



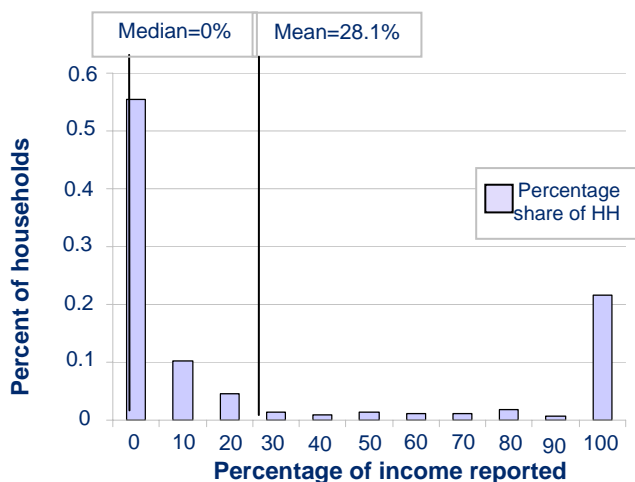
# EPRC MONTHLY NEWSLETTER

APRIL 2006

## Tax evasion in Mongolia: Estimates from the informal sector household survey of October 2004

Evidence from household interviews conducted during the 2004 Informal Sector Household Survey (ISHS), conducted by the National Statistics Office (NSO), EPRC/USAID and the Open Society Forum, shows that tax evasion in Mongolia is quite pervasive. While this should come as no surprise to most observers, ISHS data provide the first opportunity to attempt to quantify just how pervasive tax evasion is. If the respondents' answers are to be taken at face value, significant underreporting of household incomes leads so substantial underestimation of tax liabilities.

**Exhibit 1: Share of household income reported to tax authorities**



The succinct answer to survey question 169 of the ISHS: "How much of your household's income was declared in 2003 to the tax authority?" is, without distortion, "Not very much" as Exhibit 1 shows in graphic form. More than half of the 7,470 households included in this sample declared no income—zero. Only 20 percent of the interviewed households claimed to have reported all their income.

Households that claimed to have reported 20 percent or less of their income constitute about two-thirds of the Mongolian households. From these results, it would seem that a shadow economy—defined here as the portion of income on which taxes are actively evaded—is far higher than the estimates of NSO, 10%, or international experts, 18%.

**Tax evasion by regions.** Based on other tabulations from the ISHS sample, the evasion rate varies considerably by region, from a low of 33 percent in East Region to a high of more than 80 percent in Ulaanbaatar.

The rate of evasion is higher for households with self-employment (SE) income and is highest for households whose income is solely from SE. Ulaanbaatar and the Khangai Region have the highest rate of declared tax evasion among households with incomes derived solely from self-employment. Household interviewees indicated evasion rates over 80 percent when their incomes derived solely from self-employment but 64 percent when their incomes came totally from sources other than self-employment—mostly wages and salaries.

In the regions where most of the self-employment income is generated, Khangai and Ulaanbaatar, the evasion rates are extraordinarily high—notably 89 percent in Khangai among households with income from self-employment as their only source.

**Tax evasion by economic activity.** Exhibits 2 and 3 show the extent of tax evasion by economic activity. We use the international standard industry codes (ISICs) to classify twelve industrial activities which comprise more than 87 percent of the households reporting self-employment income; some households in this table also have income from wages and salaries.

Sixty-two percent of the households concentrate in three main areas of activity (ISICs): retail trade, mining, and land transportation. Retail trade has both the largest share of households with self-employment income and the largest projected SE income, land transport has the second largest share of projected national SE income while uranium mining has the third largest projected national household income and the lowest rate of tax evasion at 42 percent.

As the graph of Exhibit 3 shows, self-reported rates of tax evasion among households with of self-employment income are uniformly high across economic activities. Rates of tax evasion are all above 60 percent, with the exception of uranium mining at 48 percent.

Rates of tax evasion in the three activities that NSO uses for its official estimates of the informal economy are 76.6 percent for trade, 67.3 percent for hotels and restaurants, and 66.4 percent for land transport.

Given these high rates of tax evasion, the implication is that neither the chance of being detected nor the penalties if apprehended are effective deterrents to tax evasion. What could be done to reduce them? Several characteristics of these self-employment incomes give clues for a better-fitting taxation system.

**Exhibit 2: Income from self employment and tax evasion by type of economic activity**

ISICs	Activity type and description	Share in sample of households by activity		Income of sample households by ISIC (millions Tgs)		Tax evasion percentage
		# HHs	%	Total	Not Declared	
11	Petroleum and natural gas extraction	99	2.4	143.0	103.9	72.7
12	Uranium and thorium mining	533	13.1	826.8	399.0	48.3
181,182	Manufacturing of Apparel	129	3.2	218.0	180.5	82.8
191,192	Manufacturing of leather garments, incl. tanning	77	1.9	76.7	59.9	78.1
201,202	Manufacturing of wood products (not furniture)	157	3.9	371.9	350.5	94.3
451–455	Construction	88	2.2	197.6	132.5	67.1
501–505	Automobile sales, repair and fuel sales	91	2.2	372.0	278.5	74.7
512–519	Wholesale trade (not autos)	153	3.8	467.7	331.8	71.0
521–526	Retail trade (not autos) <sup>4</sup>	1,622	39.9	7,236.6	5,546.9	76.6
551,552	Hotel & restaurant <sup>4</sup>	138	3.4	404.7	272.5	67.3
601,602	Land transport <sup>4</sup>	364	9.0	1,560.1	1,035.9	66.4
930	Other services	100	2.5	1,020.4	971.5	95.2
—	(other ISICs)	514	12.6	na	na	na
<b>Totals:</b>		<b>4,065.0</b>	<b>100.0<sup>3</sup></b>			

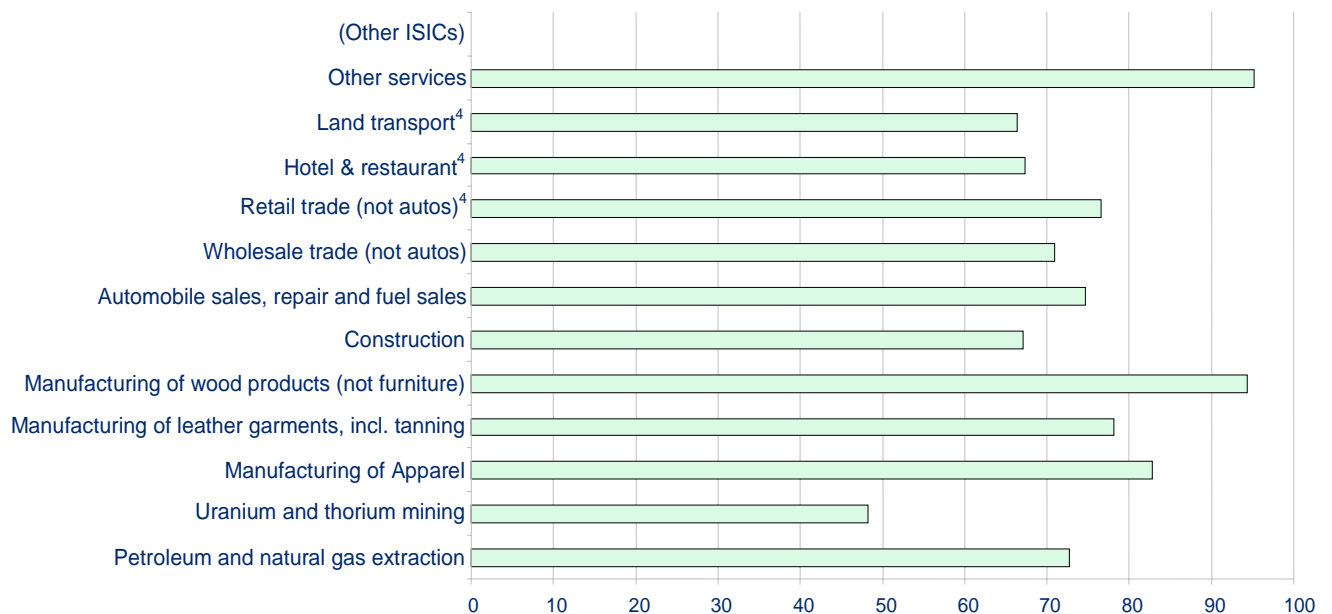
**Notes:** <sup>1</sup>Households with SE income (q80>0), income from q166 adjusted, ISICs from q75, and percentage of income reported from q169.

Incomes less than 1,000 Tgs deleted from sample.

<sup>2</sup>Ratio of income not declared to income declared, MSDB, q169 and calculations by author

<sup>3</sup>Totals may not add to 100.0 due to rounding of individual shares.

<sup>4</sup>These three ISICs are used by NSO to estimate the shadow economy and adjust GDP

**Exhibit 3: Tax evasion percentage from self-employment income by economic activity**

First of all, income is relatively concentrated: the average (mean) Mongolian household income is more than three times the median household income, and the ratio is more than four to one for households with self-employment income. Thus, without great current loss of revenue, a new taxation system could exempt from taxation a relatively large share of the population of households. The proposed Personal Income Tax (PIT) flat tax reform currently under discussion in Parliament has an income tax credit that

effectively creates a zero tax rate for up to the estimated national median household income as derived from the ISHS. Lower income segments of the population, including all those below the poverty line would be statutorily exempted from personal income tax, creating a broad base of support for the new tax reform proposals.

Second, the tax rate on personal income can be set at a low rate to encourage compliance and combined with significant

penalties for non-compliance. The PIT reform proposal currently being considered in Parliament sets a flat tax rate of 10 percent; penalties for non-compliance would need to be set addressed through improved tax administration at the General Department of National Taxation (GDNT).

Third, implementation of an effective tax registration campaign and certainty of future enforcement should be seen as precluding the advantages of further non-compliance. Effective registration flushes the unwilling out of the shadows and the threat of substantial penalties makes the registration attractive.

## Ministry and private sector participate in weekend retreat to examine tourism issues

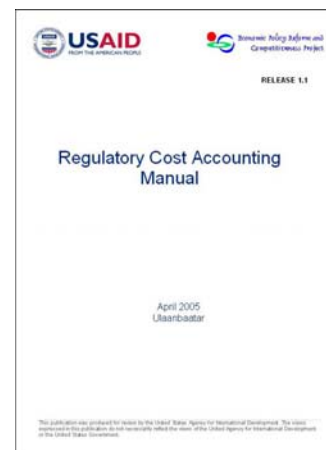
EPRC assisted the Ministry of Roads, Transport, and Tourism (MRTT) with the organization of a tourism sector retreat on Sunday 23 April, 2006. Minister Ts. Tsengel and the Director of Tourism Department T. Batjargal attended the retreat along with representatives from the Mongolian Tourism Association, Guides Association, Ger Camps Association, GTZ, and UNDP.



EPRC, MRTT and W2M made presentations on international best practice in the tourism sector, the Government of Mongolia Tourism Action Plan, and internet marketing respectively. Private sector representatives asked for additional input in tourism policy and the creation of a private-sector-led National Tourism Organization. Discussions also include the feasibility of introducing a "room tax" to support tourism promotion, and the creation of a tourism satellite account in the National Statistics Office to have a consistent methodology to estimate the contribution of tourism to GDP. Subsequent to the retreat, MRTT has requested EPRC assistance with these items.

## Central and Eastern Energy Systems initiate conversion to Uniform System of Accounts

During the week of 24 April, representatives from the Eastern Energy System, two remaining companies of the Central Energy System, and the Energy Regulatory Authority (ERA) attended a four-day project workshop in Ulaanbaatar and received training on conversion methodology, International Accounting and Financial Reporting Standards (IAFRS) and financial analysis. The training was designed to support conversion of their accounts to a Uniform System of Accounts (USOA) as a prelude for ERA's work on tariff redesign. Expected date of completion of these conversions is scheduled for August.



These are the last of the planned accounts conversions; there are no plans to convert the Western Energy System as it has no generating capacity and it is in poor financial condition. An important topic covered during the workshop was application of Government Resolution 233 governing fixed asset accounting. The companies agreed to appoint internal working groups to assess proper accounting of assets.

The conversions of these companies will complete USOA implementation for a total of 14 major licensees of the energy sector of the country. The IAFRS-based accounting conversion will support proper accounting of costs and tariff methodology.

## Newly formed Audit Unit of Energy Regulatory Authority completes its first audit

The ERA auditors, hired and trained with EPRC guidance, performed their first audit in April, completing a successful audit of Power Plant 3 (PP 3).

As a result of the audit, PP 3 management agreed on improvements that included, among others, the following:

- Further development of financial reporting and tariff development process
- Incorporation of historical accounting data into the budgeting and planning process
- Categorization of asset types and refinement of depreciation calculations
- Improved accounting of maintenance expenses.

Completion of the audit was a milestone achievement for the newly created Audit Unit of the ERA. Properly conducted regulatory agency audits will insure that energy tariffs are based on true costs by demanding that sector entities adhere

to standard USOA and best accounting practice to represent true costs.

The project provided training to the second and third newly hired ERA auditors via their inclusion in the April workshop on the Uniform System of Accounts, and International Accounting and Financial Reporting Standards (IAFRS). This training successfully concluded the intern training program that the project set up to train them.

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