



Report and Recommendation of the President to the Board of Directors

Project Number: 49210-001
September 2015

Proposed Policy-Based Loan Mongolia: Social Welfare Support Program

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 20 August 2015)

| | | |
|---------------|---|--------------|
| Currency unit | – | togrog (MNT) |
| MNT1.00 | = | \$0.000502 |
| \$1.00 | = | MNT1,991.5 |

ABBREVIATIONS

| | | |
|-------|---|--|
| ADB | – | Asian Development Bank |
| CMAP | – | Comprehensive Macroeconomic Adjustment Program |
| DBM | – | Development Bank of Mongolia |
| FDI | – | foreign direct investment |
| FSL | – | Fiscal Stability Law |
| GDP | – | gross domestic product |
| LIBOR | – | London interbank offered rate |
| MPDSP | – | Ministry of Population Development and Social Protection |
| MOF | – | Ministry of Finance |
| PMT | – | proxy means testing |

NOTE

In this report, "\$" refers to US dollars.

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PROGRAM AT A GLANCE

| | | | |
|--|---|--|---------------------|
| 1. Basic Data | | Project Number: 49210-001 | |
| Project Name | Social Welfare Support Program | Department /Division | EARD/EASS |
| Country Borrower | Mongolia Ministry of Finance | Executing Agency | Ministry of Finance |
| 2. Sector | Subsector(s) | ADB Financing (\$ million) | |
| ✓ Public sector management | Social protection initiatives | | 150.00 |
| | | Total | 150.00 |
| 3. Strategic Agenda | Subcomponents | Climate Change Information | |
| Inclusive economic growth (IEG) | Pillar 3: Extreme deprivation prevented and effects of shocks reduced (Social Protection) | Climate Change impact on the Project | Low |
| 4. Drivers of Change | Components | Gender Equity and Mainstreaming | |
| Governance and capacity development (GCD) | Public financial governance | Some gender elements (SGE) | ✓ |
| 5. Poverty Targeting | | Location Impact | |
| Project directly targets poverty | Yes | Nation-wide | High |
| Household targeting (TI-H) | Yes | | |
| 6. Risk Categorization: | Complex | | |
| 7. Safeguard Categorization | Environment: C Involuntary Resettlement: C Indigenous Peoples: C | | |
| 8. Financing | | | |
| Modality and Sources | | Amount (\$ million) | |
| ADB | | 150.00 | |
| Sovereign Program loan: Ordinary capital resources | | 150.00 | |
| Cofinancing | | 0.00 | |
| None | | 0.00 | |
| Counterpart | | 0.00 | |
| None | | 0.00 | |
| Total | | 150.00 | |
| 9. Effective Development Cooperation | | | |
| Use of country procurement systems | | Yes | |
| Use of country public financial management systems | | Yes | |

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed policy-based loan to Mongolia for the Social Welfare Support Program.

2. The program will support reforms under the country's economic adjustment plan to (i) improve fiscal policy management, and (ii) develop policies and regulations to improve targeting and consolidate social welfare programs. Through these reforms, the program will help mitigate the adverse effects of fiscal consolidation on the poor, and sustain financing for social welfare programs.¹

II. THE PROGRAM

A. Rationale

3. **Development problems and opportunities.** Years of economic reforms and the country's vast mineral wealth made Mongolia a middle-income country in late 2011. Prosperity and increased fiscal revenue allowed the government to strengthen social welfare programs with positive results. Accounting for about 40.0% of the poor's income, social transfers in Mongolia have significantly reduced poverty. Since 2010 poverty has declined by 17 percentage points to 21.6% in 2014. It is estimated that the poverty rate would be about 10 percentage points higher today in the absence of social welfare programs.²

4. Although a decade of strong economic growth has substantially boosted average incomes and reduced poverty incidence, one in five Mongolians still lives in poverty and largely depends on welfare benefits for basic subsistence.³ Nomadic families, households headed by women, and urban migrants have a particularly high poverty incidence, and are more vulnerable to the country's extreme cold winters. Income inequality, as measured by the Gini coefficient, has been reduced from 0.36 in 2008 to 0.32 in 2014. Despite progress, inequality is severe between the urban and rural areas, especially in the remote western regions.

5. Because of its limited economic diversification, Mongolia is highly dependent on the mining sector, which in turn relies heavily on Foreign Direct Investment (FDI) inflows. This exposes the economy to external shocks, particularly swings in commodity prices and the economic cycles of its trading partners. The current external environment, characterized by falling commodity prices⁴ and slowing growth in the People's Republic of China,⁵ is constraining Mongolia's mineral production and fiscal revenue collection. This has been compounded by plummeting FDI⁶, delaying the start of large revenue-generating mining projects. Against this background, GDP growth has sharply declined, reducing job opportunities for the poor and vulnerable.⁷

¹ The design and monitoring framework is in Appendix 1.

² National Statistical Office of Mongolia and the World Bank. 2015. *Poverty Profile in 2014. Results of the Household Socioeconomic Survey 2014*. Ulaanbaatar.

³ Detailed poverty data are provided in the Poverty and Social Impact Assessment (accessible from the list of linked documents in Appendix 2).

⁴ The prime mineral exports of Mongolia are coal, copper, iron ore, crude oil, and gold. Minerals constitute about 90% of total goods exports. From December 2011 to March 2015, the price of gold has declined 22.6%, coal 60.0%, and copper 17.3%.

⁵ The People's Republic of China accounts for about 90% of Mongolia's total mineral and non-mineral exports.

⁶ FDI fell by 55% in 2013 and 80% in 2014 due to political instability and weak investor confidence.

⁷ GDP has declined from its peak of 17.3% in 2011, and the weakening growth momentum has continued. GDP growth slowed to 7.8% in 2014 and to 3.0% in the first half of 2015.

6. The economic slowdown underscores the importance of strengthening social protection in Mongolia. Current macroeconomic imbalances caused by falling commodity prices threaten the continuation of social welfare programs. Reductions in the welfare budget will reverse poverty reduction gains by creating new poor and bringing those that crossed the poverty line back into poverty. Given the positive impact of social welfare programs on poverty reduction in Mongolia, continued support for them is vital.

7. **Social welfare programs.** Social welfare in Mongolia is an integral part of social protection.⁸ In 2015, the Government of Mongolia allocated MNT285 billion on social welfare. The Child Money Program contributed an additional MNT246 billion in 2015. The combined funding amounts to 2.7% of GDP, exceeding the average 1.6% of GDP in other emerging economies.⁹ Social welfare programs are generally pro-poor with about 35% of the benefits reaching the poorest 20% in Mongolia.¹⁰ By comparison, about 20% of benefits in Thailand reach the poorest 20% (footnote 10).

8. Welfare programs in Mongolia focus on the provision of social pensions, allowances, and services to citizens with special needs who are in poor health, lack family, and are not capable of living independently. Programs also support individual household members who require social welfare assistance or care to meet their minimum needs. The Ministry of Population Development and Social Protection (MPDSP) administers 71 social welfare programs, which can be grouped into seven broad categories.¹¹ These programs reached about one-third of the total population in 2014. Expenditures for all programs have been increased since 2010 to reflect demographic trends in an expanding population, offset the impact of inflation on real incomes, and reduce poverty.

9. In addition, the Food Stamp Program distributes MNT18 billion to its 144,000 beneficiaries. Initiated on a pilot basis in 2008 with Asian Development Bank (ADB) financing,¹² the program became part of the entitlements guaranteed by the Social Welfare Law in 2013. It supports the consumption of basic foods by extremely poor families to reduce vulnerability to food insecurity and increase the household members' daily calorie intake. The Food Stamp Program is the only welfare program using proxy means testing (PMT) to identify the poorest households.¹³

10. Since 2012, the Child Money Program has provided monthly payments of MNT20,000 to about 1 million children 18 years old and younger. It is the largest program, accounting for half of the government's cash transfers. Given its universal coverage, the program has helped reduce poverty significantly. It is funded by the Human Development Fund, which uses mining revenue to support the economic and human development of the country.

⁸ Social protection in Mongolia has three major components: social welfare, social insurance, and labor market programs. Details are in the Sector Assessment (Summary): Public Sector Management (Social Protection Initiatives) (accessible from the list of linked documents in Appendix 2).

⁹ World Bank. 2014. *The State of Social Safety Nets*. Washington, DC.

¹⁰ World Bank. 2015. *Review of the Mongolian Social Welfare Program Design and Beneficiary Profile*. Washington, DC.

¹¹ The categories are social welfare pensions, social welfare allowance, community-based services, social welfare allowance for the elderly with state merit, allowance for the elderly, allowance for the disabled, and allowance for mothers and children.

¹² ADB. 2008. *Report and Recommendation of the President to the Board of Directors: Proposed Asian Development Fund Grants to Mongolia for the Food and Nutrition Social Welfare Program and Project*. Manila.

¹³ PMT is a targeting methodology that estimates household income by associating indicators or proxies with household expenditure or consumption. The test assesses eligibility for government assistance, based upon whether the individual or household possesses the means to do without that help.

11. However, challenges persist. Most social welfare programs are targeted by category, which is costly, as some of the recipients are not poor. Moreover, the fragmentation of programs results in the duplication of benefits and high administrative and implementation costs. Some welfare benefits are administered through various ministries and institutions, such as the school textbook and electricity subsidies. These subsidies would have a greater impact on the poor if they were better targeted. To reform these welfare programs, policy actions should focus on improved poverty targeting and consolidation to reduce implementation costs and increase their impact and sustainability.

12. **Government action plan.** The government, which assumed office in November 2014, has taken important steps to stabilize the economy and consolidate fiscal expenditure. Parliament approved the government's Comprehensive Macroeconomic Adjustment Program (CMAP) in February 2015. The CMAP, which covers 2015–2016, contains a wide range of short- and medium-term policy actions targeting macroeconomic stabilization and structural reforms to lay the foundation for sustainable growth. In addition to actions for fiscal consolidation and improved debt management, the CMAP includes measures to strengthen social welfare in order to mitigate the impact of the adjustment costs on the poor, boost employment, and bolster the investment climate.

13. The core of the CMAP is improved fiscal policy management. The following policy actions have already been implemented: (i) a budget amendment was passed in January 2015 to reduce fiscal expenditure, (ii) government ministries and agencies were downsized, (iii) a salary increase for civil servants was postponed, and (iv) capital expenditure was reduced. Efforts to boost revenue collection include an 80% increase in excise taxes for fuel in January 2015, which generated an additional MNT228 billion for the budget. To improve budget transparency, the Fiscal Stability Law (FSL) was amended to include off-budget expenditures from the Development Bank of Mongolia (DBM)¹⁴ and the Price Stabilization Program.¹⁵

14. The FSL was also amended to reflect the adoption of a medium-term fiscal framework targeting the gradual decline of the fiscal deficit to 2% of GDP and debt levels to 40% of GDP by 2018.¹⁶ To mitigate the impact of the adjustment costs during fiscal consolidation, social welfare protection was prioritized in the budget amendment. Pensions and welfare programs were increased in January 2015 to offset the impact of inflation on purchasing power. Resources for the Food Stamp Program, which is vital for the country's poorest, were augmented by 80%.

15. **Fiscal gap.** Despite the government's efforts, the short-term contractionary effect of the adjustment program, compounded by the persistent unfavorable external environment, has resulted in additional fiscal revenue shortages. The 2015 fiscal gap is MNT500 billion. To meet the requirements of the FSL for 2015, social welfare programs may have to be curtailed when

¹⁴ The DBM was established as a state-owned entity in 2011 with the mandate to support the financing of major projects and programs for the country's development. However, the DBM's lending activities have generated large additional fiscal deficits that were kept off-budget to circumvent the requirements of the FSL. The law caps the fiscal deficit at 2% of GDP and public debt at 40% of GDP. The consolidated fiscal budget, including the off-budget expenditures of the DBM, was 11.6% of GDP in 2014.

¹⁵ The central bank loosened the monetary stance and embarked on the provision of programs of quasi-fiscal policy loans to support diverse sectors in the economy in 2012–2014. The largest program, the Price Stabilization Program, provided highly subsidized loans that were exempt from limits on large exposure and industry concentration, and kept off-budget.

¹⁶ Parliament temporarily increased the fiscal deficit ceiling from 2% to 5% of GDP in 2015, followed by a gradual reduction to 4% (2016), 3% (2017), and 2% (2018 onwards). Similarly, the amended FSL lifted the debt ceiling from 40% of GDP (in net present value) to 58.3% in 2015, followed by a gradual reduction to 55% (2016), 50% (2017), and 40% (2018 onwards).

they are needed most. This would slow the government's poverty reduction efforts. Thus, policy actions must be developed to ensure social welfare funding in order to protect the vulnerable and the poor during the country's adjustment program.

16. **Government efforts, ADB's policy dialogue, and development coordination.** ADB has been at the forefront of social protection reform in Mongolia since 2001, focusing on expanding the scope and quality of social networks, poverty targeting, and health insurance.¹⁷ ADB has been particularly active in reforming the social welfare system, including the introduction of PMT to target the poor, the establishment of the Food Stamp Program, and the passage of the amended Social Welfare Law in January 2013. ADB supports the government's strategic vision to further modernize the social welfare system through improved targeting, consolidation of benefits, and financial sustainability.¹⁸ Social protection is a pillar of ADB's inclusive growth strategy. Other partners involved in the sector are the World Bank, the Government of Japan through the Japan International Cooperation Agency, and United Nations agencies.¹⁹ The program has been prepared in close coordination with key development partners. The program supports the International Monetary Fund's recommendation to strengthen safety nets during the adjustment process to protect the poor and improve the targeting of benefits.²⁰

17. **ADB's value addition.** ADB will introduce reforms in fiscal policy management and social welfare that (i) address the immediate need to sustain social welfare programs and protect the poor during the implementation of the CMAP, and (ii) help strengthen sector mechanisms to ensure the sustainability and impact of social welfare programs in the future. Policy actions have been selected based on international best practice and sector analyses. ADB's strength lies in its experience and deep policy engagement in the sector since 2001 through three successive policy-based programs (footnote 17). This program will (i) build on the policy dialogue and reforms achieved earlier, (ii) expand the use of the targeting database created under the Food and Nutrition Social Welfare Program, and (iii) support the implementation of the policy actions with technical assistance from an ongoing ADB project.²¹ This integrated response linking programs and developing capacity will support the creation of a stronger and more sustainable safety net for the future.

18. **Alignment with ADB strategy and lessons learned.** The program is consistent with ADB's interim country partnership strategy for Mongolia, 2014–2016, which highlights sustainable growth and inclusive social development as its main pillars.²² It is also in line with

¹⁷ ADB. 2001. *Report and Recommendation of the President to the Board of Directors: Proposed Loans and Technical Assistance Grant to Mongolia for the Social Security Sector Development Program*. Manila; ADB. 2008. *Report and Recommendation of the President to the Board of Directors: Proposed Asian Development Fund Grants to Mongolia for the Food and Nutrition Social Welfare Program and Project*. Manila; and ADB. 2009. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Grant and Technical Assistance Grant to Mongolia for the Social Sectors Support Program*. Manila.

¹⁸ The Development Policy Letter is in Appendix 3.

¹⁹ Development Coordination (accessible from the list of linked documents in Appendix 2).

²⁰ International Monetary Fund. 2015. *Article IV Consultation Staff Report*. Washington, DC.

²¹ ADB. 2013. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant to Mongolia for the Additional Financing of the Food and Nutrition Social Welfare Project*. Manila. The project includes technical assistance to support updating of the inter-sector database and developing policy options for expanding targeting and consolidating benefits.

²² ADB. 2014. *Interim Country Partnership Strategy: Mongolia, 2014–2016*. Manila.

the emphasis on inclusive economic growth in ADB's Strategy 2020²³ and on social protection in its midterm review.²⁴

19. The Social Welfare Support Program builds on lessons learned from earlier economic crises and past assistance in the sector. Key lessons on containing the poverty impacts of previous crises include the importance of (i) strengthening and implementing social protection systems and welfare programs, and (ii) investing foreign aid to expand social protection in countries with limited fiscal space.²⁵ A major lesson from ADB's intervention in the sector is the need to have sustained engagement because reforming social welfare requires long-term commitment. While ADB past operations have been successful introducing poverty targeting mechanisms to distribute welfare benefits and establishing the Food Stamp Program, less progress has been achieved in terms of welfare program's consolidation.²⁶ Another key lesson is the need for a realistic policy framework with manageable policy actions to achieve the intended results and successfully implement the reforms.

B. Impact and Outcome

20. The impact will be the mitigation of the adverse effects of fiscal consolidation on the poor. The outcome will be the maintenance of social welfare programs.

C. Outputs

21. The outputs will be (i) improved fiscal policy management, and (ii) improved policies and regulations to support targeting and consolidation of social welfare programs. The program will support a policy framework with corresponding outputs and policy actions, as detailed in the policy matrix (Appendix 4). The first tranche of the program has 11 policy actions; the second tranche has 7 policy actions.

22. **Output 1: Improved fiscal policy management.** The program aims to improve fiscal policy management in order to maintain social welfare during the fiscal consolidation process. Policy actions to restore fiscal stability include amendments to the FSL to gradually reduce the fiscal deficit and public debt ceilings by 2018, and amendments to the 2015 fiscal budget to reduce fiscal expenditures to comply with the requirements of the revised FSL. Policy actions to improve budget transparency include (i) consolidating budgetary expenditures of the DBM under the state budget to eliminate off-budget spending, (ii) terminating the Price Stabilization Program to reduce quasi-fiscal operations in the central bank, and (iii) making effective the Budget Transparency Law to strengthen public financial management. A draft legislation is in the Parliament to establish a wealth sovereign fund, once approved it will help to mitigate the impact of future swings in commodity prices and FDI inflows. The government has adopted a medium-term debt management strategy to strengthen debt sustainability. Improved fiscal management will help protect the most vulnerable by (i) increasing funding for the Food Stamp

²³ ADB. 2008. *Strategy 2020: The Long-Term Strategic Framework of the Asian Development Bank, 2008–2020*. Manila.

²⁴ ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila.

²⁵ Institute of Development Studies. 2009. *Global Financial Crisis, Developing Countries and Policy Responses*. Sussex.

²⁶ Welfare programs consolidation was pursued in 2009 under ADB. 2009. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Grant and Technical Assistance Grant to Mongolia for the Social Sectors Support Program*. Manila. However, the Parliament's approval of necessary legislation was postponed as Mongolia was fighting a severe balance-of-payments crisis where other reforms were prioritized. As such, the intended targets were not met during the life of the program. Details are in ADB. 2013. *Completion Report: Social Sectors Support Program in Mongolia*. Manila.

Program, which targets the poorest households in the country; and (ii) subsidizing health insurance contributions for household members in need of welfare services.

23. Output 2: Improved policies and regulations to support targeting and consolidation of social welfare programs. To strengthen poverty targeting, a cabinet resolution will be issued to require at least two ministries to use the poverty-targeted integrated household information database to allocate benefits in selected programs. Resources will be allocated in the 2016 budget for maintaining and updating the database to capture the new poor resulting from the economic stabilization and adjustment process. To increase social welfare effectiveness, a working group of ministries will be established to prepare a plan to consolidate social welfare programs. Consolidation will reduce administrative and implementation costs, as well as the duplication of benefits. The program will ensure funding for the quarterly implementation of the household socioeconomic survey to strengthen monitoring and evaluation of social protection.

D. Development Financing Needs

24. The government has requested a loan of \$150 million from ADB's ordinary capital resources to help finance the program. The loan will be disbursed in two tranches. The first tranche of \$100 million will be disbursed upon loan effectiveness as the first tranche policy actions have been satisfactorily completed. The second tranche will disburse \$50 million upon achievement of the second tranche policy actions.

25. The loan will have a 15-year term, including a grace period of 3 years, an annual interest rate determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility, and a commitment charge of 0.15% per year. The average loan maturity is 12.1 years and no maturity premium is payable to ADB. The government has provided ADB with (i) the reasons for its decision to borrow under ADB's LIBOR-based lending facility based on these terms and conditions, and (ii) an undertaking that these choices were its own independent decision and not made in reliance on any advice from ADB.

26. The loan proceeds will be used to finance the full foreign exchange cost (excluding local taxes and duties) of items produced and procured in ADB member countries, excluding ineligible items and imports on the negative list attached to the loan agreement. The proceeds of the loan will be disbursed in accordance with ADB's simplification of disbursement procedures and related requirements for policy-based loans.²⁷

27. Current revenue shortages stemming from external shocks constrain the financing of the country's development needs. The stringent fiscal consolidation program adopted by the government to comply with the FSL has also limited public spending.²⁸ The government is committed reducing the fiscal deficit to 5.0% of GDP in 2015 from 11.6% in 2014. This suggests a major adjustment during an economic slowdown and an unfavorable external environment, which could threaten the sustainability of inclusive growth. As a result, the budget was amended in January 2015 to reduce expenditures by 7.3% from initial projections. Most cuts were in capital expenditure to preserve social spending in order to protect the poor.

28. However, the consolidation of the DBM budgetary activities and the Price Stabilization Program in the central government budget has added about MNT1.2 trillion for capital

²⁷ ADB. 1998. *Simplification of Disbursement Procedures and Related Requirements for Program Loans*. Manila.

²⁸ Economic Analysis (accessible from the list of linked documents in Appendix 2).

expenditure. A second budget amendment in 2015 in the amount of MNT500 billion is required to meet the fiscal deficit target for the year. Given the severity of the revenue shortages, in addition to new reductions in capital expenditure that will further depress GDP growth and employment generation, social welfare programs will have to be curtailed. This may reverse significant gains in poverty reduction.

29. The program will support the government's fiscal adjustment plan, while protecting the basic needs of the poor. In determining the loan size, consideration was given to the importance of supporting (i) the government's macroeconomic and fiscal stabilization program, (ii) the country's development financing needs, and (iii) social welfare programs to alleviate adjustment costs on the poor. The loan proceeds will help close about 58% of the fiscal gap in 2015, whereas loans from other bilateral and multilateral institutions will cover the remaining deficit, in compliance with the FSL's target of 5.0% of GDP. Without foreign assistance, the 2015 fiscal deficit would be 7.1% of GDP.

E. Implementation Arrangements

30. The Ministry of Finance (MOF) will be the executing agency, overseeing and coordinating the timely implementation of the policy actions. The MPDSP will be the implementing agency. A program steering committee, comprising senior representatives from the MOF and MPDSP, will be set up and chaired by the MOF secretary. The committee will meet quarterly to monitor progress under the program. ADB will assess program implementation through periodic progress reports submitted by the MOF, and will field missions to confirm the fulfillment of policy actions for tranche releases. ADB and the World Bank will closely coordinate to ensure no overlap or duplication of activities during program implementation. The program will be implemented over 19 months from 1 December 2014 to 31 December 2016.

III. DUE DILIGENCE

A. Economic

31. The program will fund short-term revenue shortages, which, if unaddressed, would result in significant cuts in welfare programs in 2015. These cuts would disproportionately affect the existing poor and push more Mongolians into poverty. Cuts in the social welfare budget will severely affect the poorest as many depend heavily on benefits for daily subsistence. The program will substantially mitigate the adverse impact of the fiscal consolidation program on the poorest. In particular, the 80% increase in the budget for the Food Stamp Program will expand the benefit by 30% and the number of household beneficiaries by 75%.

32. Under the ADB-financed program, policy actions to improve targeting and consolidate welfare programs will make those programs more effective and fiscally sustainable. The implementation of the proposed reforms will also help the government (i) adjust social benefits annually for inflation to maintain the purchasing power of real incomes; and (ii) raise benefit levels, particularly of the poorest, without increasing the fiscal burden. Given the importance of social transfers on the poor's income in Mongolia, the reforms will underpin poverty reduction efforts. Improved poverty targeting means the nonpoor will be dropped as beneficiaries in programs that are currently targeted by category, particularly welfare programs that are merit based instead of needs based (i.e., allowances for the elderly with merit, which largely accrue to the well-off). However, as the overall amount is not substantial for nonpoor recipients, their loss of income will be marginal.

B. Governance

33. **Public financial management.** Pro-cyclical fiscal management and misalignment of public expenditure and strategic priorities are two major public financial management challenges. To provide strategic guidance for the annual budget process and reduce vulnerability to the boom–bust economic cycle, the Government of Mongolia introduced a 3-year, medium-term budget framework in 2003. However, this has not been effective because of poor windfall revenue management and frequent amendments affecting budget expenditure. In addition to greater countercyclical fiscal discipline, budget preparation and public expenditure need to be better aligned with policy priorities. Nevertheless, the medium-term fiscal framework, linked to the amended FSL, appears credible. The comprehensiveness of information included in the budget, its public disclosure, and citizen participation have improved. However, recent increases in off-budget expenditures and the limited oversight of fiscal risks in state-owned enterprises, particularly the DBM, undermine this progress.²⁹

34. The program contains measures to mitigate the public financial management challenges, including policy actions to promote compliance with the FSL and the effectiveness of the Budget Transparency Law. These will strengthen fiscal discipline by reducing the pro-cyclical nature of fiscal policy and by increasing the transparency of public entities and their financial reporting and auditing standards.

35. **Public procurement.** The procurement system has strong legal and regulatory foundations. However, ensuring the proper implementation of laws, regulations, and procedures has been challenging. Procurement risks include (i) a lack of capacity and transparency; (ii) weak compliance and enforcement; and (iii) poor planning, evaluation, and contract management.

36. **Corruption.** Corruption is a major challenge in Mongolia. The government's legal, policy, and institutional framework and capacity remain inadequate to contain widespread corruption in national and sector systems. Major corruption risks include weak institutions and enforcement, lack of capacity of integrity institutions, political interference, lack of transparency and accountability, and the prevalence of conflicts of interest. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government.

C. Poverty and Social

37. While official labor market data does not yet reflect the economic slowdown, other indicators, such as the depreciation of the currency and the consumer price index,³⁰ point to protracted stress on household budgets. Studies on the impacts of the financial crisis in Mongolia in 2009 found that all income groups, but especially the poor, felt the impacts through declining job opportunities, lower incomes, and rising prices for imported foods. Reducing consumption and increasing reliance on credit and social welfare benefits were among the most common coping strategies. The impact evaluation of the Food Stamp Program determined that it is a significant safety net for the poor, helping to ensure food consumption and reduce negative coping strategies.

38. The program will have a positive impact on poverty and social issues. The expansion of the food stamp benefit rate and coverage will help to ensure that an adequate safety net

²⁹ Public Financial Management Performance (accessible from the list of linked documents in Appendix 2).

³⁰ The consumer price index was 7.5% year-on-year in May 2015.

responsive to the impact of the adjustment process is put in place. Policy measures that promote sustainability and expand the use of PMT targeting across other welfare benefits will strengthen the social welfare system by supporting the prioritization of available resources and assistance based on demonstrated need. Previous economic crises have demonstrated that cuts in government spending on social services profoundly disadvantage women.³¹ The program's overall goal of ensuring spending for social welfare during the implementation of CMAP will have a positive impact on women. In addition, the program ensures that the updating of the targeting database includes capacity to disaggregate data by sex, and that the working group established to analyze options and impacts of social welfare programs' consolidation includes a gender analysis.

D. Safeguards

39. Program activities are confined to policy reforms. None of the policy actions will result in or lead to involuntary resettlement or adversely affect indigenous peoples.³² Benefits will accrue to all Mongolians. No adverse environmental impacts have been identified. The program is categorized C for the environment, involuntary resettlement, and indigenous peoples.

E. Risks and Mitigating Measures

40. The integrated benefits and impacts of the program are expected to outweigh the costs. Despite some political instability and the mixed results of previous policy-based operations in social welfare (footnote 26), the program is justified to address the urgent needs of the vulnerable and the poor in Mongolia. Major risks and mitigating measures are summarized in Table 2 and described in detail in the risk assessment and risk management plan.³³

Table 2: Summary of Risks and Mitigating Measures

| Risks | Mitigating Measures |
|--|---|
| Political instability, including the possibility of early elections, paralyze the reform program | Continued engagement with the government, including the Asian Development Bank (ADB) top management intervention, and close coordination with development partners. |
| Prices of mineral resources plummet beyond expectations, sharply reducing government fiscal revenue | Given the country's vulnerability to external shocks, a deterioration of the external environment beyond expectations would require additional resources to ensure the effectiveness of the program. |
| Weak public financial management | The effectiveness of the Budget Transparency Law, a policy condition under the program, will strengthen public financial management by increasing the transparency of public entities' financial transactions reporting and auditing standards. |
| Capacity limitations could constrain the implementation of the technical aspects of the proposed reforms | Ongoing related technical assistance by ADB and the World Bank will strengthen capacity in poverty targeting and welfare programs consolidation. |

Source: Asian Development Bank.

³¹ United Nations Children's Fund. 2008. *Economic Crisis and its Social Impact: Lessons from the 1997 Asian Economic Crisis*. New York.

³² Potential Safeguard Impacts of Policy Reforms (accessible from the list of linked documents in Appendix 2).

³³ Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

IV. ASSURANCES AND CONDITIONS

41. The government has assured ADB that implementation of the program shall conform to all applicable ADB policies including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement, as described in detail in the loan documents. The government has agreed with ADB on certain covenants for the program, which are set forth in the draft loan agreement. No disbursement shall be made unless ADB is satisfied that the government has completed the policy actions specified in the policy matrix relating to the program.

V. RECOMMENDATION

42. I am satisfied that the proposed policy-based loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan of \$150,000,000 to Mongolia for the Social Welfare Support Program, from ADB's ordinary capital resources, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility, for a term of 15 years, including a grace period of 3 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan agreement presented to the Board.

Takehiko Nakao
President

7 September 2015

DESIGN AND MONITORING FRAMEWORK

Impacts the Program is Aligned with:

Adverse effects of fiscal consolidation on the poor mitigated (Comprehensive Macroeconomic Adjustment Plan, 2015–2017)^a

| Results Chain | Performance Indicators with Targets and Baselines | Data Sources and Reporting Mechanisms | Risks |
|--|--|--|---|
| Outcome Social welfare programs maintained | Social welfare expenditure maintained in 2015 at MNT285 billion | Annual budget report | Prices of mineral resources plummet beyond expectations, sharply reducing government fiscal revenue |
| Outputs 1. Fiscal policy management improved | (All baselines: Not applicable, except 2a) 1a. Parliament approves the CMAP by October 2015. 1b. The government makes the Budget Transparency Law effective by October 2015. 1c. The Parliament approves the amended FSL to (i) include budgetary expenditures financed by the Development Bank of Mongolia under the state budget; and (ii) reflect a gradual reduction of fiscal deficit and debt levels to the original targets of the law by 2018 (2% and 40% of gross domestic product, respectively), by October 2015. 1d. The government terminates the Price Stabilization Program and transfers the outstanding loans from the central bank to the state budget to be subject to the FSL by October 2015. 1e. The government submits to Parliament the second budget amendment to the 2015 budget to adjust fiscal expenditure, ensuring that funding for social welfare programs is maintained, by December 2015. | 1a. CMAP 1b. Budget Transparency Law 1c. Amended FSL 1d. Government decree on the program's termination 1e. Amended budget | Political instability, including the possibility of early elections, paralyzes the reform program Weak public financial management |

| Results Chain | Performance Indicators with Targets and Baselines | Data Sources and Reporting Mechanisms | Risks |
|---|--|--|---|
| <p>2. Policies and regulations to support targeting and consolidation of social welfare programs improved</p> | <p>2a. Total poverty-targeted transfers to poorest households increased in 2015 by 60% (2014 baseline: MNT10 billion)</p> <p>2b. Parliament approves the Revised Citizens' Health Insurance Law to subsidize health insurance contributions for household members in need of social welfare services by October 2015.</p> <p>2c. The cabinet issues a decree to use the poverty-targeted integrated household information database across government programs by October 2015.</p> <p>2d. The government allocates funding under the 2015 MPDSP budget to maintain and update the integrated household information database, including capacity to disaggregate data by sex, to capture the new poor and improve targeting by October 2015.</p> <p>2e. The government, through the MPDSP, issues a ministerial order requiring the Health Insurance Organization to ensure health insurance coverage for household members in need of social welfare services by June 2016.</p> <p>2f. The government prepares a draft resolution for at least two ministries to use proxy means testing in selected programs by June 2016.</p> <p>2g. The Prime Minister establishes an inter-ministerial working group to analyze options and impacts (including gender analysis) to prepare a plan to further consolidate social welfare programs of the MPDSP.</p> | <p>2a. Annual budget report</p> <p>2b. Revised Citizen's Health Insurance Law</p> <p>2c. Draft cabinet decree</p> <p>2d. MPDSP budget</p> <p>2e. MPDSP ministerial decree</p> <p>2f. Draft government regulation</p> <p>2g. Prime Minister's order</p> | <p>Political will to complete the reforms is lacking.</p> |

| Results Chain | Performance Indicators with Targets and Baselines | Data Sources and Reporting Mechanisms | Risks |
|--|---|--|--------------|
| | 2h. The government strengthens monitoring and evaluation of social welfare programs by ensuring budget allocations for the quarterly preparation of the 2016 household socioeconomic survey by December 2015. | 2h. Annual budget report | |
| Key Activities with Milestones Not applicable. | | | |
| Inputs Asian Development Bank: \$150 million policy-based loan | | | |
| Assumptions for Partner Financing Not applicable. | | | |

CMAP = Comprehensive Macroeconomic Adjustment Program; FSL = Fiscal Stability Law; MPDSP = Ministry of Population Development and Social Protection.

^a Government of Mongolia. 2015. *Comprehensive Macroeconomic Adjustment Plan, 2015–2017*. Ulaanbaatar. Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/RRPs/?id=49210-001-3>

1. Loan Agreement
2. Sector Assessment (Summary): Public Sector Management (Social Protection Initiatives)
3. Contribution to the ADB Results Framework
4. Development Coordination
5. Economic Analysis
6. Country Economic Indicators
7. International Monetary Fund Assessment Letter
8. Summary Poverty Reduction and Social Strategy
9. Risk Assessment and Risk Management Plan
10. List of Ineligible Items

Supplementary Documents

11. Poverty and Social Impact Assessment
12. Public Financial Management Performance
13. Potential Safeguard Impacts of Policy Reforms

**MINISTER OF FINANCE OF MONGOLIA**

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Takehiko Nakao
President
Asian Development Bank

Date 20.08.2015
Ref. 10-1/4978

Dear President Nakao,

**Mongolia: Social Welfare Support Program
Development Policy Letter**

The Mongolian economy is confronting the challenges stemming from falling commodity prices and the economic cycles of its main trading partners. The uncertainty of the world economy and increased volatility of mineral prices has adversely affected the country's mineral production, depressing exports and fiscal revenue inflows. The impact of external shocks is aggravated by domestic economic imbalances. GDP growth is expected at 4% in 2015, declining from 7.8% in 2014. The economic slowdown is affecting the non-mining sector, an important driver of economic growth and employment, leading to job losses and deteriorated living standards of the most vulnerable.

The current Government assumed office in November 2014 with the determination to bring Mongolia back to the path of sustainable inclusive growth. In less than a year, the Government has pursued decisive reforms to strengthen macroeconomic stability, with a focus on fiscal consolidation. Early in the year, the Government prepared a far-reaching plan to address economic instability, the Comprehensive Macroeconomic Adjustment Program (CMAP). The program aims to restore macroeconomic fundamentals through a series of structural reforms to diversify the sources of growth, improve the investment climate, foster employment generation, and ensure social protection. The Program was promptly approved by the Mongolian Parliament in February 2015.

The Government believes that fiscal consolidation is the key to the successful implementation of the CMAP. To that end, the Ministry of Finance has been tasked with the responsibility of executing an extensive fiscal consolidation plan to restore macroeconomic and fiscal stability.

Despite Government's concerted efforts, the persistence of the unfavorable external environment and the short-term contractionary impact of the adjustment program, have resulted in larger fiscal revenue shortages than anticipated. Addressing the current fiscal financing gap implies further fiscal restraint measures. The required fiscal discipline will thus result in cuts in capital expenditure that will weaken economic growth and employment generation. In addition, in the absence of external financing to bridge the gap in the budget, social welfare expenditure will have to be reduced when it is most needed. The Government is engaged in continued dialogue with major development partners to seek their support to overcome the short-term difficulties challenging the Mongolian

economy. The Government of Mongolia considers the support of the Asian Development Bank, our key development partner, essential to mitigate the adverse impact of the necessary macroeconomic and fiscal policy adjustments in Mongolia. In this context, we request the assistance of the Asian Development Bank in the form of a Program loan in the amount of \$150 million to support social welfare programs.

By funding short-term revenue shortages that, if unaddressed, will translate into significant cuts in welfare programs in 2015, the Program will help the Government to ensure social welfare expenditure is sustained during the implementation of the country's macroeconomic adjustment and fiscal consolidation plan. It will also support reforms to enhance the effectiveness and sustainability of social welfare in the long term.

Against this background, and on behalf of the Government of Mongolia, I would like to provide you with a brief update of the comprehensive policy actions already adopted to strengthen fiscal stability, and plans to launch reforms to maintain social welfare programs, improve their effectiveness, and ensure their sustainability in the long term.

Strengthened Fiscal Sustainability

Examples of policy actions adopted this year to strengthen fiscal consolidation include the amendment of the Fiscal Stability Law to gradually bring down the current fiscal deficit and public debt levels to 2% and 40%, respectively, by 2018. The Law has also been amended to consolidate the budget of the Development Bank of Mongolia under the State budget. This has added about MNT800 billion to capital expenditure to the budget, widening the fiscal gap, but it is a necessary action to enhance transparency and fiscal discipline.

A medium-term fiscal framework has been prepared to ensure compliance with the targets established by the Fiscal Stability Law. Actions implemented to date include a budget amendment to reduce fiscal expenditure by 7.3% from the projected figure, downsizing of Government ministries and agencies, reductions in capital and current expenditure, and increased excise taxes on fuel.

Other reforms worth highlighting are advances in the preparation of key legislation. The Budget Transparency Law became effective in January 2015 and will strengthen transparency in audit and public financial management. The draft Sovereign Wealth Fund Law has been submitted to Parliament. The Sovereign Wealth Fund is the key to cushion the impact of future swings in commodity prices and foreign direct investment inflows. A revised General Taxation Law is under discussion in the Parliament to clarify procedures to resolve tax disputes with foreign investors, including the role of the judiciary. The revised Law will strengthen the investment climate to attract steady inflows of foreign direct investment, which are essential to develop Mongolia's vast mineral wealth, and sustain growth in the long term. Moreover, the Parliament approved the Debt Management Law and the Medium-Term Debt Management strategy.

Enhanced Social Welfare

Along the years, and with the support from the Asian Development Bank and other development partners, the Government has established comprehensive safety nets and welfare programs, and social expenditure has been increased accordingly. Larger social transfers have had a significant impact in terms of poverty reduction. However, there is room to implement further reforms to increase the impact and effectiveness of social welfare programs. At present, costly universally-targeted benefits burden the social welfare funding. This is compounded by the fragmentation of welfare programs, which results in

overlapping benefits, high administrative and transaction costs, and difficulties to monitor the effectiveness of the programs.

Addressing these issues is a priority under the current economic slowdown. To support the implementation of the Government's stabilization plan it is vital to protect the vulnerable throughout the adjustment process. Given the limited fiscal space, policy actions to strengthen social welfare must focus on consolidating social welfare programs while improving targeting to the neediest. Improved poverty-targeting and benefits' consolidation will result in enhanced effectiveness, increased benefits for the more vulnerable, and expanded coverage of key welfare programs.

Actions already undertaken by the Government to enhance social welfare programs include the approval of a Cabinet resolution to manage and use the poverty-targeted Integrated Household Information Database across welfare programs. Parliament has approved a revised Citizens' Insurance Law to subsidize health insurance contributions for household members in need of social welfare services. In addition, funding to key social welfare programs was augmented, including an 80% increase in the allocation for the Food Stamp Program.

The Government is committed to continue reforms to improve the effectiveness of social welfare expenditure. Social welfare programs will be identified to adopt the use of the poverty-targeted Integrated Household Information Database. Steps will be taken to request the Health Insurance Organization to assure health insurance coverage for household members in need of social welfare services. In addition, a working group will be established to analyze options and prepare a plan to consolidate social welfare programs.

Mr. President, I would like to thank the Asian Development Bank for working closely with the Government of Mongolia in developing this Program. I wish to reiterate our full commitment and support to it.

Sincerely,

A handwritten signature in black ink, appearing to read 'S. Bayartsogt', with a long horizontal flourish extending to the right.

S.BAYARTSOGT
Minister and Chief of Cabinet Secretariat
Government of Mongolia

POLICY MATRIX

| TRANCHE 1 (by Q3 2015) | | TRANCHE 2 (12 months after T1) | |
|--|--|---|-----------------------|
| Policy Actions | Implementation Status | Policy Actions | Implementation Status |
| Output 1. Fiscal Policy Management Improved | | | |
| <p>1. The Parliament approved the Comprehensive Macroeconomic Adjustment Program.</p> <p>2. The government made the Budget Transparency Law effective.</p> <p>3. The Parliament approved the amended 2015 budget that reflected (i) a 7.3% expenditures reduction; and (ii) increased fuel taxes revenue by MNT228 billion.</p> <p>4. The Parliament approved the amended Fiscal Stability Law to (i) include budgetary expenditures financed by the Development Bank of Mongolia under the State budget; and (ii) to reflect a gradual reduction of fiscal deficit and debt levels to the original targets of the Law (2% and 40% of GDP, respectively) by 2018.</p> <p>5. Parliament received the draft Future Heritage Law to Parliament (Sovereign Wealth Fund).</p> | <p>Complied with. (Required document: copy of Parliament approval of the Program)</p> <p>Complied with. (Required document: copy of published Law)</p> <p>Complied with. (Required document: copy of Budget Amendment and clarification letter from the State Secretary, MOF)</p> <p>Complied with. (Required document: copy of Amended Fiscal Stability Law)</p> <p>Complied with. (Required document: copy of the submission to Parliament)</p> | <p>1. The government will submit to Parliament a second 2015 budget amendment to adjust fiscal expenditure ensuring that funding for social welfare programs is maintained.</p> <p>2. The government will submit to Parliament a revised Development Bank of Mongolia Law to improve the bank's transparency and accountability, including (i) subjecting the bank to the central bank's supervision; (ii) ensuring independent investment decision-making; and (iii) regular financial statements' disclosure.</p> | |

| TRANCHE 1 (by Q3 2015) | | TRANCHE 2 (12 months after T1) | |
|---|--|-----------------------------------|-----------------------|
| Policy Actions | Implementation Status | Policy Actions | Implementation Status |
| <p>6. The Parliament approved the mid-term debt management strategy, 2016-2018.</p> <p>7. The government terminated the Price Stabilization Program, and transferred the outstanding loans from the central bank to the State budget to be subject to the Fiscal Stability Law.</p> | <p>Complied with. (Required document: copy of Parliament's decree)</p> <p>Complied with. (Required document: cabinet resolution)</p> | | |

| TRANCHE 1 (by Q3 2015) | | TRANCHE 2 (12 months after T1) | |
|---|---|---|--|
| Policy Actions | Implementation Status | Policy Actions | Implementation Status |
| Output 2. Policies and regulations to support targeting and consolidation of social welfare programs improved | | | |
| 8. The government increased funding for the Food Stamp Program by 80%, expanding both the benefit and coverage of the program. | Complied with. (Required document: copy of the budget page stating the increase and clarification letter from the State Secretary, MOF) | | |
| 9. The Parliament approved the Revised Citizens' Health Insurance Law to subsidize health insurance contributions for household members in need of social welfare services. | Complied with. (Required document: copy of revised Law) | 3. The government, through the MPDSP, will issue a ministerial order requiring the Health Insurance Organization to provide health insurance coverage for household members in need of social welfare services. | (Required document: copy of MPDSP ministerial order) |
| 10. The Cabinet issued a resolution to use the poverty-targeted Integrated Household Information Database across government programs. | Complied with. (Required document: copy of Cabinet resolution) | 4. The government will prepare a draft Cabinet resolution to require at least two ministries to use proxy-means testing in selected programs. | (Required document: copy of draft cabinet resolution) |
| 11. The government allocated funding under the MPDSP budget to maintain and update the poverty-targeted Integrated Household Information Database in 2015. | Complied with. (Required document: copy of the page showing the budget allocation in 2015 and clarification letter from the State Secretary, MOF) | 5. The government will include a budget line under the MPDSP's 2016 budget for maintaining and updating the poverty-targeted Integrated Household Information Database in 2016. | (Required document: copy of the page showing the budget line) |
| | | 6. The government, will establish an inter-ministerial working group to analyze options and impacts (including gender analysis) to prepare a plan to further consolidate social welfare programs of the MPDSP | (Required document: Prime Ministerial decree for the establishment of the working group) |

| TRANCHE 1 (by Q3 2015) | | TRANCHE 2 (12 months after T1) | |
|---------------------------|-----------------------|---|---|
| Policy Actions | Implementation Status | Policy Actions | Implementation Status |
| | | 7. The government will strengthen monitoring and evaluation of social welfare programs by ensuring budget allocations for the quarterly preparation of the HSES are maintained in 2016. | (Required document: copy of the page showing the budget allocation in 2016) |

GDP = gross domestic product; HSES = household socio-economic survey; MNT = togrog, MPDSP = Ministry of Population Development and Social Protection