors and inspectors should be orally explained to the immediate superior, and then to the next level superior, with a final oral explanation given to the head responsible for the tax unit, and his written approval should be obtained.

3) Selection Procedure for Inspection Target

The selection is for the purpose of conducting a tax inspection on the target company. Among the objectives for tax inspections, the following are representative:

- discovery of errors or illegal practices in the filing or performance of its tax obligations
- to gather peripheral data; and
- conduct periodic inspections

The selection takes place in sequence until the selected inspection targets equal the planned inspection numbers. At the time of selection each year, all cases should be included in the selection.

1. Procedure to Identify Inspection Cases to Discover Errors or Illegal Practices in Reporting and Performance by the Taxpayer

In order to implement efficient and effective selection of inspection targets:

- ① plans to increase gathering of third - party tips on tax evasion
- ② measures to gather and file data for various peripheral investigation from inspectors
- ③ other measures - must be prepared promptly by GDNT.

Particularly, information to be used in the inspections must be prepared at the time of selection to be the subject of inspection.

2. Selection Procedures for the Inspection Cases for Collection of Peripheral Data

Even in the case of companies ranked A under the Dutch method, inspections to gather information to conduct peripheral inspection should be performed.

3. Procedure for Selecting Cases for Periodic Inspections

These types of inspections are carried out on a rotational basis on companies that have not received inspections earlier.

(3) Plans for Improvement Based on How the Tax Organization Should Be and Recommendation with the Ideal Organization as a Premise

The ideal state of taxation division is an organization that has clearly and functionally divided the tax administration organization within GDNT into 3 sectors: Taxation Division, Tax

Collection Division, and other divisions. The staff within each of the divisions is also divided along tax categories by functions into collection officers, inspectors, and investigators.

The internal structure of these sectors should be organized according to tax classifications. The taxation division, in addition to inspection operations, is responsible for taxpayer registration by tax categories, receipt of tax returns, selection of inspection targets, identification of statistical information on various taxes, identification of inspection data, interpretation of tax laws, personnel administration, tax assessment, implementing staff training, issuing ministerial directives, internal inspections, implementing training programs, development of inspection procedures, collection and administration of inspection case histories and communicating with the tax collection division. The existing inspection divisions should be transformed into such inspection divisions within the taxation divisions organized along tax classifications.

(4) Recommendations for GDNT's Official Receipt Format

In consideration of the various conditions in which the Mongolian tax administration finds itself, the following points need to be identified as overall issues.

1. GDNT, as an organization, is new and has no funds with which to deal with various circumstances. It is extremely difficult for GDNT to appropriately deal, on a day to day basis, with the economy that is in the process of transition to a market economy.
2. The Bookkeeping/Accounting system has not taken root among the Mongolian taxpayers. The pillars of national revenues, value-added tax and corporate income tax are predicated upon the acceptance and practice of The Bookkeeping/Accounting system. It is, therefore, logical to conclude that, without the prerequisites in place, the taxation is not being collected on appropriate incomes. There is a substantial leakage in collection of personal income tax that would have been assessed and raised had the system been properly functioning in Mongolia. Also, there are great inefficiencies that exist in the national tax administration under these conditions.
3. Personal income tax has not been, in effect, levied, and it is estimated that 95% of proprietorships have not been taxed. Although the personal income tax law has been in place, it has not been implemented. Some of the causes for this are:
 - ① a proprietor is not able to calculate his income himself
 - ② he has no knowledge about tax laws
 - ③ a system for imposing penalties has not been put into place.

4. Most of the transactions among enterprises and individuals are based on cash, and there is no custom for the issuance of receipts in these dealings. It is extremely difficult for tax authorities to identify the true amount of transactions without proper bookkeeping records and this makes inspection of cash transactions effectively impossible. It can be pointed out that taxpayers are also using this as their most effective weapon to evade taxes.

It would be desirable for GDNT to quickly take steps to rectify the above issues, but this would be extremely difficult. In pondering solutions that can quickly resolve the issues in one fell swoop, we came up with the following recommendations.

This requires a system of issuance of receipts for all transactions conducted in Mongolia (realistically above a certain minimum amount). All receipt numbers should be grasped by GDNT. This arrangement is designed to obligate taxpayers to use legally specified receipt forms. Provisions should be included that, in principle, disqualify expense claims without the accompaniment of Official Receipts, as evidence of being eligible as deductible expenses for tax calculation purposes. Through this, instill among enterprises and individuals that all transactions must be based on receipts. We make this recommendation based on the fact that the population base of Mongolia is small and the number of taxpayers is low, and in spite of enterprises not keeping books, as long as there are Official Receipts, the system, though imperfect, will enable taxation to be implemented satisfactorily. This approach need not be adopted in whole, but careful consideration should be given to further develop the plan or adopt parts of it.

[Recommendation for Official Receipts by GDNT]

The Scheme of GDNT Official Receipts

**Name: GDNT - Issued Official Receipt Method
Scheme**

Proposed Method No. 1: At the end of each year GDNT will prepare and sell, to a taxpayer, receipts, in triplicate (receipt/copy/tax office copy), numbered with numbers individualized for each taxpayer, to be used in the following year, through the jurisdictional tax office of the registered taxpayer (a receipt thus sold will be referred to as an "Official Receipt"). At the time of the sale, unused receipts of the current year and receipts that have become void due to erroneous entries, etc., will be recovered. With the recovery, all of the receipts of the taxpayer will be classified as used. Examination of the submitted GDNT copies of the receipts will enable a determination of sales, except for sales that took place without the issuance of receipts, even without proper bookkeeping. If, at the time of an

inspection, the appropriateness of a receipt needs to be verified, the inspector can perform inspection of the counterpart of the receipt himself to check (or if in a distant location, request the jurisdictional tax office to conduct a peripheral examination of the counterpart) to verify that the amount of sale and purchase match. Similarly for the expense side, the inspector can go to the counterpart, issuing the receipt (or if at a distance, request the jurisdictional tax office to conduct a peripheral examination) to verify the match between the sale and purchase amounts.

Naturally, without any improprieties, the amount sold and amount purchased on the same receipt match. If all Official Receipts issued by GDNT can be collected nation wide, a documentary trail can be established for use in peripheral inspections. Since, for the receipt counterpart, GDNT copies are evidence of purchase, they can be used as antipodes to the purchased amount and sent to the jurisdictional tax office, to be included into individual taxpayer files, and they also can be used in inspections and can be a powerful tool in identifying major tax frauds.

Proposed Method No. 2: If it is not possible to sell GDNT issued receipts, an alternative is for the jurisdictional tax office to stamp its acceptance onto serial -numbered receipts, in duplicate (receipt and copy) (the stamped receipts would be referred to as "Official Receipts"), brought to GDNT by the taxpayer. It is necessary to place in safekeeping a record of issuance of the serial numbers and a number of copies of the receipt copy.

In this Method 2, a determination of sales is also possible by inspecting the copies of the receipts kept by the taxpayer, except for sales that took place without the issuance of receipts, even without proper bookkeeping. If, at the time of an inspection, the appropriateness of the receipt needs to be verified, the inspector can go to the counterpart of a receipt himself to check (or if in a distant location, request the jurisdictional tax office to conduct a peripheral examination of the counterpart) to verify that the amount of sale and purchase match. Similarly for the expense side, the inspector can go to the counterpart issuing the receipt (or if at a distance, request the jurisdictional tax office to conduct a peripheral examination) to verify the match between the sale and purchase amounts.

Common Systems Between Method 1 and Method 2

1. Registration and administration of taxpayers will be done at the location of the domicile of the taxpayer at the tax office (Ulaanbaatar) or other tax offices in the provinces. Each tax office will strictly administer the registration of all taxpayers in the jurisdictional area, and administer Official Receipt numbers on a fiscal-year basis. Under this system of

taxpayer administration, individual receipts of each taxpayer can be identified, thus providing an easy way of quickly responding to inquiries from other tax offices (e.g. regarding address/whether the receipt is used by the relevant taxpayer).

2. A legal amendment or ministerial directive should be issued by the Director General of GDNT to disallow, as tax deductible expenses costs, expenses and disbursements without Official Receipts, and to seek public understanding through the use of mass media.
3. A potential problem area is a case in which the buyer and seller conspire and both exclude the amounts in their sales.

In other words, If B purchases from A 100,000 Tg. in goods and resells the same to a third party (consumer) for 150,000 Tg., and A agrees to exclude the sale amount (very beneficial for A) , and B also excludes the sale to the third party, and as a result, both A and B avoid taxes on the sale.

In such a case, A will not produce a receipt, and it would be extremely difficult to uncover the real transaction. This would be the same in the case of the Official Receipt as well, but through adoption of the following enhancements, much of the difficulties can be ameliorated.

The reason for such a case occurring is the non-issuance of receipts in transactions involving general consumers and other cases in which cash transactions take place. A situation needs to be created in which all transactions will involve the exchange of receipts, filing of the receipts, and provision of the same to the tax authorities. Possible measures that can be adopted are as follows.

A Lottery Method

If GDNT issues and sells to taxpayers, Official Receipts, it is possible to determine, at the beginning of the following year, the total number of used receipts, and the individual receipt numbers can be determined at GDNT level. Under the lottery method, using the individual numbers, in the year following the year of use or within the same year, have a drawing once a month, or every three months, and with great fanfare, announce the winner of the lottery, who will receive a prize. This will motivate consumers to keep receipts and eventually create conditions whereby all transactions are accompanied by Official Receipts.

Prizes can be

- ① fixed prizes and
- ② topical prizes.

A fixed prize could be 10,000 Tg given to 1000 winners. It will be important to ensure that as many people as possible receive the prizes.

Topical prizes could be assets that the Tax Agency has seized from taxpayers in satisfaction of tax obligations in arrears.

B Purchase of Used Official Receipts

Plan to buy up used Official Receipts from consumers at a determined percentage of the face value of the Receipts (for example, receipts totaling 100,000 Tg. for 500 Tg.). In this case, only receipts with the names of individuals, and upon presentation of identification that can verify the identity of a claimant, will be eligible.

C Parallel Use of the Lottery and Purchase Method

Introduce the lottery scheme, and in addition, those that did not qualify for a prize would be bought up. The purchase price will need to be lower than that applied in the case of the Purchase Method being solely applied.

There might be other alternative methods that may be conceived, but the important point to bear in mind is that used Official Receipts held by people represent irreplaceable antipode that allow determination of sales amounts of various kinds of taxpayers. Thus, it is unavoidable for GDNT to incur some cost in obtaining the Receipts, and the informational value should be analyzed against the cost of acquisition to determine whether or not to implement such schemes.

In addition, with introduction of the Official Receipt Method, stamp tax law will also need to be introduced. A stamp is attached on various types of contractual agreements, with the stamp tax varying according to the amount involved in the agreement. This could be a significant revenue source. Also, in the case of a receipt, by requiring a fixed amount to be paid as revenue duties (e.g. for a receipt for sale of 10,000 Tg., a revenue stamp of 100 Tg. is to be attached), it can be a good source of revenue.

2.4 Legal Sector

2.4.1 The Present State and Problems of the Legal Sector

Generally, presiding judges have little knowledge about tax issues, and they are prone to hand down rulings favorable to taxpayers. If a tax organization brings an action against a tax evader, the court concerned is liable to turn it down. This tendency poses a serious problem.

Another serious problem that frequently occurs in Mongolia at present is that an inspector or tax collection official frequently becomes a victim of violence or threatening by a taxpayer when the former exercises his duties. No countermeasures are taken regarding such an incident. As such, some officials always carry recorders with them.

2.4.2 Recommendations for Improvements in the Legal Sector

[Steps for Improvement in Tax Administration Suits]

(1) Although judges' lack of knowledge about taxes and immaturity of democracy in trials may be pointed out, detailed study should be carried out as to reasons for tax organizations' inability to win tax trials. The following matters must be cited as reasons for the inability, so appropriate measures should be taken in connection with them.

- 1) Tax organizations lack ability to bring sufficient evidence to courts.
- 2) In instituting lawsuits, specialized state tax organization officials in charge of litigation should execute all litigant actions, except for interrogation of witnesses.

(2) GDNT should attain detailed agreement/confirmation with legal authorities (specifically courts) with regard to exercise of duties in tax administration.

The matters requiring particular study by courts and GDNT are interpretation of provisions of individual tax laws, relations between specific provisions of individual tax laws and provisions of other tax laws, relations between individual tax laws and international accounting standards and unified views on details of relations between individual tax laws and other laws. The unified views should be conveyed to tax officials in the form of notices, etc.

Furthermore, GDNT needs to determine conditions for taking tax evasion countermeasures (in particular, various conditions for criminal prosecution procedures against tax

evaders) jointly with legal authorities (courts and police stations) and to improve related laws.

(3) Measures to be adopted if cooperation of legal authorities cannot be obtained

If cooperation of legal authorities cannot be obtained, efforts should be made to institute courts specialized in tax affairs under the jurisdiction of GDNT. At least, a system regarding courts for the solution of tax disputes or equivalent organizations should be established.

When it becomes necessary to execute advanced inspection with regard to the corporate income tax and value-added tax, there is a great possibility that danger of violent acts against tax officials or damage of threatening will increase. As measures against such a possibility, serious study should be made of setting up armed police department within GDNT and its subordinate organizations to facilitate taxpayer inspection, tax evader investigation, asset seizure and on-site inspection.

2.5 Information Processing and Statistics Sector

2.5.1 Present State and Problems of the Information Processing and Statistics Sector

(1) Statistical Information Processing Work

In statistical information processing work, lack of accuracy and efficiency poses problems.

(2) Tax inspection information work

Determination of information work effective for tax inspection is an urgent task.

General problems in this sector are as shown below:

- a. Machinery and equipment are in shortage, and existing machinery and equipment are functionally too old. Software should be improved.
- b. Information exchanges between the Information Statistics Section and other sections are insufficient.
- c. Information about taxpayers is not open within tax organizations.

2.5.2 Recommendations for Improvements in the Information Processing and Statistics Sector

Recommendations for improvements in the information processing and statistics sector are based on the premise of establishing the desirable structure classified according to tax items, excluding inspection-use data/information work.

(1) Organizational Reform Plan

The present Information Processing and Statistics Division should be renamed the Information Division. Its structure should be divided, based on functions, into ① Statistical

Information Section and ② Inspection Data Information Section. These departments should perform their respective functions in a specialized manner.

(2) Operational Improvement Plan

Operational work improvement in the information processing and statistics sector should be pursued in both statistical information work and inspection data information work, as described below.

1) Improvement plan for statistical information work

Individual tax-handling sections of Taxation Division and Investigation Division of GDNT should have a complete grasp of all information about taxation and settlement of criminal Investigation of taxpayers in their respective fields. As for revenue information, the Tax Collection Division of GDNT should grasp all revenue information (both determined revenue portion and arrears portion) of taxpayers throughout the Mongolian territory. It is necessary to work out a system in which such taxation information and revenue information are automatically accumulated in the Information Section within GDNT within a specified period.

2) Improvement plan for inspection-use data information work

It is necessary to position the collection of various kinds of antipodal inspection data about taxpayers as an important task of inspectors and tax collection officials.

As one form of information collection, it is important to record newspaper articles, radio and TV advertisements, transaction and sales information, etc., and utilize them as inspection data.

As inspection data, accurate information about yearly foreign exchange rates, product prices and raw material/other costs, which are greatly important for standard tax imposition, as well as market prices of business undertakings and services, should be collected continually and provided to inspectors regularly as common inspection materials.

Finally, information about tax evasion is obtained from third persons by offering rewards in Mongolia. These activities should be further expanded.

2.6 Recommendations for the Preparation of a Taxpayer Environment in the Training and Information Center

2.6.1 State and Issues Related to the Preparation of a Taxpayer Environment in the Training and Information Center

- (1) The scope of taxpayer education in terms of the target audience and training vehicles is overly confined.**
- (2) A Blue Return system has not been established.**
- (3) There have been no provisions for improving the tax-payment environment for preparing the state tax officials (such as prevention of corruption, motivation of staff, etc.).**

2.6.2 Plans for Improvement of the Taxpayer Environment Practices of the TIC

Considering that it has only been a short time since the initiation of the process of transition to a market economy, and that the Training and Information Center has only been in operation since 1997, much effort has been expended in the preparation of a taxpayer environment. However, with the objective of enhancing tax collection, such issues as those raised above must be examined, and appropriate plans, including plans to deal with the next steps, must be examined for quick implementation.

(1) Plans for Improvement in Taxpayer Education

A curriculum that includes continuing taxpayer education must be established for use in elementary, secondary and post-secondary educational institutions, and GDNT needs to seek ways to reach an agreement with the Ministry of Education concerning this issue.

(2) Plans for Improvement in Dissemination and Services

It is also important, from the viewpoint of tax administration, to disseminate information on tax evasion and consequences thereto, to imprint a lesson through example, in addition to

general publicity that uses mass media.

A program, such as an essay contest related to topics concerning taxes for secondary school students, who will one day become taxpayers, should be implemented.

(3) Establishment of a "Blue Return" System

As the other side of the coin to the warnings on the perils of tax evasion, a system in which taxpayers who have outstanding records in tax performance are selected from among all taxpayers for commendation, should be established.

(4) Measures for the Taxpayer Environment for the State Tax Officials

It is obviously important for enhancement of the taxpayer environment for the taxpayer to be expedited, but it is also important to take measures to promote the taxpayer environment toward the tax office staff.

1) Measures to Prevent Corruption by State Tax Officials

- ① **Setting Up of a System for Return of Gifts and Items of Value**
- ② **Internal Inspections to Inspect the Performance of the Staff Must Not Be Confused With Covert Inspection to Prevent Corruption**
- ③ **State Tax Officials Should be Rotated Once a Year, Under a Unified Set of Instructions From the General Affairs Division of GDNT**
- ④ **Establish a Commendation System for the State Tax Officials**

2) Plans for Improvement in Raising the Living Standards of the State Tax Officials

<Improvements in Salary Levels>

The level of the living standards of state tax officials must be elevated, to prevent corruption. Staff housing concerns and staff welfare and benefits are important considerations; therefore, continuous consideration of these issues, and implementation of measures for

improvements, are also necessary.

<Establishment of a System of Tax Accountants>

In order for state tax officials to enjoy a higher level of motivation in the performance of their daily tasks, it is necessary for the person to hold some hope and expectation regarding their future. GDNT has not put in place or implemented any measures that will enhance the future security of state tax officials. A new tax accountancy system should be established, as a new nationally recognized qualification, to provide state tax officials with economic and social security for the future when they retire from their post. If this system can be implemented, state tax officials will be able to base their hope on having a recognized qualification and be able to tackle their daily tasks with a positive attitude. It may be possible that, even without substantial improvement in the salary level, by having newfound hope, they would be able to tolerate economic hardships and be able to accomplish the difficult tasks facing him. Tax accountant qualification is given upon qualifying under a national examination, and having a specified period of practical experience in tax or corporate accounting after qualification. Those who are state tax officials will receive certain exemptions in the required subjects based upon the years of experience in the tax agency, and the system should be devised such that state tax officials will be able to obtain his qualification immediately after their retirement.

A Tax Accountancy System can be of immense value and poses no downside risks, so GDNT should quickly make a decision and implement an efficient tax administration.

We have prioritized implementation of the recommendations presented in the above Chapters 1 and 2, taking into account the effects of the reductions in the implementation cost and enhancement to revenues.

Priority Ranking of Recommendations (Chapters 1 and 2)

First Priority: Those that should be implemented with the most urgency:

- 1. 2.2.3 (1) (Legal amendments related to “Taxpayer Consent” and “Suits at the Court”)**
- 2. 2.2.3 (2) 1) (Revenues should be maximized from other tax classifications)**
- 3. 2.3.3 (4) (Recommendation relating to GDNT’s Official Receipts)**
- 4. 2.6.2 (4) (Establishment of a Tax Accountancy System)**

Secondary Priority: Those that should be implemented as soon as possible.

- 1. 2.2 (Recommendations related to tax collection excluding 2.2.3 (1) and 2.2.3 (2) 1))**
- 2. 1.1 (Recommendations related to the tax collection organization)**
- 3. 2.3 (Recommendations related to inspection, excluding 2.3.3 (4))**
- 4. 2.4 (Recommendations related to the legal system)**

Tertiary Priority: To be implemented after implementation of First and Secondary Priority items,

Items not included in the above First and Secondary Priorities.

3. Recommendations on the Training of Tax Collection Staff

3.1 Issues Related to the Existing Training Conditions

An Introductory Level Training Program is being given for the training of tax collection officers, but the training period is short and cannot be considered adequate. Intermediate and Advanced Level training courses are being planned but have not yet been implemented. The three programs have little in common and lack linkages, and it is apparent that a long-term training curriculum for tax collection officers does not exist. In order to enhance the quality of tax administration, upgrading the level of specialized knowledge and skills is essential.

3.2 Recommendations for Tax Collection Staff Training

It is not possible to develop or train capable tax collection staff overnight, and the training must be carried out with a long-term perspective. In order to smoothly execute the functions of tax administration and improve the effectiveness of tax collection, it is necessary to develop and train qualified tax collection officers, which in turn requires that the officers receive well-planned, long-term training. Through the long-term training, develop and train qualified staff and upgrade the quality of tax administration by: ① upgrading character and intelligence, ② teach the necessary specialized knowledge and skills, and develop the capacity to apply such knowledge and skills, and ③ undertake advanced research into taxation theories and application of tax laws.

We recommend the creation of a long-term training program consisting of three components: ① an "Introductory Level Training Program," for newly hired full-time tax officers, to provide a set of basic knowledge and skills required of a tax officer; ② an "Intermediate Level Training Program," for officers selected from among those that have successfully completed the "Introductory Level Training Program," to develop middle management staff, and ③ an "Advanced Level Training Program," given to those selected from those successfully completing the "Intermediate Level Training Program," to develop senior management candidates. The training program will consist of the following.

3.2.1. Introductory Level Training Program

(1) Candidates

The training program will be directed to, in principle, newly hired full-time staff, and it will be given prior to their assignments to the various national tax bureaus (hereinafter referred to as "Introductory Trainees"). As an interim measure, existing staff who have not received training that is equivalent to the program, and who have potential for becoming management staff, will be permitted to enroll in the program.

(2) Training Period

The program will be given to those who have qualified under the tax staff employment examination and have become full-time tax office staff prior to their initial assignment to a national tax bureau. The period of the training will be two months.

(3) Training Objectives

To impart necessary knowledge and skills, such as basic tax laws necessary to perform tax administration and, at the same time, to broaden understanding of overall taxation matters. The program will also improve the level of good common sense and the sense of responsibility as a member of society, and, at the same time it will instill attitudes and awareness of becoming of a tax officer.

(4) Training Summary

Of the existing staff of GDNT, select those who are qualified and suitable as trainers, and they will become core trainers who will conduct classes on the following subject matters.

Training Subjects

Specialized Subjects	Other Subjects
<input type="checkbox"/> Fiscal system	<input type="checkbox"/> Moral issues facing tax officers
<input type="checkbox"/> Basic Tax Law	<input type="checkbox"/> Subjects relating to economics (for graduates of the department of law)
<input type="checkbox"/> Personal Income Taxation	<input type="checkbox"/> Subject relating to law (for graduates of the department of economics)
<input type="checkbox"/> Corporate Income Taxation	<input type="checkbox"/> Computers
<input type="checkbox"/> Value - Added Taxation	<input type="checkbox"/> On-the-job training
<input type="checkbox"/> Asset Taxation	<input type="checkbox"/> Group instructions
<input type="checkbox"/> Indirect Taxation	<input type="checkbox"/> General knowledge
<input type="checkbox"/> Other taxes	<input type="checkbox"/> Professional manners
<input type="checkbox"/> Methods of Tax Collection	<input type="checkbox"/> Other
<input type="checkbox"/> Tax Inspection Methodology	
<input type="checkbox"/> Dealing with Tax Disputes	
<input type="checkbox"/> Accounting	

(5) Points of Caution in Conducting the Training

In the implementation of the program, the following must be borne in mind.

1) The trainees are university graduates who have just been employed, and due care must be taken to ensure that, after the period of training, they can have a smooth transition into the workplace. It is important that their sense of responsibilities as tax officers be raised, and that their levels of understanding of the practical tasks required be deepened.

2) Divide the training class into groups of 10 (if there are 30 Introductory Trainees for 3 groups of 10 trainees each), with 1 trainer assigned to have responsibility for each group for group instructions (for example, raising of sense of the responsibility, instructions on practical tax tasks, guidance on getting along in life). Through the group sessions, increase the level of interaction with the trainees, and take care to foster mutual understanding among the trainees and their esprit de corp. By deepening the bond of friendship among the trainees, a harmonious and smooth workplace environment can be formed.

3) In the training program, perform examinations on the principal subjects, and consideration should be given to those that achieved superior grades, to give them priority in enrollment into the "Intermediate Level Training Program." This will increase the motivation of students toward their studies.

4) The core instructors will be the training officers, but if external instructors (for example university professors) are available, they should be actively sought.

3.2.2. Intermediate Level Training Program

(1) Candidates

An examination will be held to select candidates for the Intermediate Level Training Program. Qualifications to take the examination include satisfactory completion of the Introductory Level Training Program or an equivalent course, and having a minimum of 3 years of practical experience. Based on the results of the examination, the results of the examinations in the Introductory Level Training Program and performance in the current post, candidates who qualify for the training will be selected (hereinafter referred to as "Intermediate Trainees"). The number of trainees for the program should be limited to about half of the number of the Introductory Level Training Program. The limitation is meant to eliminate those that lack motivation and to upgrade the level of the Intermediate Level Training Program and increase the motivation for studies by impressing upon the candidates that they have been chosen.

(2) Training Period

The period of training will be for four months and will be held between April and July every year. The training period should not overlap with that of the Introductory Level Training Program. This way, 1 trainer can be responsible for both Introductory Training and Intermediate

Training within the same year, enabling him to specialize in the training functions.

(3) Training Objectives

By probing deeply into specialized subjects, such as accounting and tax law, as well as gaining a deeper understanding of related subject matter, a level of knowledge, skills and the ability to apply such knowledge and skills appropriate to taxation specialists and potential middle level managers can be imparted to the trainees. By instilling a higher level of general knowledge and broadening their perspectives, this will foster the ability to exercise initiative needed in tax specialists and potential middle managers.

(4) Summary of Training Curriculum

From among the officers in GDNT, select personnel who are qualified to become trainers and assign them as training staff to the Information Training Centers to be responsible for the training program. As the training will require an intensive training of specialization areas, a responsible training officer who is versed in each tax law will be selected. If external instructors (for example university professors) are found necessary, they should be actively sought.

Training Subjects

Specialized Subjects	Other Subjects
<input type="checkbox"/> Personal Income Taxation	<input type="checkbox"/> Computers
<input type="checkbox"/> Corporate Income Taxation	<input type="checkbox"/> Group Instruction
<input type="checkbox"/> Value - Added Taxation	<input type="checkbox"/> Lectures on General Knowledge
<input type="checkbox"/> Asset Taxation	<input type="checkbox"/> Others
<input type="checkbox"/> Indirect Taxation	
<input type="checkbox"/> Methods of Tax Collection	
<input type="checkbox"/> Tax Inspection Methodology	
<input type="checkbox"/> Dealing with Tax Disputes	
<input type="checkbox"/> Accounting	
<input type="checkbox"/> International Taxation	

(5) Points of Caution in Conducting the Training

In implementing the training program, the following points should be borne in mind.

1) The trainees have already completed the Introductory Level Training Program and already possess the basic set of knowledge and skills. The Intermediate Program should aim to further enhance their practical abilities.

2) Training should adapt to the changes in the social/economic conditions and, by including learning of related subject matter, endeavor to broaden knowledge and the ability to apply that knowledge.

3) To raise the actual work potential of trainees, lessons for tax inspection work should be centered on case studies, in order to strengthen their examination capability.

4) In the tax law segment, taking into consideration the materials learned in the Introductory Level Training Program and knowledge gained through the 3 years working experience, select the topics of study, bearing in mind the level of understanding of the trainees, placing emphasis on using discussions as the main medium of instruction. The discussions should be held in groups of about 10 trainees in a seminar format. A trainer will participate in each group and, through the group discussions, provide guidance to deepen the abilities for judgment, persuasion and adaptability as tax officers. Through the group discussions, the trainer will impart to the trainees specialized knowledge and, at the same time, promote interactions with the trainees and deepen the mutual understanding and esprit de corps among the trainees.

5) During the training period, examinations will be held for the principal subject areas. For those who excel (top 5%), a special promotion will be awarded, and consideration should be given to assigning the trainee to an important posting at the next personnel rotation. Through these rewards, the number of applicants into the program will increase and a clear motivation will be established for participation in the program, thus maintaining the level of concentration and increasing the level of motivation toward studies.

3.2.3 Advanced Level Training Program

(1) Candidates

Select staffs who have displayed exceptional excellence (2–3 staff) in the Intermediate Level Training Program and job performance evaluations, and who would be considered potential senior management staff.

(2) Training Period

The training period is desired to be extended as much as possible, as long as business is not adversely affected by the extension. Conceivable plans are participants' study at graduate schools in Mongolia and the International Tax Administration Seminar (ISTAX: a seminar held each year from the beginning of September to the beginning of December in Japan jointly by JICA and Zeimu University).

(3) Training Objectives

In order to cope with the multifarious diversification of the economy, the tax administration must be fully prepared with theoretical foundations. In the program, the advanced trainee will be given difficult issues faced by the National Tax Authority (for example, extremely high-level issues relating to tax laws, accounting issues, issues relating to tax disputes or issues relating to international taxation) to research, and through this research will instill a high level of specialized theory and skills. Further, through the research, the advanced trainee will be able to contribute to the improvement and advancement of the tax administration.

In order to aid the trainee's research, the Advanced Trainee will be sent to the Mongolian National University's Graduate School as a graduate student or researcher or to ISTAX as a trainee to improve the quality of the research.

(4) Training Summary

1) Of the GDNT officers selected as trainers at the Information Training Center, select the most capable trainers (in the future, selection will be from among the graduates of Advanced Level Training Program) to become the trainer responsible for providing appropriate guidance and leadership to the advanced level trainees with regard to the details of the

research. At the same time, the trainer will be given research topics and will also be involved in research activities.

2) A research topic will be selected from taxation theories or issues related to tax administration, and the advanced level trainee will be expected to present the results of his research.

3) As and when necessary, guidance will be contracted to a university professor, and through the guidance reinforce the relationships with the university.

(5) Points of Caution in the Training

In implementing the program, the following points should be borne in mind.

1) The research topics chosen should be from among the toughest issues facing the GDNT.

2) The trainer for the Advanced Level Trainees will provide the necessary guidance on the details of the research in order to ensure a productive research effort.

3) It is necessary to prepare an environment conducive to study, and efforts must be made to prepare research library facilities.

4) Contracting a university professor for research guidance will be beneficial in the sense that involving academics as sympathizers to the tax administration will prove to be valuable, since if a national debate over issues such as tax reform takes place, the opinions of the academics may carry great weight.

4. Training for Instructors

Instructors for introductory, intermediate and advanced level training are few or totally non-existent. To train these instructors, it is necessary to invite foreign specialists and to implement instructor training. To attain this purpose, it is necessary to request support for such training by assisting countries and organizations. Conceivable content of the training includes personnel administration theory, educational psychology, youth psychology, counseling methods, education instruction methods and high-level specialized knowledge (in the subject under charge).

5. Training Site

The present training unit is small and insufficient. It is necessary to make the training establishment independent, and also to extend its facilities and increase instructors. It is necessary to seek ODA for this purpose.

4. Taxation System

4.1 Fiscal and Tax Policy

4.1.1 Overviews and Present Situation

Like a number of other countries in transition from a centrally planned system to a market-based economy, Mongolia embarked on drastic fiscal and tax reforms in 1991. These reforms, supported by international organizations, are based on the model of developed countries, especially of that of New Zealand.

As a result of the introduction of a comprehensive fiscal policy, changes have occurred in the state budget revenues and its expenditures, as well as in the taxation system, making the financial sector much more sound. A comprehensive series of tax reforms, introduced since 1991, are designed to reduce the fiscal deficits to sustainable levels and to raise revenues to compensate for the loss of aid from the former Soviet Union. Assistance was received from the International Monetary Fund for this, both for the drafting of tax laws and the formation of a new tax administration.

4.1.2 Major Issues in Taxation System

The present fiscal situation is still unsatisfactory. Mongolia's economy and government are highly dependent on copper and cashmere export earnings. The sharp drop in copper and cashmere prices in the world market has made the budget balance worse. The budget revenue has seriously failed to satisfy targets and finance spending as a result of the unfavorable external condition of the economy, the debt chain among economic entities and organizations and the poor level of tax compliance.

Even worse, Mongolia's present fiscal systems are still insufficient for managing public finances under the current transitional economy. The present tax system is especially unfair and inefficient in its structure and collection system.

4.1.3 Recommended Direction

The major steps taken by the Government of Mongolia have been to increase budget revenue and to limit some expenditures that are of less importance to the economy. In taking these actions, the Mongolian Government has been guided by such a fundamental principle as

increasing budget revenue and providing all taxpayers with fair and equal treatment.

Refinement of the state budget policy aims at continuing to restructure some public service sectors, enhancing control over the budget performance and reducing the volume of Government loans from banking institutions. In order to intensify the process of switching the economy to a market system, it would be better to broaden the tax base, enhance tax collection, increase income resources, rationalize the structure of budget expenses and eliminate subsidies.

4.2 The State and Local Tax System

4.2.1 Current Tax System and Tax Revenue

Under the General Taxation Law of Mongolia, the national taxes of Mongolia comprise nineteen state taxes and four local taxes. The rates of the state taxes are determined by the State Great Hural and the Government, and applied in the entire country of Mongolia. The local tax rates are determined by the Citizens Representative Hural of Aimags and the capital city and applied in the relevant local areas.

National and local governments share of total revenue and grants accounted for 27.4% of the GDP in 1998, of which 17.6point was tax revenue. Their share of total expenditures was 39.1% of the GDP. As a result of these balances, the fiscal deficit amounted to 11.7% of the GDP in 1998. This deficit was largely covered with foreign assets and privatization funds and domestic borrowing.

4.2.2 Tax Reform Goals

In order to construct a good taxation system, the Government has to clarify its goals or criteria. The goals of tax reform should be established in order to attain useful results. In general, the following five principles are proposed for this purpose: revenue adequacy, stable tax system, simplicity and transparency, economic neutrality and fairness.

4.2.3 Tax Reform Strategies

The objectives of the tax reforms are to expand the tax base and make it buoyant, more transparent and uniform and more supportive of private enterprises. Considerable progress has been made in the area of legislative and organizational reform, although the current situation still needs improvement.

Tax revenues can be increased by improving tax compliance and further broadening the tax base. The narrowness of the tax base in Mongolia reflects the fact that corporate income tax is paid only by a limited number of large companies and joint ventures. Corporate income tax contributed 36.3% of total tax revenues, while personal income tax contributed only 19.2%; sales and VAT 20%; and excise duties 9.3%; with other taxes accounting for 15.2% of the total tax revenue in 1998.

Further plans to improve tax revenue are as follows:

1. For the purpose of generating a sizable revenue to cover budget deficits, GDNT is proposing drafting new tax legislation, such as the asset tax law and the departure tax law.
2. Amendments are being proposed to the excise tax law, personal income tax law, economic entity and organization income tax law, VAT law and customs law.

4.3 Issues in the International Taxation System

4.3.1 Policies for the Near Future

Attracting foreign investments and technologies is a necessary ingredient for the economic development purposes of a transitional economy, and a tax system that promotes such activities is crucial. Securing autonomous fiscal revenues, particularly tax revenues, is critical for the health of the fiscal system of independent countries, however, and there are many developing countries that have elected to increase the taxation of foreign enterprises in order to increase their tax revenues. Mongolia will have to decide on whether to sacrifice short-term tax revenues and place priority on promoting foreign investment, loans and technologies and providing preferential tax treatment; or to increase the taxation on foreign enterprises for the short-term improvements in tax revenues. This decision will influence the future attitude of potential corporate investors. Mongolia needs to strike a proper balance between the two. Therefore, the policy selected must be clear enough to dispel anxieties about the future.

4.3.2 Issues in the Present Laws and Recommendations

(I) Legal Stability and Guarantee of Predictability:

Foreign enterprises including multinational enterprises make decisions based upon an assessment of the tax implications and reliance upon the government not taking arbitrary actions against the enterprise regarding business operations, overseas investments/loans and technology transfers. Tax laws must be based on the principle of legislation, and they must be characterized by legal stability and predictability. The merit of the Mongolian tax law lies in its simplicity, but it lacks sufficient clarity in its interpretation and enforcement concerning such complicated and difficult cases as international tax imposition. Particularly with regard to the points below, explicit articulation in writing is required in both domestic laws and in international treaties. Issuance of notices is insufficient.

- A. Criteria for residents and non-residents
- B. Criteria for resident enterprises and non-resident enterprises
- C. Scope of permanent establishment (particularly, period standards for permanent establishment, period standards for supervisory activities, handling of personnel service provisions for consultancy/management guidance, handling of fills order and securing orders in a case of permanent agent establishment, handling of subsidiaries, etc.)
- D. Handling of affiliated enterprises (principle of arm's length, denial of calculation and other acts

- of affiliated enterprises, rules for income and expense allocation, transfer price taxation, etc.)
- E. Dividend taxation (There is currently no system for the integration of corporate and income taxes nor any system to eliminate double taxation. Consequently, there are no procedures for the adjustment for dividend payments between enterprises. In order to promote the inflow of foreign investments, there is a need to consider tax relief under domestic law while, at the same time, income retention tax or deemed dividend tax should also be considered in order to prevent improper income retention for the purpose of avoidance of dividend taxation.)
 - F. Taxes on interest (Since the tax on excessively small capital does not exist, regulations should be considered to deal with tax avoidance schemes that camouflage virtual investments as loans.)
 - G. Fee payments (If promotion of technological introduction is necessary for economic development, express provisions defining preferential tax treatment are desirable. The definition of the scope of fees under the present law is insufficient.)
 - H. Capital Gains (Under the "Real Estate Income" Clause and the "Capital Gains" Clause in the tax treaty, the definition of "real estate" is stipulated to be defined under domestic law, but there exists no clear definition of "real estate" under Mongolian tax laws. Although it is difficult to define real estate due to the policy of promoting transition to private ownership, the definition of real estate has important implications for the policy of introducing foreign investments and loans and, at the same time, ambiguity will lead to tax avoidance.)

(2) Ways to Eliminate International Double Taxation

In tax treaties there are provisions regarding foreign tax credits or exemptions (with a progressive feature), but there are no such provisions in Mongolian domestic laws. If enterprises that have no tax treaties with Mongolia are to establish subsidiaries in the Mongolian territory, it is unclear as to what remedies are available to these enterprises. This has the potential of dampening the interest of enterprises to invest in Mongolia.

(3) Securing Provisions for Tax Sparing Credits

The greatest effort possible must be expended to secure tax sparing credit provisions in negotiations of tax treaties with advanced countries. This is necessary in order to prevent the effects of the preferential tax treatment extended to attract foreign investment, loans and technologies at the cost of revenue losses to Mongolia from being absorbed by taxation in the advanced countries. This will also ensure that benefits accrue to the enterprise investing in Mongolia. "Advanced Country" is a relative term, and inclusion of the provision in tax treaties should be sought in negotiations with such countries as South Korea and China, treaties with which do not contain this provision, in order to protect Mongolia's interest.

(4) Provisions Against Treaty Shopping

When Mongolia defines the tax reductions and exemptions, under a tax treaty, to promote foreign investment, loans and the introduction of foreign technologies, measures are also necessary to prevent those ineligible for the benefits of the privilege from obtaining the same benefits. As one such measure, a provision relating to a "limitation on benefits" may be included within the treaty, or "laws relating to the application of tax treaties" can be enacted to check the eligibility of the applicant for the privileges. No such measures exist at present.

(5) Transfer Pricing Taxation

If Mongolia is successful in transforming itself into a country that is attractive for investment, and many foreign enterprises are established, then ① transactions between parents and subsidiaries or ② transactions between these and companies that control these companies will increase. Issues relating to the setting of transfer pricing under the principle of arm's length dealings for transactions between affiliated enterprises (sale of tangible assets, sale of intangible assets, lease of the same, expense allocations, interest, rent, etc.) will arise, leading to international tax disputes. In anticipation of such circumstances, the tax authorities need to issue an express definition of how it will address the issue in terms of: ① under which clause of the laws the adjustments will be based; ② under what principle and ③ in what manner it will be undertaken in anticipation of such circumstances. In the OECD many standards for transfer pricing have been discussed, including: ① comparable uncontrolled price method; ② cost plus method; ③ resale price method; ④ profit split method. Each country is preparing a legal framework. In Mongolia, however, there are no such provisions.

(6) Anti-Tax Haven Measures

Countries can generally be divided into those countries that promote policies to become tax havens and those that counter tax-haven policies. Cases of multinational companies establishing base companies or domicile companies in tax havens to undertake a series of complex transactions in order to harbor profits or arrange illegal transfers of income through various ways, including transfer pricing, are not uncommon. It has also been said that tax havens have been used for money laundering operations. Many countries impose taxes on profits retained in tax havens based on defined criteria, but this is not the case in Mongolia. Therefore, it is not clear to prospective investors whether Mongolia intends to become a tax haven or to counter tax havens. If Mongolia wishes to counter tax havens, it would not be desirable to maintain the status quo.

There are not currently any provisions preventing what would be taxable income in Mongolia from being diverted to a tax haven.

(7) Independent Personal Services Income

Provision in the domestic laws is unclear with regard to independent personal service income, which is a difficult category of taxation in all countries. Clarification needs to be made on the issue of whether Mongolia should ① adopt the principle that, as it is similar to business income, it will not be taxed unless a permanent establishment is held; ② apply the 183 day rule similar to the situation with subordinated personal service; or ③ apply an indirect taxation method. This is necessary to prevent tax disputes with countries that are not treaty partners.

**(8) Clarification of the Scope of Income derived from sources within Mongolia
(Mongolian “source-rule”)**

If the principle of taxing foreign enterprises and nonresidents is to tax only on income derived from sources within Mongolia, unless the Mongolian source-rule is very clearly and precisely defined in the domestic law, there is a risk of tax dispute. For such an important matter, this should not be left to the arbitrary judgment of the authorities but should be codified.

4.4 Issues Regarding Value-Added Taxes

4.4.1 Evaluation of the Present Law

The Value - Added Tax system implemented in 1998 is both modern and sophisticated. It is a multi-tiered general Value - Added Taxation. It minimizes tax exemptions and has a wide tax base. It applies a uniform tax rate, sets the tax rates on exports to zero and eliminates the cascade effect under the Invoice Method. In order to reduce administrative and management costs, the minimum annual taxable sales revenue is set at 15 million Tg. The present law virtually taxes all commodities (including capital goods) and services, and it is rated highly for maintaining economic neutrality by limiting exemptions. For the ease in securing revenues and operational administration, it can also be commended. Setting the tax on exports at a zero rate rather than opting for an exemption, thereby allowing tax credits for value-added taxes on purchases, can be regarded positively from the perspective of border tax adjustments and the international competitiveness of Mongolian products.

4.4.2 Issues and Recommendations on the Present Laws

It may be premature to pass judgment on the merits and demerits of the new laws, since only a little time has elapsed since implementation. However, we would like to touch on points that pertain to the tax system and are worth focusing on.

(1) Clarification of the Scope of Tax exemptions

Although the placing of limitations on tax exemptions should be credited, the provision is vague and it is difficult to fathom the intent of the law. For example, the scope of the exemptions in the areas that are exempted, namely ① financial services, ② medical services and ③ educational services, is not expressly clear.

(2) Review of Registration Criteria

Provided that the administrative capacity is sufficient, by setting the registration criteria as low as possible it would be possible to maximize the number of people who would be required to register. This would not only increase the capture rate of the value-added taxes but would also increase the capture rate of income taxes and provide dissemination of accounting records that are the basis of the self-assessment system. In reality, however, significant expenses are incurred in

the administration of a registered taxpayer base and in enforcement of compliance. The registration criteria and the tax exemption point should be decided based on a cost-benefit analysis of the expected incremental tax revenues and the administrative and management expenses that it involves. Continual review should be made as to whether or not the existing level of registered taxpayers is appropriate when the intent of the law is weighed against the existing tax administrative capacity.

Particularly concerning farmers, breeders and ranchers, although they are not exempt, many are below the minimum taxation threshold. Considering the tax administration capacity and costs, the group could be exempted from taxation. If tax credits for value-added taxes on purchases need to be granted for purchases of key equipment, seed fertilizer, pesticides, fuel or livestock, it would be possible to consider application of zero tax rates.

In order to minimize the costs associated with administering and managing small businesses, under the current law the exemption threshold is set at a high level, thus holding the number of taxpayers to an extremely low number.

(3) Method of Refunding Excess Payments

To prevent delinquency, focus is placed on cash flow. Cash flow may also be recognized as being important to the taxpayer for tax payments in excess of required amounts. If the application of such overpayment to future taxes is allowed, it would have to be limited to the following year's tax payment. Applying it to other forms of taxation would be questionable, even if it increases tax revenues, and would require substantial investment in the tax administration's computer system.

(4) Prevention of Delinquencies

In order to prevent the occurrence of delinquencies, the tax payment periods have been set at monthly periods. In reality, however, substantial delinquencies are taking place. Normally, this type of problem is dealt with by imposing stiffer penalties, but as we have separately recommended with regard to the "Collections", measures to motivate on-time payment are required.

4.5 Issues Regarding the Self-Assessment System

4.5.1 Establishment of a Foundation for Maintenance of Fairness

The fact that Mongolia adopted a self-assessment method of taxation, or what has been termed “taxation by conscience”, soon after its transition to a market economy is a laudable challenge. Income Taxation supported by the Principle of Ability to Pay places emphasis on “fairness”. In discussing “fairness”, consideration must be given to fairness in ① a system and ② an application; furthermore ③ horizontal and ④ vertical fairness. Without the sense of fairness, raising the motivation level of the taxpayers cannot be expected. When most of the taxation is based on self-assessment, raising the standard of assessment is the priority and is the most efficacious way to enhance tax collection. It is judicious that emphasis is placed on taxpayer morality, tax education, taxpayer services and tax-related public relations that are the foundation of self-assessment. There are, however, some issues in the tax policies that need to be considered, as outlined below.

(1) Structure of the Tax Rates (3 Tiered Progressive Tax Rates)

The current structure of individual income tax rate, composed of 10%, 20%, and 40%, represents sharp progression at the last stage. This structure facilitates avoidance.

(2) Necessity to Include Personal Exemptions

Under the current system, only the basic exemption of 36,000 Tg. is allowed. While this provides horizontal fairness, it ignores individual personal circumstances and thus lacks in vertical fairness. If the minimum taxable amount is set at too low a level, it will generally work to reduce the taxpayer motivation, and a feeling of complicity will prevail, so that the mutual monitoring function will cease to work. As a result, the tax authorities will be forced to expend expenses and human resources on tasks that do not directly tie in with tax revenues, such as tracking and administering taxpayers, and tax return examinations. It is also necessary to consider the granting of exemptions for spouses, dependent children, the aged and the handicapped.

(3) Incentives for Self-Assessment

In order to enhance tax collection in addition to exercising public powers (tax investigation, inspection, audit, increasing penalties, etc.), suitable benefits should be recognized in

the tax laws in order to encourage the timely and truthful filing of tax returns and the maintenance of accounting records, which is the foundation for such filing. This should bring about a reduction in the tax administrative costs and, at the same time, increase tax revenues. It is also necessary to provide a system to encourage the voluntary making of amendments to erroneous returns through an amendment return system before tax inspection. This will enable the realization of proper self-assessment without the need for tax inspection.

4.5.2 Issues and Recommendations on the System to Secure Self-Assessment

(1) Strengthening of Penalties and Punishments

In order to control intentional and unintentional non-filing or understatement, penalties for them need to be sufficiently strengthened. Under the tax law differences among ① additional taxes for non-filing, ② additional taxes for understatement, ③ heavy penalty taxes and ④ additional tax for non-payment classifications, are unclear. Unless the penalty system is based on a precise classification, it will not be a truly effective assurance for appropriate self-assessment.

(2) Preparation of Legal Documentation (or information return)

As a strategy for exposing improprieties, and to raise compliance levels (assuming the efficient and effective utilization of limited human resources), a policy of enabling the tax authorities to require automatic submission of information is indispensable in the enhancement of tax collection. In the current law, there are provisions regarding the tax authorities' rights to demand information and the taxpayer's obligation to submit to the demand. However, rather than making individual demands for information, requiring automatic submission of specified information will be effective in ① checking against false statement or non-filing tax returns, and ② using information for actual examinations and selection of subjects for examination (for example, requiring a payment record from the payer of wages to a person holding two jobs or buyer of real estate etc.)

(3) Establishment of a National Tax Violation Control Law

It is necessary to establish a law to define the procedures and the authority to perform criminal investigations of hiding income through disguise and other illegal acts.

(4) Administration of Taxpayers (Taxpayer Registration)

It is necessary to prepare measures to punish those avoiding taxpayer registration, a system for third party notification and a system to encourage voluntary registration. It would be desirable to have provisions that, by the system of incentives, encourage black market traders, street vendors, moonlighters, unlicensed taxi operators, etc., to voluntarily register.

4.6 Issues in Presumption Taxation

4.6.1 Assessment of Presumption Taxation

With limited human resources (quality and specialization), it is not easy to maintain a level of contacts or field examinations with the large number of taxpayers. Due to the recentness of the transformation to a market economy, taxpayers are not familiar with the concept of self-assessment and are not able to maintain accurate accounting, or there are tendencies for tax avoidance or evasion. However, if one views these as transitory phenomena, and pursues as one's policy the efficient operation of the administration, then presumption taxation is ① a realistic taxation method for small businesses, and ② a way to expand the taxable population without incurring administrative costs.

4.6.2 Issues and Recommendations on Present Laws

Many countries agree that ① self-employed persons, ② farmers, and ③ professionals are difficult subjects for taxation. Mongolia is no exception and cash transactions and barter transactions are rampant. If some method for determining ① standard income levels and ② presumed expense deductions is applied, it would at least achieve some fairness. Without these measures it would be difficult to find a standard based on which individual presumptions can be made. If economic and industrial statistical data are readily available, it may be possible to prepare reasonably objective standards. In general, ① the net worth increase method, ② the expenditure method, ③ luxury assets (luxury automobiles, luxurious house or second house, large deposits, security holdings, and arts, etc.), and ④ gross revenues can be considered. However, in order to arrive at a more precise estimate, specialist knowledge of profitability by the type of business, margins, commercial practices, geographic conditions, etc. are required. In striving for fair taxation, simple reliance on this system is not possible, and if this taxation method is continuously applied on the same taxpayer over a prolonged period, the following abuses will arise:

(1) Issues on the Side of Taxpayers

Taxpayers will not try to keep accounting records, and they will not be induced to switch to self-assessment at any time. If taxpayers face high taxes as a result of the presumption taxation, there is a risk that they will turn to the black market. If the result of the presumption tax is at a low amount, they may perceive this as an advantage and use this as an excuse to select a method in

which they are not required to maintain complete accounting records. If the tax authorities allow this situation, it would be akin to legalizing tax evasion.

(2) Issues on the side of the Tax Authorities

Unless the necessity, reasonableness and the objectivity of presumption are emphasized, the taxation standards will be left to the arbitrary judgment of the tax authorities, and improprieties will arise from the negotiations and compromises with the taxpayer. A high level of morality is required of officials who are in charge of presumption taxation.

4.7 Issues Relating to Tax Collection and the Withholding Tax System

4.7.1 Need for Incentives for Voluntary Tax Payment

Along with the spirit of self-assessment, a system which encourages the permeation of the spirit of voluntary tax payment among the difficult-to-tax taxpayers and potential taxpayers is also required. Even if new taxpayers are uncovered, if the taxpayer lacks the sufficient cash resources, the tax process will only result in a delinquency. Unless measures for dealing with the small taxpayers in the system are adopted, expansion of the tax populations through enhancements in tax registrations or application of presumption taxes will only lead to increased delinquencies. Examples of such measure include ① subdividing each installment payment, and ② granting preferential treatment to savings-for-tax associations (which would also facilitate the administration of taxpayers through the tax payment savings account held by the taxpayer).

4.7.2 Issues and Recommendations for the Tax Collection System

Under the General Tax Law, Article 11, “an incorporated entity’s tax payment obligation ceases with its liquidation”, but from a viewpoint of enhancing tax collection, this thought is problematic. It would almost be desirable to have a system whereby a party that has a defined relationship to the obligor to be a tertiary tax obligor, and to assume tax obligations for cases where the proceeds of liquidation of assets of the delinquent taxpayer are insufficient to satisfy the delinquent taxes. If delinquent taxpayers are allowed to cease their tax obligations so easily, then the tax collection system cannot be termed sufficient.

Measures for relaxation of tax collection are generally granted subject to the submission of collateral by the taxpayer. While ① extension of tax payment deadlines, ② deferred payments, ③ payment grace, ④ deferment of cash conversion, ⑤ deferment of seizure and ⑥ release from seizure should be granted based upon submission of collateral, there are in fact no provisions to this effect in Mongolia. “Laws Relating to Taxation, Payment and Collection” Article 20 does not require collateral as a condition.

In order to prevent the scattering of taxpayers assets, and, in order to ensure collection of taxes, ① the obligee’s right of subrogation (in a case where the taxpayer does not exercise his rights against a third party, the ability to exercise such rights) and ② the obligee’s right of

revocation (the right to go to court for revocation of acts to reduce the assets of the taxpayer limited to the amount required to satisfy the taxes) must be defined.

Ways to seize taxpayer's assets should be seriously considered.

For nonresidents, it is better to consider the establishment of a system in which appointment of a resident as a tax representative is mandated, and if the non-resident does not pay the tax, the said resident is obligated to pay the tax, or in which advance payment of taxes under certain conditions is made obligatory, with additional payment or refund to be made at the fixed tax payment time.

ANNEX 1

Mongolian Tax System and Some Suggestions

Abbreviations

IMF	International Monetary Fund
FSU	Former Soviet Union
GDST	General Department of State Taxation
GDNT	General Department of National Taxation

Mongolian Tax System and Some Suggestion

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Text for Freshman Tax Officer Seminar

An Introduction to the Tax System in Mongolia

1. The Roles of Government Under a Market Economy

1.1 Planned Economy and Market Economy

The Mongolian economy, in December of 1991, began its transition to a market economy from a planned economy giving everyone the freedom to participate in any productive activity of his or her choice. Under a planned economy, the state owned all production resources, such as land and capital, and the state controlled the economy under a plan determined by the state. Planned economy promised all citizens were guaranteed equality in standard of living and freedom from unemployment. However, the ideal economy failed to materialize under the planned economy. It was not possible to manage the economic units of all enterprises and people as mandated by the plan.

Under a market economy, on the other hand, ownership of resources and participation in economic activity is open to everyone. Market economy is also referred to as a capitalist economy and is the dominant economic system of the industrialized countries. Under the market economy, the forces of demand and supply determine the prices, which in turn determine production and consumption of goods. In other words, free economic activity of the people determines the wealth of the nation. "Market" used here is a conceptual term referring to a convergence of demand and supply. For example, when a person wishing to buy sheep (demand) negotiates with a person wishing to sell sheep (supply) and mutually agree upon a price, a market for sheep is established. Similarly, wages paid by enterprises wishing to employ a worker (demand) and received by those seeking employment (supply) are determined in each individual labor market.

However, market economy is also not without its problems. The recent currency crisis, which was an attack on the weaker currencies, that has plagued the Asian and Russian economies is said to be an excess of the market economy.

1.2 The Roles of Government Under a Market Economy

Adam Smith has written in his book *Wealth of Nations* that the market economy, in which consumption and production are freely undertaken, would lead the nation into prosperity.

Free market economy, however, does not connote all activities are permitted. Freedom means the ability to freely participate in a fair and competitive market. Markets in which a monopolistic enterprise impedes competition or obstructs new market entrants is not a free market economy.

It is necessary, therefore, for government to constantly to keep a watchful eye to ensure free and fair markets. One major task of the state is the elimination of monopolistic enterprises and ensuring a fair and competitive market. It is more efficient and to the people's interest that the enterprises owned by the state be privatized to the extent possible and managed under the market economy.

Another function of the state is to supply the essential goods and services that cannot be supplied by the market. Most goods and services that are required by the people can be supplied through the market. As long as there are people requiring necessities such as foodstuffs and apparels, there will be producers to meet the demand. However, there are some essentials that cannot be readily supplied through the market mechanism. Although national defense, police, roads, and fresh air and water are indispensable living in modern society, nobody is willing to pay for them. Then no private producer is willing to supply them. Another essential function of the state is to supply these of goods and services referred to as public goods and services.

2. Government Receipts

2.1 Taxes

The fiscal revenues of government depend principally on taxes. The Constitution of modern states lays down the citizens' obligations to pay taxes and the enforcement of the collection of taxes. The burden of taxes must be equitably shared among the citizens. If the system is such that tax burden on the rich is light while burden on any particular group is heavy, no one will be willing to pay taxes.

In taxation, there are some well-known tax principle. First is the principle of fairness. This means to allocate the burden to pay taxes according to the taxpayer's ability to pay. Ability to pay includes the ability to earn income, ability to consume, and ability to earn assets. Individual income taxes, which are levied in proportion to the income earned and wealth tax levied based on the size of the house owned can both be said to be taxes that are fair. The second is the principle of simplicity. A state has a tax system composed of various types of taxes, but the principle of simplicity means that it is desirable for the tax system itself to be as simple as possible and a system that the citizens can readily comprehend. Imposition of many different types of taxes, each of which yielding small tax revenue, will only create confusion among the taxpayers, diminishing their incentive to pay taxes. The third principle is that of efficiency and neutrality. Taxation impacts economic activity in many ways. For example, value added taxation reduces consumption while import tariffs reduce imports and result in increasing domestic prices. The market is inducing efficiency in production and consumption and taxation should be such that its impact on the efficiency of the market is minimized and its effects on the economic activities neutral.

Based upon these tax principles, various types of taxes are adopted in a tax mix to create a tax system that is required to secure the necessary fiscal revenues. Tax systems of countries vary depending upon the differing historical evolution of the system and the differing national traits of the countries. In postwar Europe, the America and most developed countries introduced individual income tax and corporate income tax at the core tax system and later added value added tax. Many countries have local taxation based on property, which has its taxation base upon assets such as dwellings and land.

2.2 Public Debt

Countries that have become independent from the Former Soviet Union (herein after FSU) have had the grant payments from the FSU terminated and are facing a period in which it will be difficult for them to rely solely on existing tax revenues to meet their fiscal requirements. Many of the countries have had to rely on borrowings from the people (banks) = public debt to source their fiscal resources. Public debts are obligations of the state and must be repaid by a maturity date with interest. Taxation is a claim that has been received by the state while public debts are borrowings. Thus, the established way of thinking toward public debts had been to avoid issuance except in cases of emergencies.

However, J.M. Keynes, a great economist of this century, preached that issuance of public debt to finance public construction projects as a means to stimulate the economy during periods of economic downturn, if anything, is beneficial. Following this view point, after World War II, capitalist countries have been issuing public debts.

3. The State of Public Finance in Mongolia

3.1 Reform of the Taxation and Fiscal Systems after the 1990 Transition

The fiscal systems of the transition countries, including Mongolia, embarked on independence with drastically reduced revenue bases and massive deficits, having had their FSU assistant terminated. For the Mongolian fiscal system that had just began its transition to a market economy, a reform of the tax and fiscal system to create a system in which the fiscal deficits can be eliminated and a stable fiscal management can be achieved was required.

Post independence fiscal system was created with the establishment of the Constitution, prescription of Budget Law, General Laws on Taxation, various tax laws, Accounting Law and Civil Servants Law. The national budget in Mongolia is composed of the central budget prepared by the Ministry of Finance and the local budget comprised of aimags and soms of the local governments. The central budget is passed by the State Great Hural and the local budgets are passed by the Citizens Representative Hural. A budget expresses monetarily the policies of the government and forms the root of parliamentary democracy.

Mongolia state revenues prior to transition, in addition to the grant payments, were derived from payments from state enterprises and export tariffs. But with the transition to a market economy Mongolia has been pressing forward with tax system reform with assistance from international agencies such as the IMF. Under the General Tax Law, individual income taxes and sales taxes have been established as the major national tax categories while for local taxes smaller categories such as usage taxes were established.

As part of the fiscal reforms, privatization was carried out in which enterprises, universities and housings owned by the state were sold to the private sector and the management was transferred to the market mechanism. As a result, management of enterprises and banks were transferred to the private sector and, in housing, personal right of possession became the norm.

Mongolia, thus, embarked on into capitalist society where money will buy anything, but the government has been mandated with the prevention of its abuses (widening of the gap between the rich and the poor, impediments for a free market).

3.2 The Tax System

The tax system in Mongolia was created with the enactment of the major components, namely, General Tax Law, Individual Income Tax Law, Corporate Income Tax Law, Sales Tax Law, and Consumption Tax Law in 1993. Subsequently, in 1997 9 tax laws, including the General Tax Law, were amended and in 1998 the Value Added Tax was introduced to replace sales tax.

According to the Article 16 of General Tax Law, national taxes are comprised of 19 categories including Individual Income Tax, Corporate Income Tax, Tariffs, Value Added Tax, Consumption Taxes (Excise Tax, tobacco and liquor consumption) while the local taxes are comprised of 4 categories including License Fee for the Use of Natural Resources and Payment for the Use of Mineral Springs. The rates for the national taxes are decided by the State Great Hural and the regional taxation rates are decided by the Citizen's Representative Hural in the provinces. The existing income tax rate is composed of 10%, 20%, and 40%. The corporate income tax rate is set at 30%.

Under the current tax system, the Value Added Tax is the highest tax revenue in the 1999 budget. Until the 1998 fiscal year, Individual Income Taxes was the nucleus and comprised 30% of all tax revenues but in the 1999 budget the Value Added Tax accounts for 40% while the share of Individual Income Taxes declined to about 10%. As a result, with the combination of the Value Added Tax and the Consumption Income Tax comprising nearly 60% of tax revenues, the current tax system may be categorized as being centered around taxation on consumption. Many of the countries that have tax systems centering around taxes on consumption are Latin countries including France while the Anglo-Saxon countries including the United Kingdom and the United States have tax systems that center around taxes on income. Japan also introduced a value added tax in 1990, but the majority of tax revenues is accounted for by taxes on income including Individual Income Taxes and Corporate Income Tax.

Regarding tax administration, in 1992 the General Department of State Taxation was formed as an independent agency from the Revenue Department of the Ministry of Finance and commenced its operation of tax collection. GDST has subsequently been renamed GDNT (The General Department of National Taxation) as it is known today.

4. Issues in Mongolian Tax and Fiscal System and Proposals for Reform

4.1 1998 Budget

The central government's 1998 projected results and the 1999 budget are summarized below.

Under the 1999 budget revenues are 227,438 million Togrogs and the Expenditure are 338,846 million Togrogs and as a result, the revenue deficit is 111,408 million Togrogs. While the expenditure is equivalent to 33.5% of the GDP, revenue reaches only 22.5%. The fiscal deficit, therefore, reaches 11% of the GDP and most of this shortfall is supplemented by international aid.

The state revenues include tax revenues including social insurance premia and when combined comprises the largest component accounting for about 70%, followed by non-tax revenues such as aircraft charges accounting for approximately 20%, and capital revenues such as proceeds from state owned assets accounting for 6%. On the expenditure side, in the Current Expenditures, the expenditures for general administrative expenses account for 25% while expenditures for subsidies and grants for local finances and enterprises and contribution to pensions account for approximately 30% and is the largest component. Capital expenditures account for 13%, which is not large but Lending comprises 25%, which is a significant proportion.

Central Government Budget

mil. of Togrogs

	1998	1999		
	Preliminary	Preliminary	%of Total	%of GDP
TOTAL REVENUE AND GRANTS	176,285.0	227,438.6	100.0	22.5
CURRENT REVENUE	154,375.0	205,438.6	90.3	20.3
1, Tax revenue	114,948.5	158,855.2	69.8	15.7
1. Income tax	17,567.2	21,249.8	9.3	2.1
2. Social Security contribution	36,361.6	37,287.4	16.4	3.7
3. Value added tax	34,612.0	66,124.0	29.1	6.5
4. Excise tax	17,899.7	21,314.5	9.4	2.1
5. Taxes on specific services	3,621.1	8,212.5	3.6	0.8
6. Custom duty	2,179.1	2,041.7	0.9	0.2
7. Other taxes	2,707.8	2,625.3	1.2	0.3
2. Non-tax revenue	39,426.5	46,583.4	20.5	4.6
CAPITAL REVENUE	12,810.0	14,000.0	6.2	1.4
FOREIGN GRANTS	9,100.0	8,000.0	3.5	0.8
TOTAL EXPENDITURE AND NET LENDING	292,752.8	338,846.4	100.0	33.5
CURRENT EXPENDITURE	180,980.1	200,427.1	59.1	19.8
1, Expenditure on goods & services	82,267.1	86,001.0	25.4	8.5
1. Salary and wages, allowances	22,052.9	24,794.7	7.3	2.4
2. Social security contribution	11,686.0	10,003.9	3.0	1.0
3. Other expenses on goods & services	48,528.2	51,202.4	15.1	5.1
2, Interest payments	14,977.3	15,502.0	4.6	1.5
3, Subsidies and transfers	83,735.7	98,924.1	29.2	9.8
CAPITAL EXPENDITURE	26,043.7	43,887.2	13.0	4.3
LENDING	66,136.3	85,779.5	25.3	8.5
PRINCIPAL PAYMENT OF FOREIGN LOANS	19,592.7	8,752.6	2.6	0.9
OVERALL BALANCE	-116467.8	-111407.8		-11.0
DEFICIT FINANCING SOURCES	116467.8	111407.8		-11.0
1, Foreign sources	86,074.5	108,294.2		10.7
2, Domestic sources	30,393.3	3,113.6		0.3
GDP	875,859.0	1,012,210.0		100.0

4.2 Main Issues in Tax and Fiscal System

1) Background

The current Mongolian fiscal system continues to suffer from shortages of fiscal revenues. This is primarily due to the fact that the Mongolian economy has not yet reached at stage of being self-supporting. Mongolia, in spite of its rich natural resources, had been an agricultural economy centering on livestock farming and even today remains primarily an agricultural economy. The country has Erdenet Copper Mine and several gold mines but due to the depressed world prices the profitability of the mines has suffered. This is also true of other industries and the fragile industrial structure has resulted in the shortage of fiscal resources. Electricity and transportation network of railroad and roads have become dilapidated and have become bottlenecks for production. A major task of the state for the economy is the preparation of the infrastructure.

2) Administration and Fiscal Issues

The administration and fiscal system issues can be divided into administrative organization and fiscal system. In the administrative organization the division of duties between the two is ambiguous and there is no stability in the organization. This is due to the unclear responsibilities and the lack of transparency in the system. The same can be said of local government administration. The relationship between the central and the local governments is unclear and the local administration is dysfunctional.

In the fiscal system, the lack of systematic budgetary system can be raised as an issue. In the preparation of the budget no rational estimation of tax revenues are being performed resulting in overstatement of revenues causing needless expansion in the fiscal deficits. The time allowed for the debate of the budget is short and the schedule does not allow for sufficient deliberations in the assembly.

3) Issues in the Tax System

In the tax system, issues can be raised in the tax structure and the tax collection organization. The tax system must be one that is feasible. The tax structure needs to be engineered according to the stages of economic development. In the case of an income tax, in a society where the income differential is significant, a progressive income tax scheme rather than flat rate taxation would be able to gain more public cooperation.

Although, in the legal statutes, national taxes and local taxes are made explicit, in reality

local governments collect national and local taxes and spend both as own fiscal revenue. Then the tax system is being managed in an arbitrary manner at each local government. Only the Corporate Income Tax collecting from the major enterprises is the central government fiscal revenue and the remainder has become a source of fiscal revenue for local governments.

The low level of tax collection capability of the tax collection agencies including GDNT is a major issue in the area of tax collection organization. Raising the level of tax collection skills among the tax collection staff is the problem. Without the sufficient capability to collect taxes, increases in tax collection cannot be achieved even with the best-designed tax system. If the taxes cannot be executed, the citizens' incentives for tax payment will suffer and result in destroying the system itself.

4.3 Proposals for Improvements

1) Preconditions

The first fiscal step required is to prepare the infrastructure. The preparation of production infrastructure including transportation network, information communication network, electric power and human resource infrastructure need to be expedited with foreign assistance. Secondly, a shifting of the industrial structure to that of higher value-added industries through industrialization is necessary, the government needs to make more progress in the process of privatization. 60% of the state owned assets appeared to have been privatized but also as a means to reduce fiscal expenditures, further progress in privatization is required.

2) Administrative and Fiscal Reform

The government is currently in the midst of carrying out administrative and fiscal reforms. The reform takes New Zealand as its model and aims to improve organizational efficiencies. In New Zealand's case, however, one must remember that even before embarking on the reform, the administrative organization possessed a certain level of functionality and capabilities and the system reform was meant to improve its efficiency. Introduction of the systems should be progressed with care adapting it to conditions that prevail in Mongolia.

From the perspective of the administration's human resource capabilities, the appointment of government officials should be based on invitation to all those who wish to apply and a system based on performance should be introduced for promotions in order to improve the administrative capabilities. The same is applicable to GDNT.

In the relationship between the central and local governments, a fiscal system should be reformed so that the local fiscal system can be managed autonomously.

3) Tax Reform

Tax system must be accorded with economic development. In the development stages of an economy, the taxes on consumption should be one that is less complex and that can be more easily understood. Also in the area of income taxation, the initial tax burden should be set at a low level and consideration must be given to vertical equity. In the handling of tariffs, transition countries should have some leeway in giving highest priority to its own economic well being. An effective separation between the national and local taxes should be made and make necessary efforts to operate the system under the law.

As for tax collection side, enhancement of the tax collection capabilities is important. The tax collection organization has been established but the capabilities of the tax collection officers remain at a low level. Tax collection staff must strive for and achieve a higher level of tax collection skills and improve their capability to better execute the taxation. On the other hand, taxation will increase in complexity with the introduction of value added tax and the increasing numbers of wage earners and private sector enterprises. The functionality of the tax system is dependent upon the ability to collect taxes. Omissions in tax collection will impede the achievement of fairness of taxation, resulting in the taxpayers' withholding of support and leading to a vicious cycle of tax revenue deficiency.

4) Basic Principles

The tax officers must be understanding of reasons why the citizens have to pay taxes and they should perform their tax collection duties while at the same time fostering taxpayers' understanding. And they should be trained in this direction.

ANNEX 2

Tax Inspection Manual

Textbook for Technology Transfer Seminar

**Tax Inspection Manual
Textbook for Technology Transfer Seminar**

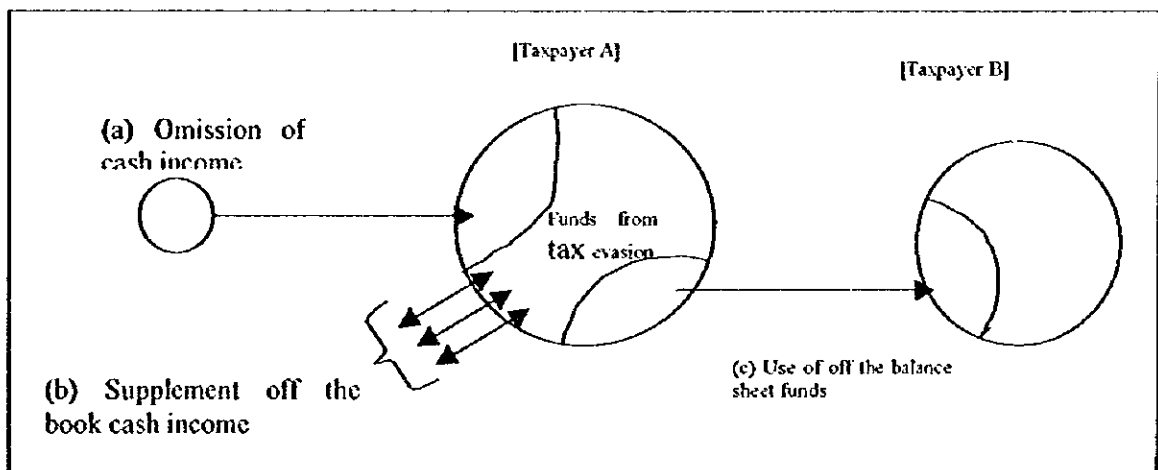
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1. Inspection Focus Relating to Cash Income

If the taxpayer maintains accounting records, it would be quite easy to perform a check to see whether the cash income is properly reflected in the tax returns by comparing the returns against the records. However, if the taxpayer does not maintain accounting records, it would be necessary to prepare an estimate in order to arrive at a proper income amount. If omissions are discovered in the recognition of revenues in the course of the inspection of cash income, it is necessary not only to inspect the taxpayer who had made the omission, but also perform an inspection of the taxpayer to whom the payment was made to ensure that he has filed a proper tax return.

Schematically, this is outlined in Diagram I-1 below. The inspector needs to exercise a broad inspection perspective in executing his duties in ensuring that not only the assigned taxpayer properly files his return but also that his business counterparts also file a proper tax return.

Diagram I – 1



Specifically, the inspection should be undertaken from the perspectives as outlined below:

1.1 Common to Personal/Corporate Taxation

- (1) How did the taxpayer recognize cash income at the time of the filing of the original tax return.

The taxpayer must have had some basis, even if it were estimation, for the recognition of cash income. It is important to confirm this at the initial stages of the inspection as a first preventive step against taxpayer's equivocation.

- (2) Reconciliation of copies of Receipts and Invoices with the Accounting Records.

For taxpayers who have kept accounting records, in order to check for omission of cash income, the copies of receipts, invoices and delivery notices need to be reconciled against the recorded income. Should omissions be discovered in the process it is necessary to inquire in detail as to ① whether this was intentional and ② determine the use of the funds or where the funds are being accumulated. Particularly ② is intended to uncover additional funds that have not been reported, as shown in Diagram I - 1 and requires close analysis.

- (3) Follow the Trail of Undeclared Funds

If an omission is uncovered the inspection should not be limited to the taxation of that taxpayer alone. The purpose for the tracing of the undisclosed funds is to include a confirmation of filing of proper tax returns by the recipient of such funds. (Diagram I - 1)

- (4) Examination of Business Counterparts

There are two ways in which to trace undisclosed funds. (A) In the course of the inspection prepare effective documentation and request the tax office with

jurisdiction over the recipient of the undisclosed funds to make an investigation; and (B) exercise the right of inspectors and confirm the transactions directly at the site. If approach (B) is taken and a field inspection is to be conducted, the same inspection procedures would be adopted as if it were a normal inspection. However, in consideration of the time allowed the inspector who is in charge of the inspection must allocate the time appropriately.

(5) Bank Examination (Examination of Financial Institution)

Usually the undeclared funds find their way to

1. Keep the funds at home (“drawer savings”)
2. Deposit the funds at a bank
3. Invest the funds through a securities company
4. Utilize the funds as working capital in an enterprise (“borrowing from directors”)
5. Use the funds for off the book salaries, off the book procurement

However, given the security of deposit and the convenience of deposits and withdrawals, in the inspection undertaking checkings with financial institutions, such as banks, may be quite effective. However, documents used by the financial institutions are varied and complex and for the benefit of tax officers not versed in bank examinations, it will be necessary for each inspector to request copies of the documents each time and accumulate the information on a tax office level. Another important tax strategy is to ensure the universal acceptance among the employees of the financial institutions of the need for cooperation with the tax inspections in order to undertake the reconstruction of the state’s finances.

(6) Determination of the Use of the Undeclared Funds

A crucial task of the tax inspection is the determination of the use of the funds that have been omitted from income (hereinafter “off balance sheet

funds”). For example,

1. If the funds have been deposited, by reconstructing the deposit records other undisclosed incomes can also be identified in one fell swoop. (= identification of off balance sheet deposits)
2. If the off balance sheet deposits had been utilized in the payment for unrecorded procurements, it is easy to surmise that the corresponding sales revenues have also not been recorded and most likely the supplier also has not recorded the income. Results of one tax inspection sometimes can lead to and be useful in several tax inspections and the inspection must not stop at a simple identification of income omissions.
3. If the off balance sheet funds had been used in making unrecorded salary payments to employees, it would be possible to levy additional withholding taxes on the salary payments.

(7) Useful Interrogation Techniques

The interrogative skills useful in tax inspections can be acquired only after experiencing many inspections. Inspectors who have not yet mastered the skills should strive to obtain the know-how from veteran inspectors by accompanying them on field inspections.

Examples of exchanges are described below:

(i) Step by step approach

Q. “Where do you keep the copies of the receipts?”

A. “In the safe.”

Q. “Where do you keep the safe?”

A. "In my executive office."

Q. "According to this receipt, amounts received have not been recorded. For what has the money been spent?"

A. "It was used to purchase my car."

Advantages: It follows progressive steps and gives the taxpayer no leeway to fabricate a story and creates a feeling of being cornered.

Disadvantages: It is easy for the taxpayer to predict the coming questions and the technique is not suited for those taxpayers who are used to tax inspections.

(ii) Affirmation Approach

Q. "Your reported income is low in comparison with your living standard, isn't it?"

A. "It might be so."

Q. "For example, according to this copy of a receipt, there is an omission in the income amounts, there some more omissions, aren't there?"

A. "Yes, there are some..."

Advantages: By human nature, it is easy to respond "no it is not" when asked a straight forward question but if the question is posed in a manner that requires the person to negate a statement, particularly when it is a fact, it is rather difficult to make the response "No, that is not so". It is an effective interrogative technique in the final stages when suspicions have been aroused.

Disadvantages: The respondent feels that the answers have been forced upon them and may become antagonistic. Therefore, if this approach is adopted from the initial stages of the inspection, cooperation may be withheld before the inspections reach the heart of the issues.

(iii) Random jump approach

Q. "It has been 15 years since you began business?"

A. "Yes, it has."

Q. "By the way, this sales revenue has not been recorded in the accounts. Is this amount a result of your collection efforts?"

A. "Well, yes it is."

Q. "In that case, being such an amount, did you deposit the money directly into the bank?"

A. "Most likely, yes."

Q. "At which bank did you make the deposit?"

A. "Well, probably B Bank."

Q. "That is a bank that is not on the income tax return."

A. "Is that right? Then the savings account itself may be omitted in the filing of the income tax return."

Advantages: The question catches the respondent off guard and often results in his blurting out the truth. It is most effective when utilized once the heart of the issue has been identified.

Disadvantages: If this approach is used too often, the taxpayer may become reticent in responding to questions causing

delays in the investigation. It should be used opportunistically.

1.2 Personal Taxation

The above inspection checklist for cash income applies to individuals and enterprises that keep accounting records but for individuals who do not keep such records, only taxation by indirect taxation method can be applied. In this section, we will outline the methodology for indirect taxation based upon disposable income.

[Indirect Method of Taxation Based on Disposable Income]

In a household, without any inflow of funds from other sources (for example, increase in borrowings from relatives), the living expenses had to have been funded out of income earned in that year. By inquiring of the household's borrowings and deposits for any increases or decreases and the normal levels of living expenses prior to initiating specific tax inspections, one can determine the minimum income amounts of the person.

Based on this, if an omission in the income tax return is discovered, based on a presumption of existence of further omissions, by challenging him with the under-reporting it is likely that the person will readily admit the fact.

If an accurate picture of his procurements can be identified, using the gross margins accurate revenue amounts can be derived. If an appropriate expense ratio is calculated using the average for the month in which the inspection is conducted, proper income amounts can be calculated.

1.3 Corporate Taxation

Just as in the case of the individuals, it is necessary to perform a proper indirect taxation for enterprises that do not prepare accounting records. The difference between the

enterprise and the individual lies in the fact that the enterprise is an incorporated entity and the income that is calculated cannot definitively be determined to be that of the enterprise or that of the individual.

In these cases, based upon a calculation of an appropriate estimated individual income, recognizing directors' remuneration as those amounts expended by the directors on a monthly basis on which withholding taxes shall be levied and the income that remains should be recognized as enterprise income. In this approach, the estimated individual income is derived using the following formula:

Estimated Individual Income = Enterprise income + Directors' Remuneration (including salaries paid to directors' relatives) + rent/interest payments (paid to directors or their relatives)

In other words, income earned is captured based on the notion of equating the enterprise and an individual and later dividing it into enterprise and individual income classifications.