

**PROPOSALS FOR TAX REFORM IN MONGOLIA**

**By**

**Tserendejid Purevjav**

**THESIS**

Submitted to  
KDI School of Public Policy and Management  
in partial fulfillment of the requirements  
for the degree of

**MASTER OF PUBLIC POLICY**

2006

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## **ABSTRACT**

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The philosophy behind a “good” tax system must be equitable and simple. It must be designed to provide for:

1. Horizontal equity, meaning that individuals with comparable incomes pay comparable levels of taxes; and
2. Vertical equity, meaning that individuals with higher levels of income pay a higher level of taxes than those with lower levels of income.

Mongolia’ s tax system consists of the enterprise (corporate) and individual income taxes, value added tax, various kinds of excise taxes, and a number of minor taxes. In 2005, tax revenue accounted for 77.3 percent of total government revenue. The corporate and personal income tax and the excise tax are the three largest revenue sources, accounting for 45 percent of total general government revenue.

Theoretically, the following are the main principles of tax reform policy such as; imposing tax rate on an appropriate low level, while increasing tax bases on the purpose of protecting economy, reducing burden of taxpayers. In this thesis, I have supposed several proposals for tax reform in Mongolia.

The source of any economical development is the production of material or wealth. Therefore, tax reform policy should be directed to support national production. This is the initial condition of economic development definitely. Thus I am proposing the one possible way of widening tax base.

Secondly, we know that consumers pay value added tax. 15 percent of value added tax

is heavy burden as well because 2/3 of our Mongolians live under the poor condition. It is possible to decrease the percent of value added tax. In addition, the special tax exemptions, tax holidays, or evading the formal economy all serve to lower the taxable base.

A “good” tax system should be simple to administer. The law, rules and regulations shall be available to public, easy to understand, and uncomplicated to calculate.

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## INTRODUCTION

What is generally viewed as a “good” tax system? Keeping in mind that nobody enjoys paying taxes of any sorts, it must be understood that taxes are a major source of revenues for governments, and that governments are responsible for providing the social and physical infrastructure that society desires. If not for tax revenues, we would not have our schools, hospitals and roads. Centuries ago the French statesman Jean Baptiste Colbert suggested<sup>11</sup>, “The art of taxation is the art of plucking the goose so as to get the largest possible amount of feathers with the least possible squealing”.

The philosophy behind a “good” tax system must be equitable and simple. It must be designed to provide for:

1. Horizontal equity, meaning that individuals with comparable incomes pay comparable levels of taxes; and
2. Vertical equity, meaning that individuals with higher levels of income pay a higher level of taxes than those with lower levels of income.

And it must be noted that, despite the fact that businesses are taxed, all taxes are ultimately paid by individuals. Businesses really serve only as collection points for taxes, by including them in prices they charge. This being the case, it is desirable that the tax rates be low, and that the tax base be large. The tax base is the most when all individuals and business operate in the formal economy and pay their fair share of taxes.

Special tax exemptions, tax holidays, or evading the formal economy all serve to lower the taxable base, thereby increasing the tax burden for others.

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<sup>11</sup> Harvey S. Rosen “Public Finance” (2002) 6-th ed, p251.

Scientists have seen that the history of taxation has begun about 150-250 years ago. Taxation is a major source of the government's revenues. Taxes impose a cost on the taxpayer. It is tempting to view the cost as simply the amount of money that somebody hands over to the tax collectors.

Analysts of tax systems elucidated that taxes should have horizontal and vertical equity, be neutral with respect to economic incentives, easy to be administered. Thus, the tax base is the most when all individuals and business operate in the formal economy and pay their fair share of taxes.

Furthermore, the government's goal is to finance the state's expenditures with a minimum tax rates, but the lower tax base causes a higher tax rates.

So what changes do we need to solve this problem? At what rates should various goods be taxed?

The answer of this question would be the topic of my thesis.

The thesis is divided into five sections. The first section is the outline of the Mongolian tax system. This part covered the initial conditions and phases of tax system in Mongolia. In addition, the section covered the current tax system overview, tax administration and tax composition.

The section two describes the considered current main challenges of tax reform. Sources and causes of tax system structural weakness in Mongolia are depicted in section three.

Section four describes the tax base research result including some calculations. A framework for this research has been developed in this section. Section five deals with proposal for tax reform.

This section reports the results from research analysis and depicted some legislatives process obstacles to tax reform. Finally, the concluding remarks have been included in this section.

## **SECTION I. CURRENT TAX SYSTEM OF MONGOLIA**

### **1. General overview:**

The tax system of Mongolia consists of taxes, fees and payments. Various taxes are imposed at the state and local levels.

The tax administration is responsible for administering 6 state taxes and 15 local taxes. Customs administration is responsible for application of Import duties, Excise taxes and Value added tax on imported goods and for the application of export taxes on certain exported goods.

The most important direct taxes are Economic Entities and Organizational Income tax and personal income tax.

The Parliament of Mongolia has the power to suspend and amend taxes. Relations arising from introduction, imposition and amendments of taxes, and their deduction, exemption, payment shall be regulated tax laws.

### **2. Responsibilities of Organizations and inspectors for tax:**

The National Tax office system consists of General Department of National Tax, local tax offices and tax inspectors, which are responsible for control on implementation of tax legislature, issue of rules, guidance, methodological instructions, training, advertisement, collection of the state and local budget. Tax dispute resolution councils are established at General Office, and tax offices of provinces and Ulaanbaatar City.

### **3. Taxes imposed, tax year**

The Economic entities and Organizational income tax Law regulates the income tax on companies, co-operatives, partnerships, foreign enterprises and joint ventures with foreign investment situated in Mongolia. The tax also applies to a permanent establishment of a foreign entity and to commercial banks, credit agencies, insurance agencies and legal entities. The tax year is the calendar year.

***Business Entities and Organizational Income Tax:*** All domestic corporations and resident foreign corporations are taxed on their net income from all sources worldwide. Non-resident corporations are taxed on their Mongolian net source income. The taxable income of a taxpayer shall be determined by deducting direct expenses as evidenced by receipts from the income.

**figure1:**

The annual taxable income is taxed by the following rates:

/1USD=1165 Mongolian togrog/

Taxable income for the tax year /togrog/	Tax rates
0-100'000'000	15%
Over 100'000'000	15'000'000 plus 30% of the amount of income exceeding 100'000'000 tugrug

The following kinds of income are taxed at special rates:

15 % on dividends and gains of shareholders

10% on royalty income

40% on income from lotteries, quizzes, games, sale of video and audio cassettes, and recording services.

2% on the income from sale of immovable property

Depreciation rates are determined on straight-line method considering the following usage and passage of time.

**figure 2:**

Asset group	Depreciation life (year)
Building construction	40
Machinery or equipment	10
Special purpose machinery or equipment for scientific research, ..computer	5
Other assets	10

A business entity with **foreign investment** established in any of the following sectors shall be entitled to tax exemptions as follows:

-A business entity engaged in mining or the processing of minerals, apart from precious metals, oil and hard fuel, metallurgy, chemical or iron production, electronics or manufacturing of machinery shall be tax exempt for the first five years and credited by fifty percent for succeeding five years.

-A business entity with foreign investment to be established in any sector other than those specified in the law may be entitled to tax credit.

An investment made by a business entity or organization in the construction of energy sources and networks, or the refurbishment of the initial production technology, shall be tax exempt for the first 10 years and credited by 50 percent for the succeeding 5 years. We can see the total *Business Entities and Organizational Income Tax* income of 2006, in the following:

**figure 3:**

Revenue from *Business Entities and Organizational Income Tax* /2006/

(Millions of Tg): /1USD=1165 Mongolian togrog/

Rates:	Government Receipts			CIT Revenues as Share of Total Taxes		
	2003	2004	2005	2003	2004	2005
15%	4,330	5,859	6320	<1%	<1%	
30%	64,451	94,045	107810	12%	14%	14.7%

Large corporations pay most of the Business Entities and Organizational Income tax. State-owned mining corporations pay 67% of total payments, equal to almost MNT 60 Billion. The largest 100 Mongolian companies accounted for 22% of *Business Entity and Organization Income Tax* revenue and state-owned companies contributed 7%.

**figure 4:**

State mining companies	67%
Other state owned enterprises	7%
Largest 100 private companies	22%
Small and medium private companies	4%

**Value added tax:** Value added tax is the tax imposed on the goods imported by a citizen or legal entity, also on the goods produced and sold or imported and sold, jobs performed and services provided in the territory of Mongolia.

Value added tax of 13 % is imposed on every of the imported or sold goods, performed jobs and rendered service. Value added tax of the exported goods, job and

service (except gold) equals zero. Value added tax of 10% of the sale income from the gold (999 purity gold) sold and exported by enterprises.

**Excises:** Excises are imposed on import and some of domestic products and goods. Excises payer is a citizen, enterprise or organization importing and producing the following goods and products: Alcoholic drinks, Tobacco, gasoline and diesel fuel, petrol, Cars. Excise rate is determined by based on the price of sale and imposed on the unit of the goods. In the Law of Excises it is in detail indicated what excise is imposed on the concrete item of the above goods.

**Personal Income Tax:** A citizen of Mongolia, a foreign citizen or a stateless person residing in the territory of Mongolia and a non-resident earning income within Mongolia shall be deemed taxpayers.

**figure 5:**

Tax computation

**/1USD=1165 Mongolian togrog/**

Taxable income	Tax rates
0-2'40'000 tog	10%
240'001-4800'000 tog	240'000 tug plus 20 % of amount of income exceeding 240000 tog
480'001 and more	720'000 tog plus 40% of the amount of income exceeding 480'000 tog

There are also specific tax rates on the number of sources of income such as remuneration for scientific, literary or artistic production, copyright, patent and new invention, and designer's fee; sale of immovable property; dividends and so on.

## SECTION II. CURRENT MAIN CHALLENGES OF TAX REFORM

Deep reforms in the Mongolian tax system and tax administration began as a result of the falling copper prices in 1995. Faced with falling revenue and potential erosion of all the early gains from the stabilization process of Mongolia since the 1997 accelerated revenue enhancement reforms through changes in the tax system and tax administration processes.

These reforms were very successful as revenue went from 23 percent of Gross domestic product in 1995 to 31.8 percent of Gross domestic product in 2004. As part of the reforms the value added tax was introduced and increased from 10 to 15 percent replacing the sales tax in 1998.

In 2005, tax revenue accounted for 76.9 percent of total government revenue. The sales tax, the enterprise income tax and the excise tax were the three largest revenue sources, accounting for 45 percent of total general government revenue.

**figure 6:**

SHARE OF TAX REVENUES IN TOTAL  
REVENUES 1993-2005 (IN PERCENT)

	1996	1997	1998	1999	2001	2002	2003	2004	2005
Income taxes	20.8	14.3	14.3	12.1	15.6	15.2	17.5	16.8	16.3
Social security contributions	8.4	9.5	12.6	12.2	10.7	12.3	11.3	12.4	13.2
VAT	9.8	12.6	15.8	18.8	18.3	23.7	24.7	23.3	21.0

Excise taxes	5.1	6.7	8.4	8.3	9.8	12.1	11.2	12.3	11.1
Taxes on specific services	2.1	1.6	2.2	2.1	1.7	2.0	2.8	2.4	2.8
Customs duties and export tax	6.4	2.9	0.5	2.8	5.4	6.1	5.1	5.2	5.9
Other taxes	2.6	2.6	2.7	2.8	2.8	2.8	2.7	2.5	2.6

The Government of Mongolia (GoM) is committed to implementing tax policy reforms that will reduce the tax burden on labor and businesses, encourage private sector growth, and strengthen Mongolia's competitiveness in the global market.

Cabinet has submitted a draft package of newly formulated tax laws and it has approved by the Parliament in the Fall Session of 2005. **The followings are objectives of tax reform measures under consideration package aimed at “strengthening of economic capacity and increasing competitiveness”:**

1. Increase country competitiveness by lowering the tax burden on businesses, creating a job market;
2. Relief the tax burden on workers by reducing the tax rate and labor costs on wage earners;
3. Simplify tax administration procedures to reduce compliance costs and arbitrariness, by focusing more on service to taxpayers;
4. Expand the tax base by reducing the size of the shadow economy
5. Support domestic investors by removing discriminatory tax provisions; and
6. Create a sound fiscal environment by adjusting the tax system into a proper structure.

7. Raising the income threshold, at which the 15% tax rate increases to 30%; the current threshold of 100 million togrog encourages businesses to form subsidiary companies rather than concentrate capital and grow larger, become more efficient, and more competitive. Permitting companies to pay the 15% rate to a higher income level would encourage them to grow.

8. Eliminating tax exemptions and holidays: There are a variety of provisions in the law that permit certain investors and industries to avoid paying any income taxes. The package was discussed extensively during Cabinet meetings and in numerous working sessions with Ministry personnel and other bodies. As a result, the following laws are rewritten in their entirety:

1. Legal Entities and Organizational income Tax Law
2. Personal Income Tax Law
3. Law on Value-added Tax
4. Excise Tax Law
5. Immovable Property Tax Law

The package of laws was prepared to support the above goals and enhance the economy of Mongolia. Passage of the package will lessen the tax burden on businesses, will permit competition among all businesses in Mongolia and will encourage Mongolian businesses to become more competitive internationally.

Government's position is that changing the tax structure will encourage investment, both domestic and foreign. Additional investment will create additional jobs and would reduce poverty. These additional jobs would be part of the formal economy,

thus increasing the tax base. Increasing the tax base permits lower percentage tax rates:

$$\text{Tax Base} \times \text{Tax Rates} = \text{Government Income From Taxes}$$

Hereby, of primary concern is the taxation of businesses. Among others, this includes income tax and value-added tax. These two taxes combined represent almost one-half of total government tax revenues and are the most influential in affecting business behavior.

**Composition of Tax Revenues in Total Budget Revenue** (in percent) In assessing the efficiency of a tax system and determining the scope for necessary reforms, analysts find the concepts of tax elasticity and tax buoyancy useful.

The elasticity of tax is defined as the relative change in revenues from that tax under a given tax system (which remains unchanged) compared with the relative change in the tax base. Elasticity provides a tax system with built-in flexibility. It can be written as:

$$\text{Elasticity of tax revenue} = \frac{\text{Percent change in tax revenue (under an unchanged tax system) of tax revenue}}{\text{Percentage change in the tax base (GDP growth change)}}$$

If Gross domestic product is taken as a proxy for the tax base, then elasticity with respect to Gross domestic product would be:

**figure 7:**

**Growth Comparison Between GDP and Government Tax Revenue:**

**Tax Elasticity Performance**

**/1USD=1165 Mongolian togrog/**

	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Nominal GDP, in billion togs	1131.3	1228.8	1359.3	1526.6	1691.3	1873.9
Nominal GDP, in percent	<b>108.2</b>	<b>108.6</b>	<b>110.6</b>	<b>112.3</b>	<b>110.8</b>	<b>110.8</b>
Tax revenue, in billion togs	274.2	304.8	355.8	421.0	458.4	497.8
Tax revenue growth, in percent	125.9	109.4	117.2	117.8	109.2	108.9
<b>Tax elasticity rate</b>	<b>1.164</b>	<b>1.007</b>	<b>1.06</b>	<b>1.049</b>	<b>0.986</b>	<b>0.983</b>

A tax system is elastic when it has an elasticity value greater than one, suggesting that tax revenues are increasing at a higher rate than Gross domestic product without new taxes or increases in tax rates. Elasticity is desirable in a tax system and should be encouraged in countries such as Mongolia where government expenditures trend to increase more rapidly than Gross domestic product in short run and medium term period.

### **SECTION III. SOURCES AND CAUSES OF TAX SYSTEM STRUCTURAL WEAKNESS IN MONGOLIA**

Mongolian businesses currently must pay taxes in a profitable year, but receive no benefit from suffering a loss in one year. Also, new companies often lose money in their early years when they are also making substantial investments. Many people think Mongolia's current tax laws are hindering the economy. Government's position is that changing the tax structure will encourage investment, both domestic and foreign. Additional investment will create additional jobs and would reduce poverty. These additional jobs would be part of the formal economy, thus increasing the tax base.

Income tax and value-added taxes represent almost one-half of total government tax revenues and are the most influential in business behavior.

To encourage business growth, it is very important to raise the income threshold, at which the 15% tax rate increases to 30%; the current threshold of 100 million togrog encourages businesses to form subsidiary companies rather than concentrate capital and grow larger, become more efficient, and more competitive.

Permitting companies to pay the 15% rate to a higher income level would encourage them to grow. Furthermore, we need to permit additional deductible expenses; the current law restricts many types of legitimate business expenses that may truly be reasonably necessary for the business to operate.

There are a variety of law provisions, which permit certain investors and industries to avoid paying any income taxes.

A carry-forward provision would permit companies to pay taxes based on long term financial performance. These are some of the more major changes being considered,

and it may not be possible to accept all of them. Among other possibilities, government must carefully evaluate the potential revenue losses and overall economic gains that would result before it adopts specific measures.

But to become more competitive, Mongolian tax system must conform to the international best practices.

The Foreign Investment Law of Mongolia has transformed the anti-business environment of Soviet era into today's investor-friendly regime.

Some economic activities such as franchising, leasing, joint venture companies were not mentioned in earlier Mongolian statutes, they were technically illegal. In 1993 the government enacted The Foreign Investment Law to legalize all manner of foreign investment in Mongolia (amended in 2002 to allow for representative offices and franchises). This law defines the broad ranges of activity that would otherwise have no validity under the Mongolian law.

It also defines that the meaning of foreign investment under the civil code without limiting activities that foreign investors can conduct. The definition is mainly for tax incentives, as only foreign investments over 10,000 USD qualify for tax breaks under the law. The Foreign Investment Law also, establishes registration procedures for foreign companies. It creates a supervisory agency, the Foreign Investment and Foreign Trade Agency (FIFTA), to run the registration process, liaise between businesses and the Mongolian government, and promote in- and out-bound investments. We have found FIFTA a reasonably fair and efficient agency.

Foreign investors under the Foreign Investment Law of Mongolia and the Tax Law of Mongolia are entitled to a sliding scale of tax holidays. The exemption increases in

the amount and duration as the investment increases. For larger projects seeking a more comprehensive tax treatment and more extensive package of incentives, foreign investors have two routes. They may utilize an off-the-shelf stability agreement that locks in current tax and fee structures, as they existed at the time the agreement was signed and approved by the Ministry of Finance. This relatively new arrangement has not given rise to any disputes, and we have no reason to think that the Mongolian government would not honor it.

The second approach is to negotiate a customized agreement directly with the government. Such a stability agreement locks in current tax rates and fees as well the entire range of regulations, statutes, and rules that existed when the agreement was signed and approved by the Parliament of Mongolia. The full range of labor, environmental, tax, and any other laws and rules are frozen as matter of statute by the establishment of such an accord. The parties agree between themselves on the widest array of incentives, laws, practices; Parliament approves it; and the agreement becomes a unique statute unto itself.

Although the process of making and executing law are key problems, we note a particularly troublesome area that all foreign and domestic investors identify as a must solve:

Firstly, the General Tax Law of Mongolia is not consistent with best practices in either Europe or North America. Key complaints from the American and western investors center on the deductibility of legitimate expenses and depreciation. This failure to adopt best practices raises the effective tax rate on business activities in Mongolia, making Mongolia less competitive than other business venues. Secondly,

the law, vague on concepts of income and taxation, lets the auditors determine what is and is not taxable.

On the revenue side of the Government, sweeping reforms in the tax system and tax administration over the last decade substantially increased revenue performance, but there is room for improvement. The main problem on the revenue side is the increasing tax burden, which is already very high. Mongolia will need to reform on the tax administration and continuing to adopt reforms that favor a more efficient tax regime, with fewer distortions and increased compliance.

Problems with the tax incidence and the increasing fiscal measures to meet rising expenditure commitments continue to undermine performance. In the medium-term and following expenditure reductions, reforms should focus on reducing tax burden to promote growth by strengthening the tax administration, broadening the tax base, reducing exemptions and improving legal framework for revenue assignments.

#### **Main reforms adopted in last years**

- The number of corporate income tax rates was reduced from four (15, 25, and 40 percent) to two (15, 30 percent), and the depreciation system was simplified to single rate, and the straight-line method;
- the base of the sales tax was broadened to include selected enterprises in the food, construction, and communication sectors, and the annual turnover threshold was eliminated;
- All customs duties were eliminated, and stabilized at 5 percent, except a 15 percent duty on alcoholic spirits;

- the excise on petroleum products, spirits and wine were doubled;
- The royalty rate on mineral was reduced at 2.2 from the previous system of negotiated rates in the range of 1.5 to 12.5 percent;
- A 15 percent customs duty on flour and vegetables was reintroduced on a temporary basis.

Distortions created by the tax system, it also constrained the corporate sector. A key distortion arises from the corporate tax system. As mentioned above, Mongolia levies a progressive rate, whereby the tax rate is 15% for companies with profits less than 100 million togrog and 30% for companies with higher profits.

This has had significant adverse effects. First, it penalizes efficient companies with high profits. Second, the tax system encourages companies to split into smaller companies to avoid paying the higher rates of taxes.

Besides not being able to benefit from economic scale, the smaller companies are not able to raise funds through the capital market. By encouraging the creation of subsidiaries, the corporate income tax system also complicates management structures, resulting in inefficiency and lack of transparency.

The differential tax treatment on the returns of different types of financial assets is another distortion. Interest on government debt is tax exempt.

According to the Business Entities and Organizational Income tax law, interest income on bank deposits is subject to a 15% tax rate. However, this article will be enforced only in 2008. Therefore, interest on bank deposits is currently tax-exempt.

However, dividends are subject to a 15% tax rate, and capital gains on equity investment to up to 30%, discouraging investment in the equity market.

In most countries, one reason why founders of closely held limited liability companies list on the stock exchange is to realize a capital gain as share prices increase. Reserves for expected losses, are tax deductible for commercial banks and Credit Unions but not for other financial institutions. Harmonizing the taxation of banking and NBF sectors is crucial to develop a broad-based financial sector.

**Value added tax** has substantial effects on both businesses and on the economy as a whole.

Effects on businesses:

1. Although the net “expense” of Value added tax is intended to be zero, there is a financing cost associated with paying the Value added tax on purchases and not recovering from the amount until production completion and sale. This is causing negative effect to Mongolian businesses, and the high interest rates available.

2. Unregistered businesses must pay the value added tax on their inputs, but cannot charge the Value added tax on the sale of products.

As a result, they do not recover the cost of the Value added tax on their purchases of goods, works and services. This leaves these smaller businesses at a disadvantage when competing against larger businesses. It is particularly harmful to business start-ups that must pay the Value added tax on their initial purchases. Effects on the economy:

3. As Value added tax (VAT) is paid upon every purchase of goods, works and services, it is the most difficult tax for businesses to avoid. Participants in the informal economy must pay it when they make the value added tax-taxable purchases through the formal economy. It is beneficial for companies operating in the informal economy to be registered as VAT payer.

This provides an incentive for these the companies to register, and to participate in the formal economy.

4. Value added tax is the best economic tool for encouraging domestic production, by collecting Value added tax on all imports and exempting exports and smaller or selected local producers. This is one way for domestic businesses to better compete against foreign competitors.

5. With the relatively large level of imports of Mongolia, the majority (approximately 60 percent) of VAT is collected at the borders. This means that the collection and administration costs are relatively low in relationship to the total amount collected. These expenses for other types of taxes are higher, but bring in less revenue.

**figure 8:**

**Overview of Standard VAT Rates (In percent)\***

A. Selected Transition Countries		B. Selected EU Countries	
<b>Advanced Transition Countries</b>	21.5	Austria	20
Czech Republic	22	Belgium	21
Estonia	18	Denmark	25
Hungary	25	Finland	22
Poland	22	France	20.6

Slovak Republic	23	Germany	16
Slovenia	19	Greece	18
<b>Other Transition Countries</b>	20	Ireland	21
Albania	20	Italy	19
Bulgaria	22	Netherlands	17.5
Croatia	18	Portugal	17
Romania	20	Spain	16
Russia	20	Sweden	25
Ukraine	20	United Kingdom	16.5
<b>A v e r a g e</b>	20.8	<b>A v e r a g e</b>	19.6

Source: IMF, Fiscal Affairs Department. \* International comparisons are complicated by the existence in most countries of several other VAT rates applicable to specific groups of goods and services.

## SECTION IV. TAX RESEARCH ANALYSIS

Every economy has their limitation in paying tax, and if the payment of tax exceeds the limit, it will cause of a negative affect to the economy. This theory shows that if the level of tax is around 10-15% of total GDP, it is adequate, but if exceeds this percent it causes the decrease of national economy. In Mongolia, the average level of tax is 28 percent in last 5 years, which is higher than well developed and developing countries' in 10 units.

It seems that the government's role to serve for people is becoming not clear and the tax is being used on the purpose of financing expenses of huge apparatus (budget expenses of the state), which was created already. This is the reason of higher tax level than other countries' average.

Therefore, today we need to simplify tax administration procedures to reduce compliance costs and arbitrariness, by focusing more on service to taxpayers and expand the tax base by reducing the size of the shadow economy by raising the income threshold, at which the 15% tax rate increases to 30%; the current threshold of 100 million togrog encourages businesses to form subsidiary companies rather than concentrate capital and grow larger, become more efficient, and more competitive. Permitting companies to pay the 15% rate to a higher income level would encourage them to grow. Furthermore it is very important the eliminating tax exemptions and holidays.

The source of any economical development is the production of material or wealth. Therefore, tax reform policy should be directed to support national production. This is the initial condition of economic development definitely.

Some scientists and experts are proposing to impose income tax without any stages, besides that, others are proposing various versions of proposals such as to increase current stages.

It is most important to support or develop small and medium enterprises by tax policy in order to make huge number of national giant producers according to the principle of shifting from small to the big.

If considering abovementioned situation, it is not the time to be shifted into the 1 staged tax system and the right option is to follow current income tax system until the producer's *profitable year*. It is considered as profitable investment in international standards if the expense of initial investment to any production is recovered within 4.4 years.

Last two years/2004 - 2005/, inflation level has not been decreased from 10 percent. Theoretically, economy is developed if the inflation level is kept in one digit.

The initial threshold of income tax for legal entity has been changed from 100 million tugriks to 500 million tugriks since 2006.

**figure 9:**

**/1USD=1165 Mongolian togrog/**

Year	Consumers price index /by 2006 price/	500 mln /by 2006 price/	500 mln tugrik of the Y2006 /by those years/
2006	100	500 mln tog	500 mln.tog

2007*	105.8	472.6 mln.tog	529.0 mln.tog
2008*	111.9	446.8 mln.tog	561.3 mln.tog
2009*	117.9	424.1 mln.tog	594.9 mln.tog
2010*	123.9	403.6 mln.tog	630.6 mln.tog

If we see above table /table #1/ we can see that the 500 million tax threshold of the Y2006 would be equal to 630.6 million tugriks of the Y2010, including the inflation.

In 2005, the course of exchange dropped by 60 % compared to 1997, while the 100 million tugriks tax threshold were stable. As we know that, time is the lost possibility.

So, if we had changed it from time to time, we could get a lot of tax income.

Thus I am proposing above version of widening tax base. That means legal entity who has an income of 630.6 million tugriks, must be imposed an income tax and must pay a tax of 30 percent. Tax base will be widened by 130 million tugrics and 30 percent of tax will be exempted as a result of it.

**An individual income tax:** Although individual income tax constitutes about 3 percent of Gross Domestic Products, its burden is comparatively high for ordinary people. In such situation, we should take in our attention this matter. In other words we should discuss that the possibility of how to change tax base. It is estimated that the income which is exempted from individual income tax will be 88.1 thousand tugrics, and the other income to be imposed a tax according to the upper stage will be 756.9 thousand tugrics.

**figure 10:**

Tax free income /individual/

**/1USD=1165 Mongolian togrog/**

Years	Income per person/2006 level/	70 thous.togrog of the Y2006 /by those years/
2006	100	70 thous.tog
2007*	105.8	74 thous.tog
2008*	111.9	78.4 thous.tog
2009*	117.9	83.1 thous.tog
2010*	123.9	88.1 thous.tog

\*-Presumption

**figure 11:**

Taxable income /individual/

Years	Income per person/2006 level/	600 thous.togrog of the Y2006 /by those years/
2006	100	600 thous.tog
2007*	105.8	634.8 thous.tog
2008*	111.9	673.5 thous.tog
2009*	117.9	713.9 thous.tog
2010*	123.9	756.9 thous.tog

\*-Presumption

In other words, as widening base of individual income tax one taxpayer should be pay 30 percent of tax for the income exceeds from 756.9 thousand tugrics. So, we could say that, it is possible to widen the tax base according inflation level.

## SECTION V. CONCLUDING REMARKS AND PROPOSALS

### **Proposals for tax reform.**

Theoretically, the following are the main principles of tax reform policy such as; imposing tax rate on an appropriate low level, while increasing tax bases on the purpose of protecting economy, reducing burden of taxpayers. In this case, let me tell some definite proposals of how to change or reform tax system.

### **1. Income tax.**

The source of any economical development is the production of material or wealth. Therefore, tax reform policy should be directed to support national production. This is the initial condition of economic development definitely. Some scientists and experts are proposing to impose income tax without any stages, besides that, others are proposing various versions of proposals such as to increase current stages.

It is most important to support or develop small and medium enterprises by tax policy in order to make huge number of national giant producers according to the principle of shifting from small to the big. If considering abovementioned situation, it is not the time to be shifted into the 1 staged tax system and the right option is to follow current income tax system until the producer's *profitable year*. It is considered as profitable investment in international standards if the expense of initial investment to any production is recovered within 4.4 years.

Last two years/2004 - 2005/, inflation level has not been decreased from 10 percent. Theoretically, economy is developed if the inflation level is kept in one digit. The initial threshold of income tax for legal entity has been changed from 100 million tugriks to 500 million togrogs since 2006.

As well as, we can see from the over mentioned calculation, that the 500 million tax

threshold of the Y2006 would be equal to 630.6 million tugriks of the Y2010, including the inflation.

In 2005, the course of exchange dropped by 60 % compared to 1997, while the 100 million tugriks tax threshold were stable. We know that time is the lost possibility.

So, if we had changed it from time to time, we could get a lot of tax income.

Thus, I am proposing above version of widening tax base. That means legal entity who has an income of 630.6 million togrogs, must be imposed an income tax and must pay a tax of 30 percent. Tax base will be widened by 130 million togrogs and 30 percent of tax will be exempted as a result of it.

## **2.Value Added Tax.**

3/1 percent of Income from taxation is collected with Value added tax. This is significant source of budget income certainly. So it is more important that from where and how this source is collected. We know that consumers pay 15 percent of value added tax. This is heavy burden as well because 2/3 of our Mongolians live under the poor condition. It is possible to impose 5 percent of VAT for goods for commodity, 10 percent for all goods for primary necessity, 15 percent or more for alcoholic beverages and tobaccos.

## **3. Other taxes.**

Theoretically, the method that generates best income is to impose more tax on goods still in high demand despite high tax. According to this principle, it is possible to collect more tax income by imposing high taxes on alcoholic beverages and tobaccos, old cars or equipments and gambling.

It is not a secret that we are losing our possibilities to collect more income than today for the budget by payments and fees. The national investors are increasing,

therefore we need to change current law provisions that reducing imposed tax on foreign investors immediately and to reconsider a version of to increase a fee for the exploitation of natural resources. Just consider “Tavan tolgoi” coalmine. There is a research, determined this mine has a resource of 500 billion dollars. Natural resource deposit that has a resource of 3-5 times bigger than the resource of “Tavan tolgoi” coalmine will be exploited in nearly years. That determines that how big is Mongolian resource. It is possible to increase the fee for natural resource exploitation until 10-15 percent. This is a real possibility. The resource of 5 billion dollars will be exploited a year if estimating the coal mine “Tavan tolgoi” will be exploited for 100 years. We can estimate that it is possible to collect income of 500 million dollars as a fee for the resource exploitation to the budget a year, if we impose a fee of natural resource exploitation as 10 percent.

Number of gold mines started to cause huge pollution and imbalance to nature and environment. Therefore, we should reconsider that there is a version to create ecological tax.

#### **4. Management reform**

The government of Mongolia has declared a war on poverty. Also, determined that the source of it is corruption. It is starting to take definite measurements directed to combating with corruption. The second source of the poverty is high tax that burdens people’s life. This high tax causes high price of production and services and impossibility of creating accumulation for people. Therefore I wish that the government should declare a war on high tax. If it will be implemented, the poverty could have a real decrease. It is effective, if making a reform by considering tax as regulation method.

In conclusion is that, the special tax exemptions, tax holidays, or evading the formal economy all serve to lower the taxable base, thereby increasing the tax burden for public.

A “good” tax system should be simple to administer. The law, rules and regulations shall be available to public, easy to understand, and uncomplicated to calculate.

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