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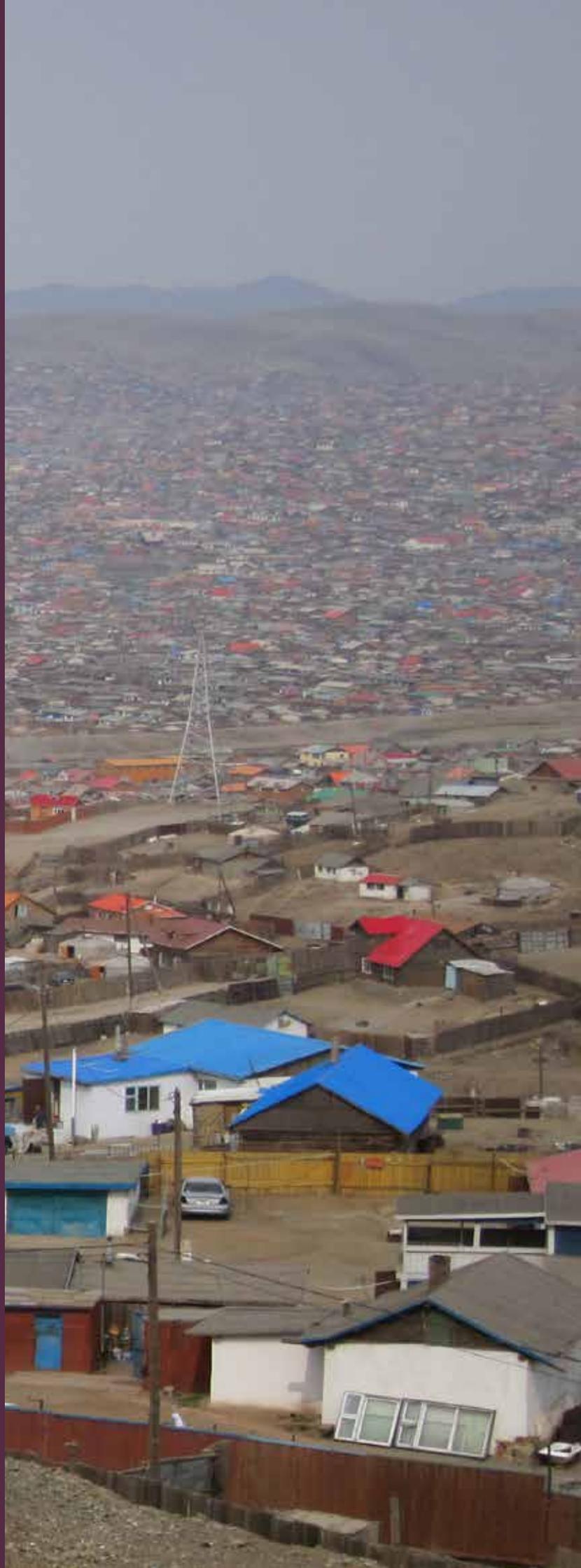
DFAT-TAF PARTNERSHIP  
WORKING PAPER SERIES #3

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# THE INFORMAL ECONOMY IN ULAANBAATAR: POLICY OPTIONS TO PROMOTE GROWTH IN THE GER AREAS

William Turner  
and Mark Koenig

October 2015





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# Foreword

The DFAT-TAF Partnership represents a new form of collaboration between the Australian Department of Foreign Affairs and Trade (DFAT) and the Asia Foundation (TAF) aimed at supporting programs and policy innovations that can improve aid effectiveness in the Asia Pacific Region. This objective is consistent with the development policy of the Australian government which seeks to promote prosperity, reduce poverty, and enhance stability.

The main premise underlying the Partnership is that investment in knowledge exchange and joint learning at the strategic and program levels can improve both impact and value for money in the assistance provided by both organizations. To this end, we have been developing, testing, and promoting cost-effective innovations that can increase the impact of development assistance that responds to the dynamic and evolving needs of the region. Key areas of innovation include (a) efforts to advance entrepreneurial and politically-informed approaches to reform; (b) improving results through more effective and dynamic integration of research with on-the-ground action; (c) efforts to accelerate country-level reform and development through cross-border and regional solutions; and (d) exploration of very quick response assistance to meet local needs as these emerge. In all of these areas, our approach has been to tap the deep knowledge and insights of our partners and staff, and to combine investment in the most creative ideas with rigorous assessment of results.

As a contribution to organizational learning within DFAT and The Asia Foundation, the Partnership has launched a *Working Paper Series*. This series draws out some of the rich lessons being learned through the many country- and regional-level initiatives implemented under the Partnership. In many cases, these initiatives have taken on some of the most difficult and intractable development problems in the region, and often build skills, knowledge, and relationships in one part of the region that can be refined and brought to similar contexts in other countries. Ultimately, this analytical work will enhance the knowledge base on which DFAT and the Asia Foundation can draw in their efforts to improve development policy and programs. The series will also be of interest to the broader international community, helping to better ground debates in empirical evidence, advance theory, and ultimately improve development policy and practice across a variety of subject areas.

The third paper in this series, *The Informal Economy in Ulaanbaatar: Policy Options to Promote Growth in the Ger Areas*, focuses on the economic environment in the capital's unplanned settlements. With city leadership now fully committed to accelerating inclusive growth to spur overall development, greater knowledge of the informal economy and how it might develop is essential. Yet, minimal research has been done in recent years on the country's informal economy, and virtually none in Ulaanbaatar. This paper takes a step toward addressing this important gap, updating some of what is understood about the informal sector, how it engages with the formal economy, and how the sector is currently governed in Ulaanbaatar. In doing so, the authors provide preliminary policy recommendations for donors and local actors to consider.

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Finally, the authors wish acknowledge their collaboration with M.A.D. Investment Solutions on this research. M.A.D. Investment Solutions is a boutique investment and research firm based in Ulaanbaatar that focuses on real estate and undertaking research for public and international agencies that working on sustainable development in Ulaanbaatar and Mongolia's other high growth cities.

# Section 1:

# Introduction

Mongolia's rapid economic expansion in recent years has attracted significant attention. To date, growth has been driven largely by capital-intensive sectors, most notably large-scale mining. Accordingly, policymakers, investors and analysts have focused their attention on these sectors. While there is no question that Mongolia's economy and development will remain dependent on continued investment in its vast natural resources, in reality, most citizens will only be able to participate in the country's growth if labor intensive sectors thrive. It is the individual and small-scale enterprises that most affect the daily lives of ordinary Mongolians. Nowhere is this more obvious than in Ulaanbaatar, where 87% of companies currently have fewer than nine employees,<sup>1</sup> and a further 107,000 individual traders are estimated to be operating informally.<sup>2</sup>

As Ulaanbaatar tries to promote inclusive growth that will spur the city's development, it is crucial to consider both the current status of the informal economy, as well as the possibilities for how it might develop. This is relevant both for policies to support small and medium enterprises (SMEs) and strategies to promote the development of the 'ger' areas of Ulaanbaatar,<sup>3</sup> as well as for their economic, social and physical integration with the rest of the city. In recent years, the informal economy in Mongolia, and Ulaanbaatar specifically, has not been a focus of research and analysis. This paper aims to contribute towards rectifying this trend. In doing so, this study updates some of what is understood about the informal sector, how it engages with the formal economy, and how the sector is currently governed in Ulaanbaatar. This has led to the authors proposing some preliminary policy recommendations.

The critical importance of the informal sector in Ulaanbaatar today should be no surprise. Much of the story of Mongolia's transition to a market-based economy in the early 1990s was not that of big businesses leading

the transition, but rather of rapidly expanding informal activity. At that time, a still-developing regulatory framework and capital market meant that it was the technically informal businesses that responded to rapid changes in the economy. Businesses, both large and small, sprang up to take advantage of unmet demand and supply goods not previously available. Indeed, many of the business groups that today control the heights of the economy were launched during this period as informal businesses.

This sudden burst in the number of informal businesses came as people responded to the complexities of the early 1990s, which included comprehensive political reform, an economic crisis, mass rural-urban migration, and the wholesale realignment of economic resources that led to the government cutting back on social protection programs provided during socialist times. As support programs for housing, certain types of welfare, and other programs collapsed at the same time that jobs were shed across the economy, the result was an imperative for Mongolians to survive with little help from the state. However, as curbs on private economic activity also dissipated, opportunities arose for employment and income generation that were previously unavailable.

Small-scale informal enterprises, most often run on an individual or family basis, reacted nimbly to developments in the 1990s and have since become a mainstay of the economy. By 1998, for example, it was estimated that 40% of Ulaanbaatar's population were employed in the informal sector.<sup>4</sup> Although this in-depth survey has not been updated for many years, more recent data from the National Statistics Office in 2006, estimated that the informal economy generates 8% of total Gross Domestic Product (GDP), and continues to be of considerable importance.

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1. Statistics Department of Ulaanbaatar. Accessed March 5, 2015.

2. Mongolian Statistical Information Service. Accessed March 5, 2015.

3. 'Ger' means home in Mongolian and refers to the round, felt tents that Mongolian nomads have lived in for centuries. Since the end of socialism in Mongolia in the 1990s, rural people have left the countryside for the cities in order to access better jobs, services, and education. Ulaanbaatar has the largest numbers of migrants, and with little affordable housing available, most settle in the 'ger' areas that ring the city. These settlements are quiet diverse, in that many families have upgraded to detached houses on their plots of land, but almost all 'ger areas' suffer from poor public service provision, and generally have greater poverty rates than apartment areas.

4. Anderson 1998.

This growth of the informal sector during economic transition is common in developing countries. Research shows that in post-Soviet countries, the informal sector has helped to generate income and mitigate social costs when social protection programs declined due to new economic and governance realities.<sup>5</sup> There is less consensus, however, on what happens when economies move out of a transition phase into a fully realized market economy. Contemporary research increasingly demonstrates the diversity of pathways that economies take in transitioning from government control to a market economy.<sup>6</sup> This calls into question the assumptions of classical economists who have long assumed that economic development will “solve” the issue of informality.<sup>7</sup> This was based on the theory that the growth of higher-value, modern industries will absorb labor from the informal economy, and thereby cause it to shrink and eventually disappear. However, this linear progression has not occurred in reality and, according to estimates from the International Labour Organization, 60% of developing Asia’s work force still operates in the informal sector.<sup>8</sup>

Mongolia’s case does not yet counter these classic assumptions as the country’s economy is, in many ways, still undergoing transition. For the market economy to continue developing successfully, further privatization of state-owned enterprises is clearly needed in certain sectors, as is further improvement of regulatory frameworks, and recasting of the role of government from operating enterprises to supporting and regulating them. However reform remains a challenge, especially as, like in many transitional economies,<sup>9</sup> rigidity remains in some of Mongolia’s institutions that are responsible for making the needed changes in government attitudes and practices.

Given that Mongolia is still a transitional economy in 2015, the prevalence of its large informal sector should come as no surprise. At the same time, the economic system is most likely in the final stages of transition as the government is introducing regulations and reforms that will move the economy forward. Today Mongolia is promoting formalization in order to spur the growth of a “modern” economy, however, as the situation is

still significantly fluid, government policies regarding informal businesses need to take into account the short-term needs and realities of Mongolian workers. The longer-term vision for the economy also needs careful thought, but this should not start from an assumption that informal businesses will disappear as the economy modernizes. The task requires more fundamental thinking and envisioning of how the informal economy should fit in a mature, Mongolian market-based system once it has fully developed.

Depending on one’s economic assumptions and/or analysis, informal economic activity can be viewed in various ways—as a passing phase of development, as a drain on efficiency, or as a constructive part of the economy. Regardless of one’s views, it is clear in Mongolia that the informal sector is a major source of employment and entrepreneurial activity, as well as an integral part of the overall economy. The choice of business owners to operate informally tends to derive from different forms of exit or exclusion, or a combination of the two.<sup>10</sup> Some entrepreneurs decide on informality based on a rational cost-benefit analysis, while others choose informality in reaction to burdensome measures, including taxation, regulation, and an inflexible labor market that prevents entrepreneurs from participating in the formal economy.<sup>11</sup> Government, in turn, needs to have a clear vision of how it would like to structure the incentives, both positive and negative, that influence business owners to formalize. Currently, this vision seems to be missing in Mongolia.

This paper discusses information that the government could consider with regard to the informal sector in Ulaanbaatar, and policy options that might be applied. In doing so, the paper draws on some original survey and interview data, secondary research that suggests causal variables driving informality in Ulaanbaatar, as well as the major issues facing those who operate in the informal sector today.

Despite its importance, the informal sector has received relatively little attention from policymakers in the last decade. A state policy was passed in 2006 for the sector, but since then tangible changes have been few and far

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5. Round and Williams 2010, pp. 183–196.

6. Berglof and Roland 2007.

7. The Economist 2013.

8. International Labour Organization 2015.

9. International Labour Organization 2015, p 6.

10. ‘Exit’ refers to economic actors that choose to remain informal as they perceive this to be in their best interest; ‘exclusion’ refers to those economic actors that might want to formalize but face barriers that prevent them from taking this path.

11. An inflexible labor market indicates a market in which legal protections for labor regulate such things as compensation, holidays, and rules for hiring and firing staff that might make a small business economically unviable.

between. Perhaps this neglect is the result of assuming that the informal economy is a relatively mundane issue, and one that will resolve itself as the economy grows. This assumption, however, is far from the truth. Instead, the informal sector is a dynamic one, with multiple causes and effects in play. However, it is also clear that informal operators are negatively affected by a number of structural limitations, and that relatively small changes might help improve the overall business environment for informal businesses, and produce widespread benefits.

According to the business thinker C.K. Prahalad in "The Fortune at the Bottom of the Pyramid,"<sup>12</sup> while there is a tendency to overlook the low cost goods being traded and consumed at the bottom of the economic pyramid as each transaction is so small, the importance of this level of the economy should not be underestimated.<sup>13</sup> Prahalad reminds us that low-margin transactions, like those being carried out by the informal sector, may be individually insignificant but collectively are a major part of a society's overall wealth and economic well-being. This underscores the need for greater understanding of the informal sector, which will continue to play a vital role in the economic life of Ulaanbaatar for years to come. This paper thus aims to support dialogue on informality that could lead the city of Ulaanbaatar to take steps to improve the business enabling environment for all enterprises, including informal ones.

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12. Prahalad 2004.

13. Prahalad 2004.

# Section 2:

## Framing Informality

Before further examining aspects of the informal sector in Ulaanbaatar, a few concepts about informality should first be explored. Informality is paradoxical as it is both intuitively understood and, at the same time, notoriously difficult to define. This paradox stems from the broad nature of informality which incorporates three separate elements:<sup>14</sup> the informal sector, informal employment,

The structural problems that lead to these four variables cannot be 'fixed' entirely, so there will never be an economy without any informal sector activity. However, the adjustment of government policies can influence the size of the informal economy by shaping incentives, potentially motivating a greater number of entrepreneurs to join the formal sector and/or deterring them from remaining informal. The policies that will be effective in achieving this vary from country to country, but potential mechanisms might include the easing of requirements for actors to join the formal sector, or extending flexibility within regulations for 'moonlighting' (work in addition to a regular job) or using irregular workers when needed, and extending possibilities for informal financing.<sup>20</sup>

### BOX 1. Criteria for Judging Informality

- Degree of compliance with official registration, laws, and taxes
- Effective income of workers
- Division between capital and labor
- Sophistication of record-keeping
- Ease of incorporation of the activity or output into national statistics
- Permanence of the place of business
- Participation in social and health insurance schemes

Source: Chen 2012.

and the informal economy. The informal sector refers to production and employment that takes place in unincorporated or unregistered, usually small and medium-sized enterprises; informal employment refers to employment without legal or social protection; and the informal economy refers to all informal enterprises, activities, and workers, as just defined, as well as the output produced by them. This output is often under represented or not captured at all in official statistics.

The informal sector has developed both out of necessity and by choice. At the structural level, four variables determine the size and nature of the informal economy:<sup>15</sup> the tax burden,<sup>16</sup> labor rigidity,<sup>17</sup> institutional quality,<sup>18</sup> and regulatory burdens in the financial and product markets.<sup>19</sup>

Taken together, it is the interaction between economic agents and the overall structural framework of the economy that determines the size and nature of the informal economy. The extent and form of informality thus differs from place to place. However, regardless of the exact shape of the informal sector, a number of common issues affect informal businesses and how they interact with the local as well as the worldwide economy.<sup>21</sup> These issues can limit the growth potential of individual informal businesses, discourage their transition to formality, limit their positive impact on economic growth, and constrain overall economic growth by constricting the informal sector on both the supply and demand sides. The most salient issues include:

1. **Inadequate Demand:** Low consumer purchasing power limits effective demand for the goods and

14. Chen 2012.

15. Abdih and Medina 2013.

16. The amount of taxes a company would have to pay if registered with the government.

17. An inflexible labor market indicates a market in which legal protections for labor regulate compensation, holidays, and rules for hiring and firing staff that might make a small business economically unviable.

18. This includes factors such as the difficulty in registering a business, the burdens on formal businesses, and the ability of an economic entity to meet these requirements.

19. This term indicates laws or regulations that might make their business illegal, ie outlawing narcotics make those selling narcotics informal businesses, products difficult to source formally, or financing difficult or impossible to secure.

20. Morris 2001.

21. Morris 2001 p. 39.

services of the informal sector. The Asia Foundation's (the Foundation's) survey, for example, found that 23.8% of respondents had a monthly income of less than \$200.<sup>22</sup> While informal enterprises do provide cheap products and services, they also suffer from low profit margins, low savings, lack of investment, and limited opportunity to expand.

2. **Legal and Regulatory Issues:** Informal operators' uncertain status vis-à-vis laws and regulations can be a major issue affecting the growth of their business and their willingness to reinvest their profits in their business.
3. **Organizations and Associations of Informal Sector Workers:** Most informal workers and business owners are not members of any association, and this lack of representation and of opportunities to interact with policymakers often negatively impacts informal operators.
4. **Productive Resources:** Securing productive resources, in particular financial capital, technology, and other inputs, is a major difficulty for the informal sector. These resources are often too expensive for informal operators. In Mongolia, for example, the annual interest rate for most loans is 20% or higher.
5. **Business Development Services:** Due to cost and availability of various services, informal enterprises are usually less able to improve their human resources through training or to use business service providers to develop effective business plans. Informal actors' lack of vocational training or access to such training when available, often compounds their problems.
6. **Risk & Uncertainty:** Risk and uncertainty permeate the informal sector, especially when legal and financial protections do not apply to them. This increases their risk when making purchases and sales, deciding on storage options for goods, negotiating contracts, and deciding how to respond to solicitation of bribes. All of these are day-to-day concerns for informal actors.

7. **Social Protection:** Informal businesses often fail to adhere to health and safety standards, and their workers tend not to contribute to, or benefit from, social security schemes. The Foundation's survey found that 51.6% of respondents lacked any form of social insurance. Finding a way to overcome this problem is one of the biggest issues for policymakers who are dealing with the informal sector.

Recognizing these reasons for informal sector activity, as well as the difficulties faced by informal operators, does not have to lead to concluding that the informal economy is a problem. Along with negative characteristics, informality also has positive ones. For example, informal operators are often more flexible and nimble than their formal counterparts, and can act quickly to fill market gaps. In filling gaps, informal entrepreneurs can generate needed income and also achieve social mobility. In addition, informal employment can provide a safety net when government social security programs are absent or in decline, or provide needed irregular or unplanned employment opportunities. In a resource-driven economy such as Mongolia's, with fluctuations in demand and prices for its commodities, the fast-reacting, flexible informal sector can be of critical importance in mitigating the negative impact that boom and bust cycles have on households.

Of course these possible benefits need to be weighed against the vulnerability that informal workers often face, as well as their exclusion from government services and protection. However, at the most basic level, the informal economy is a sign of entrepreneurial spirit as well as of the market responding to the incentives that govern it. Any useful policy discussions on how to engage more effectively with the informal sector must take place within a specific context and with recognition of the incentives shaping informality, so the next section of this paper will explore in greater detail the specific dynamics affecting informality in Mongolia.

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22. In 2014, the Foundation and M.A.D. Mongolia surveyed 600 people over three weeks in two ger areas of Ulaanbaatar in order to capture a snapshot of informality in the city's ger areas.

## 2.1. INFORMALITY IN MONGOLIA

After the end of the Soviet period in the early 1990s, Mongolia began to transition from a centrally-planned, one-party state to a free market, multi-party democracy. This was a period when both the economy and ordinary Mongolians were forced to adapt to new socioeconomic realities. GDP, for example, fell from a peak of \$3.57 billion in 1989 to a low of \$768 million in 1993,<sup>23</sup> while unemployment became a major issue as the state retreated from the economy. The informal economy played a role as a shock absorber and safety net throughout this process. It was during this period

### Box 2. “The Size, Origins, and Character of Mongolia’s Informal Sector during the Transition”

The 1998 World Bank study by Anderson was the first post transition study of the informal sector in Mongolia and concluded that the informal sector had expanded rapidly since the collapse of communism. The study saw the informal sector as a positive manifestation of entrepreneurialism and competition—the market principles which, Anderson concluded, could benefit the formal sector.

of high informal activity, between 1998 and 2001, that all three landmark studies of the informal economy in Mongolia and Ulaanbaatar were completed. Since that period, similarly ambitious efforts have not been made to estimate the scale of, or traits of the informal sector in Mongolia. Thus, given the lack of more recent information and analysis on the informal sector, the three earlier studies remain relevant despite the time that has passed since they were conducted.

The first of these studies,<sup>24</sup> carried out by the World Bank, found that a rapidly expanding informal sector was playing an ever-larger part in the life of Ulaanbaatar. The study isolated four main reasons behind informal sector expansion: economic crisis, rural-urban migration, the reallocation of economic resources resulting from the transition from a centrally-planned to a market-based economy, and policy frameworks and associated regulations that made it much easier to establish informal businesses in comparison to formal ones. Specific factors that contributed to rapid growth of the informal economy were: the combination of the economic imperative for

households to survive, a large labor pool made available by increased migration, the need to fill gaps in supply and demand that arose during the transition to a market economy, the flexibility of labor, and the small scale of informal enterprises.

The World Bank’s 1998 study found that up to 51% of households in Ulaanbaatar had some informal income, and that the sector employed between 105,000 and 130,000 people, or about 40% of the city’s working population at that time. The study found both positive examples of entrepreneurialism, and also worrying structural constraints, or, as the author put it, “an optimistic depiction of people following market signals and addressing society’s needs, juxtaposed with sobering lessons on the direction in which policy is driving entrepreneurial energy.”<sup>25</sup> The main concerns expressed in the study included the government’s approach to taxation and the potential that policies in place would result in higher, relative tax burdens for the poorest, informal operators. There were also concerns that the policies relating to registration of enterprises and labor rules, among others, that had enabled informal operators to thrive and generate income, were not going to be extended into the formal economy. Instead, additional constraints would be built out in ways that would inhibit portions of the informal economy even more.<sup>26</sup> These

concerns remain relevant today in light of recent efforts to strengthen labor protection and discussions about extending taxation. The policies in question have potential unintended consequences that could limit the growth of both formal and informal small business operators.

Estimating the size of the informal sector is notoriously difficult, but several efforts have been made to do so in Mongolia. Another seminal study<sup>27</sup> on the informal economy which was funded by the United States Agency for International Development (USAID) was published in 2000. This study suggested that the informal economy accounted for 13% of value-added GDP. In 2004, the National Statistical Office (NSO) of Mongolia put this figure at 10.5%, and the informal sector’s share of GDP was revised downward again to 8% following a census in 2006.<sup>28</sup> As for the informal economy’s share of overall GDP, the International Monetary Fund asserted in 2008 that the informal economy accounted for 37% of output.<sup>29</sup>

23. “World Databank.” World Bank. Accessed March 5, 2015. <http://databank.worldbank.org/>. Both figures presented are in current dollar terms.

24. Anderson 1998.

25. Anderson 1998 p.1.

26. Anderson 1998 p.27.

27. Bikales et al. 2000.

28. Ayush 2008.

29. Abdih and Medina 2013.

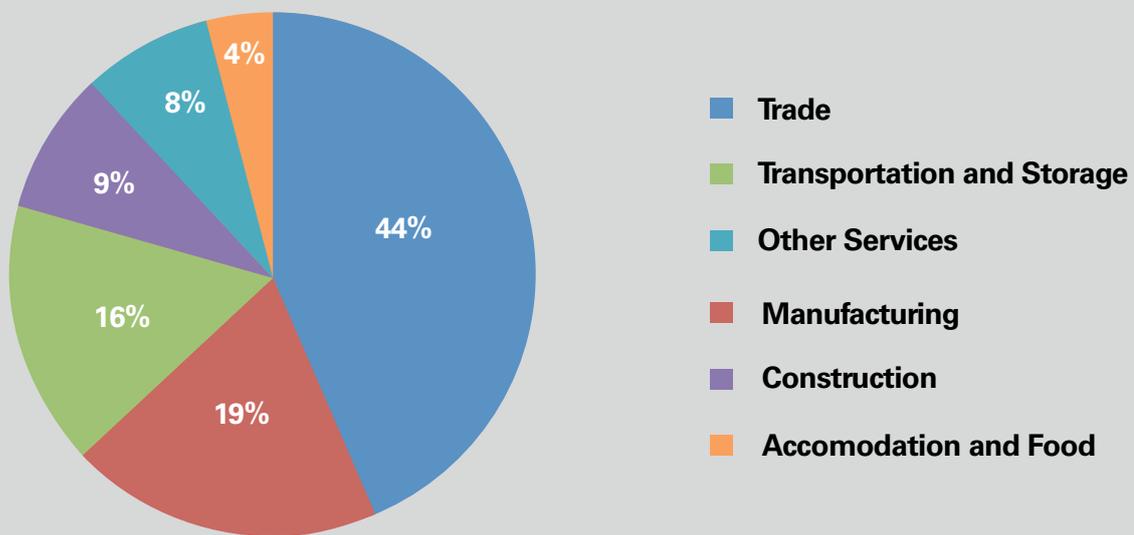
With regard to the major activities conducted by the informal sector, in its 2010 study,<sup>30</sup> the NSO estimated that wholesale and retail trade accounted for half of informal sector production. Transportation and storage were estimated to account for a quarter of informal sector production, and manufacturing was identified as the third largest activity, accounting for 9% of informal sector output.

According to the Mongolian Statistical Yearbook for 2013, the largest percentage of informal outputs in Mongolia is produced by individual traders or small firms. Within Ulaanbaatar, for example, 87% of active business establishments (30,269 out of 34,777) employ fewer than nine workers,<sup>31</sup> and in 2013, the NSO estimated that there were 107,685 informal traders active in Ulaanbaatar.<sup>32</sup> Taken together, these statistics

indicate the informal sector's substantial contribution to employment. The scale of informality in Ulaanbaatar may have changed since the 1990s, but unfortunately there are no studies of sufficient methodological rigor to confirm this. However, estimates do seem to suggest some decline in the size of the informal economy.

Despite some decline in size, the main characteristics of informal economic actors appear to have remained surprisingly constant. The 1998 World Bank study discussed above described the informal sector as "small scale, usually family-based, economic activities that may be undercounted by official statistics, and may not be subject, in practice, to the same set of regulations and taxation as formal enterprises."<sup>33</sup> As this definition implies, in Ulaanbaatar, policy or lack of it, is central to informality.

**Figure 1: Informal Employment by Sector**



Source: National Statistical Office of Mongolia, 2010.

Mongolia's informal sector is relatively exceptional in that most participants are registered with the tax authorities and pay what they owe on a regular basis. The key difference between a formal entity and an informal one is the legal regime under which enterprises are registered. Instead of registering as economic entities, informal traders are governed by the *Income Tax Law of Individuals Engaged in Work and Services, Income of Which Cannot be*

*Immediately Determined*. As the 1998 World Bank Study noted, "This law is the single best objective identifier of informality, and it is also the single most important piece of legislation governing the lives of Mongolian informals."<sup>34</sup> This remains the case today.

30. National Statistical Office of Mongolia 2013.

31. National Statistical Office of Mongolia 2014.

32. National Statistical Office of Mongolia 2014.

33. Anderson 1998.

34. Anderson 1998.

This law governs a wide range of economic activities, from fortune telling to carving. Most importantly, however, its stipulations regulate a number of activities that predominate in the informal sector. These include trading stands and kiosks, repair work, and the production of, and trade in, various foods. The law applies to those

social security payments (10% of the salary from the employee and between 11 and 13% on the part of the employer). Informals, by contrast, are subject to a flat amount of tax which is charged on a monthly basis. The quantities vary according to location and economic activity. The highest monthly tax is Mongolian Tugrik (MNT) 53,000 (approximately \$28)<sup>35</sup> for artisanal miners while the lowest is MNT 1,200 (\$0.69) for fortune tellers and plant sellers. Kiosk traders in Ulaanbaatar are expected to pay MNT 6,000 (\$3.20) per month.

## BOX 3. Legal Regimes Governing Businesses

### **Economic Entities:**

- Company Law (passed in 1999, revised in 2012) regulates the establishment, registration, and organization of economic entities.
- Economic Entity Income Tax Law (passed in 2007) regulates imposition of tax on these entities.

### **Informal Traders:**

- Income Tax Law of Individuals Engaged in Work and Services, Income of Which Cannot be Immediately Determined (passed in 1993, revised in 2001).

“who conduct various types of work and services which are not managed through any contact or deal with an economic entity or organisation.” As a result, the law is applied to both “work and services, the income of which cannot be immediately determined,” as well as “other work and services which are not managed through any contact or deal with an economic entity or organisation.”

The key differences between the two laws in Box 3 relate to taxation and labor arrangements. Economic entities are subject to corporate income tax (between 10 and 25%), as well as being bound by the conditions of the Labor Law, which makes them responsible for

In this case, poor informals can end up paying a large portion of their income in tax, while richer informals are subject to a miniscule tax burden relative to profits. Of course, it is a simple legal regime and one that is easy to implement, but the price for simplicity, in this case, is equity. Informals are, in theory, also bound by the Labor Law. However many are one-person operations, and in cases where outside labor is used it is often arranged on a flexible and cash basis, meaning that social security requirements are circumvented.

Mongolia has, of course, changed considerably since these studies were published, but within the informal sector, change has been gradual. In fact, the interviews and analysis conducted for this study found that many of the core issues, including access to finance and the legal framework, remain pertinent. Before considering how, if at all, this picture has changed, it is worth considering the wider socioeconomic context within which informal businesses operate in Ulaanbaatar.

## BOX 4. Common Characteristics of Informal Businesses, 1998–2001

- Mostly operated by individuals, but sometimes with part-time workers
- Average of 1.4 employees per business
- Most business operators saw themselves as unemployed
- Transport, finance, trade were major activities
- Little use of the formal banking system (only 0.5% had formal loans)
- Belief that competition and formalization would reduce the scale of the sector
- Belief that lower taxes, less bureaucracy, better enforcement of rules, more assistance from self-help organizations, and more credit would facilitate formalization

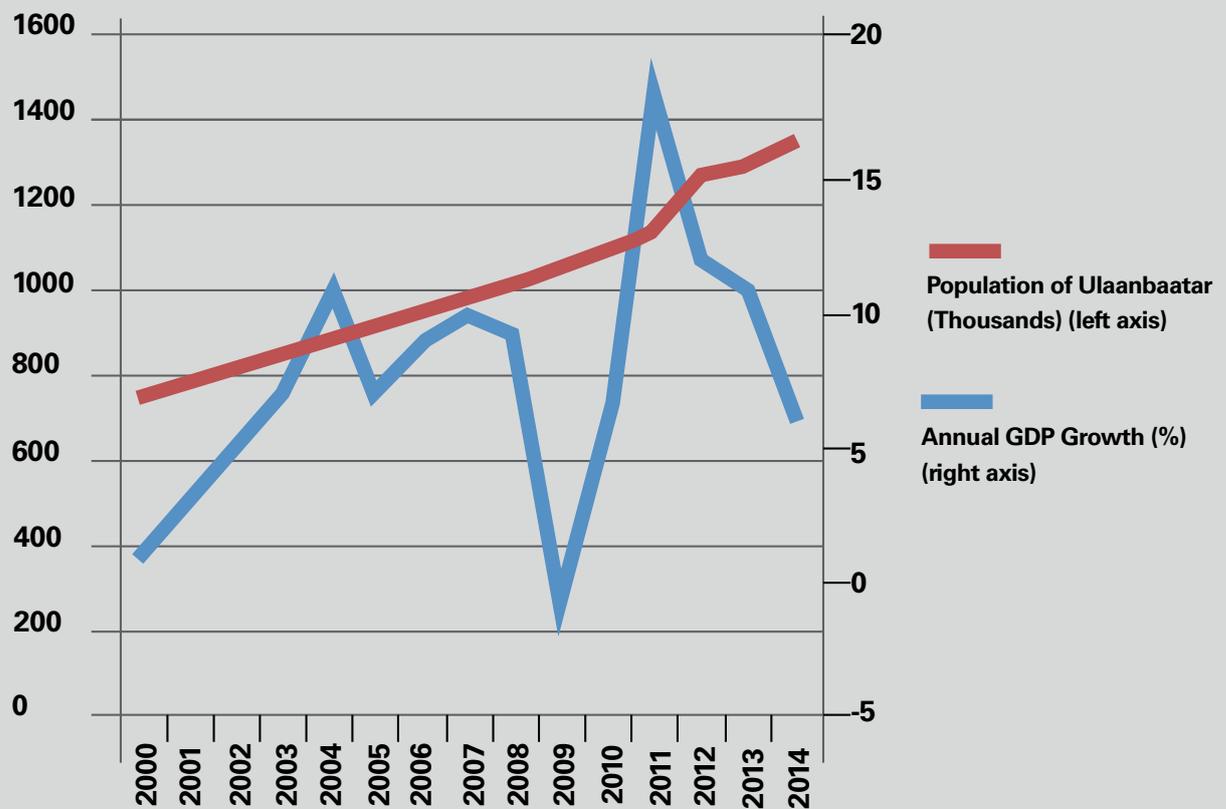
35. Using exchange rate of January 1, 2015 which was approximately MNT1,876 to \$1. All dollars in this paper are US dollars and have been converted using this exchange rate (unless otherwise specified).

## 2.2 THE SOCIOECONOMIC CONTEXT

Within Ulaanbaatar, the informal economy is most heavily concentrated in the ger areas that surround the city. These areas of low-density, unplanned housing, have always existed but have increased in size over the last two decades—a result of rapid economic growth and concomitant rapid urban population growth. The city’s population increased by 54% over the last 10 years alone, and the bulk of new residents are settling in these unplanned settlements.<sup>36</sup> This rapid increase in population has placed a strain on the city’s infrastructure and housing stock and, at present,

it is estimated that 60% of the city’s population live in the peri-urban ger areas. In contrast to the apartment areas in the center of Ulaanbaatar, the ger areas suffer from a wide range of development issues, including: higher poverty levels; lack of infrastructure, services and social facilities; weak governance; limited economic opportunities; and inadequate urban planning. These issues cause a number of problems that negatively affect both the city center and the ger areas, including high levels of pollution, constrained economic growth, congestion, and unbalanced development. There are also broader issues such as how both the physical space and residents of the ger areas are integrated into Ulaanbaatar as a whole.

**Figure 2. Population and GDP Growth in Ulaanbaatar**



Source: Statistics Department of Ulaanbaatar<sup>37</sup>

36. Statistics Department of Ulaanbaatar. Accessed March 5, 2015.

37. Statistics Department of Ulaanbaatar. Accessed March 5, 2015.

A wide range of academic and development studies have been conducted on the ger areas and the main challenges they face are well known.<sup>38</sup> In the ger areas, 45% of residents have incomes below the poverty line, they are unable to build savings or invest, and they suffer from lack of access to urban services. However, in contrast to many developing countries, lack of land tenure is not a serious problem in Mongolia, and most ger area residents have legal title to their plots of land (known as *khashaas*). Instead, the problem is an over-supply of open land which results in low population densities and thereby makes expansion of urban services prohibitively expensive. Ger area residents also face social exclusion. Evidence shows that ger residents rely heavily on their own family and social networks in day-to-day life. Survey data collected in the Foundation's recent study showed that 28.39% of respondents (the largest group) sought jobs primarily through friends and family. Commentary also suggests that residents feel somewhat alienated. As new migrants to the city, they experience dislocation on arrival and suffer from social and political exclusion.<sup>39</sup>

As already discussed, the economic profile of the ger areas differs from the apartment areas. Incomes in the ger areas are 40% lower and residents suffer from higher poverty and unemployment rates than those in other areas of the city.<sup>40</sup> Given these conditions, government benefits and allowances, as well as unofficial income, play an important role in the ger areas as they supplement what is often insufficient household income.

Types of employment vary widely in the ger areas, but retail and trading, manufacturing and construction are some of the main sectors of work for residents. These sectors of ger area employment are the same sectors listed by the National Statistics Office as the three largest for informal employment. The importance of informal employment and businesses in the ger areas is also reflected in the still-prevalent and important practice of 'trade in kind', in which labor is traded for goods and services. Informal businesses, mostly run on an individual or family basis, predominate in these areas and are central to social and economic life.

Economic activity in the ger areas is adapted to their unique features. Proximity-based retail and services, such as kiosks and repair shops are prevalent, and specialized economic hubs have also developed. The low-density settlement pattern of the ger areas means that much of the local economy is based on supplying and storing goods and offering services that could not be provided from locations in the city center. The availability of land and space within *khashaa* plots is one of the

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AND UNEMPLOYMENT RATES  
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primary comparative advantages of ger area businesses. The commercial and light industrial activities taking place on land throughout the ger areas ranges from individual repair shops, recycling businesses, and craftsmen, to larger, more specialized producers and markets. Production or retail clusters have developed over time such as Zun-ail, the main construction market, and the Da Khuree market, which is the principal location for auto sales and repairs.

Many ger area businesses attract customers from across the city and provide both critical inputs and services for the formal economy, but also act as a major source of employment and wealth generation for ger area residents. Clearly the ger areas are home to vital economic actors, and provide critical inputs to the overall economy of the city. However, as this activity is largely informal, questions arise about how to stimulate growth and the development of some economic actors, without restricting the vitality and flexibility that is critical to income generation across the city.

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38. Cities Alliance 2010.

39. Cities Alliance 2010.

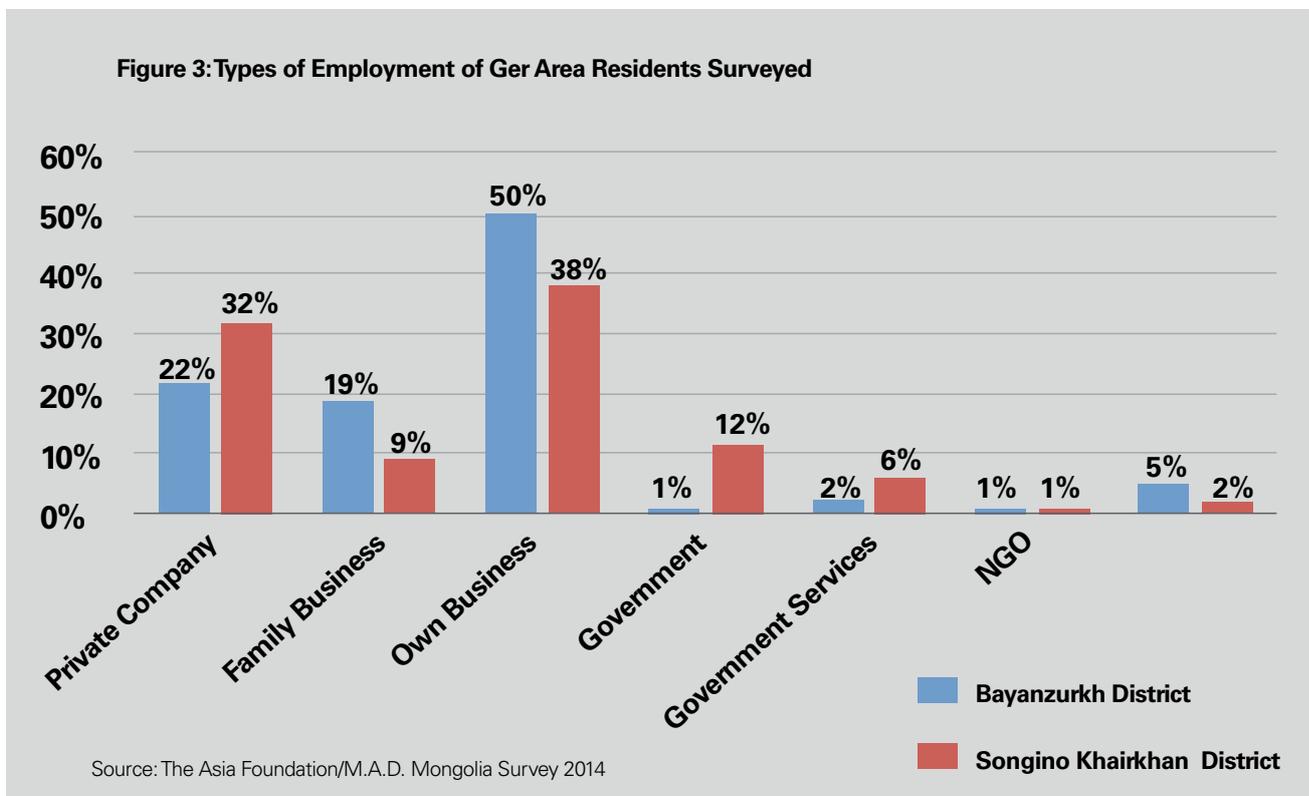
40. Cities Alliance 2010.

# Section 3: Updating Thinking On Informal Actors in the Ger Areas

## 3.1 PERCEPTION SURVEY RESPONSES

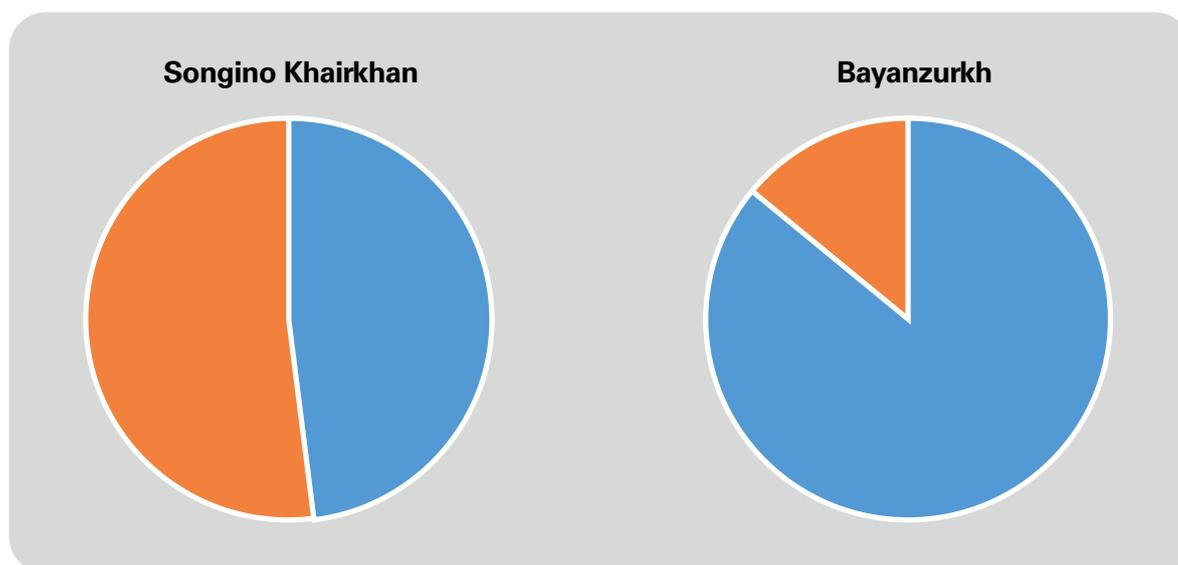
In 2014, the Foundation commissioned a quick qualitative assessment on the informal economy and economic integration in two ger area *khoroos*<sup>41</sup> of Ulaanbaatar. The survey was part of analysis undertaken by the Foundation to contribute to a city-led effort to develop strategic economic policy. The methodology consisted of a perceptions survey administered to 600 ger area households, combined with 10 in-depth interviews with business owners based in the ger areas. The 600 households were surveyed over three weeks in two areas of Ulaanbaatar (the 9<sup>th</sup> Khoroo of Songino Khaikhan District in the West of the city, and the 17<sup>th</sup> Khoroo

of Bayanzurkh District in the Southeast). Both areas are mid-tier ger areas, less established than the ger areas closer to the city center, but more economically advanced than the ger areas on the fringes of the city. The 10 qualitative interviews engaged both formal and informal business operators to explore key issues that emerged from the survey. The survey and interviews, which were intended to be a quick assessment that would update previous information and statistics, were not based on a representative sample of the ger areas or of informal economic actors. However, such a systematic analysis of the informal sector would certainly be beneficial to provide a more thorough analysis.



41. A khoroo is an administrative unit of the city that is below a district. There are 152 khorooos in the city.

**Figure 4: Employment Locations of Ger Area Residents Surveyed**



■ Working in Same Khoroo Where They Live      ■ Working in a Different Khoroo

Source: The Asia Foundation/M.A.D. Mongolia Survey 2014

The Foundation’s quick assessment shows a dynamic sector that is more integrated with the wider economy than might be expected. For example, 44% of respondents reported having their own business and 39% of female respondents reported ownership of a business—a substantial percentage of women entrepreneurs. A further 14% of respondents worked for family businesses. Conversely, only 26% of respondents work for private companies, which seems to support the assertion that the informal economy is a major driver of employment in ger areas. In addition, employment appeared to be both full time (90% of respondents) and non-seasonal (77%), and having only one job was the norm (90%). Nearly half of the respondents (48%) reported a monthly salary of between 400,000 and 750,000 MNT (\$213-\$400).<sup>42</sup> Of those reporting earnings of between 750,000 and 1 million MNT per month (\$400-\$533),<sup>43</sup> 59% operated their own business, which suggests that the informal sector includes both business owners as well as wage laborers, and that as a basic rule, those owning businesses are better off economically.

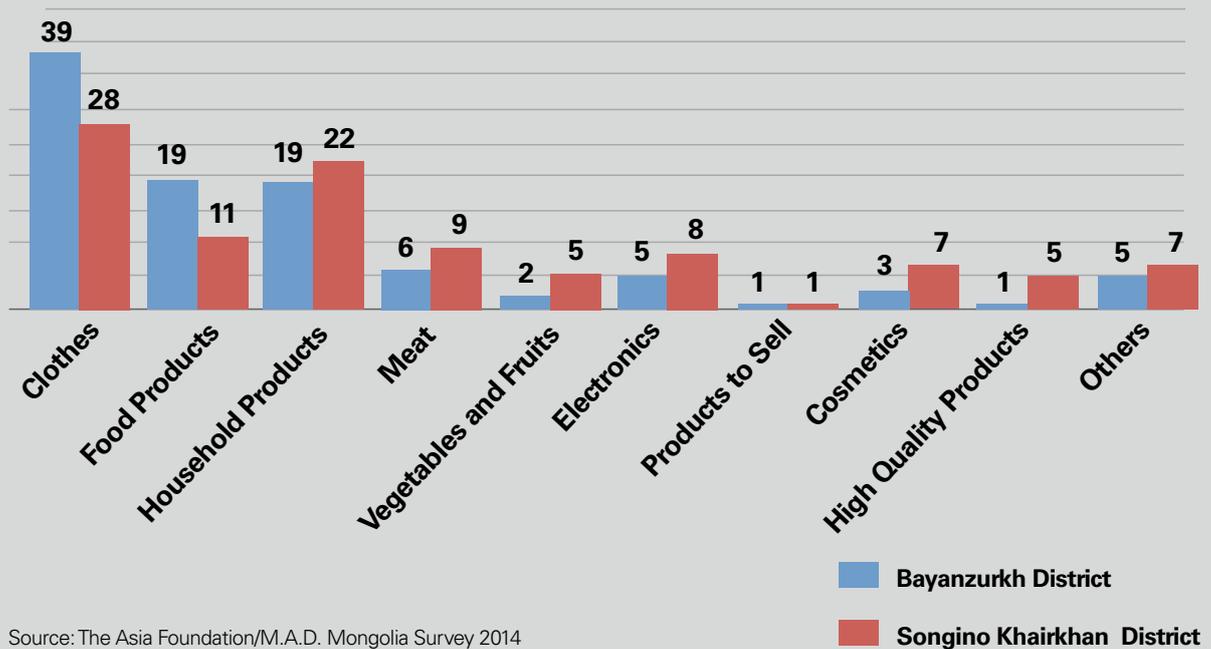
The Foundation’s study also indicated that the integration of ger area residents into the city’s economy was extensive, but varied. In Bayanzurkh,

86% of respondents worked within their khoroo, and many at the local market, while in Songino Khaikhan, 51% of respondents left their khoroo for employment. Of those leaving the khoroo, almost 50% spent 40 minutes travelling each way to, as well as from, work. Questions on consumer habits also demonstrated that the economies of ger area khoros are in no way isolated. Respondents from both khoros indicated a significant percentage of ger area consumers leave their khoroo regularly for shopping, and especially for clothes, food and household products (see Figure 5). In addition, respondents reported shopping at markets across the city, with some differences depending on khoroo and location, but the large markets like Narantuul and Khuchit Shonkor were popular, regardless of khoroo. These figures offer just a snapshot into two neighborhoods in the city but a couple of simple conclusions can be drawn. First, while khoros have specialized at times, the ger areas are not mini-economies that are self-contained or localized. Given the high level of informality in the ger areas, the flow of consumers and labor throughout the city is an important reminder of the integration of both the informal and formal economies.

42. Using exchange rate of January 1, 2015 which was approximately MNT1,876 to \$1.

43. Using exchange rate of January 1, 2015 which was approximately MNT1,876 to \$1.

Figure 5: Goods Residents Cannot Purchase in their Khoroo



Despite the robust economic activity of the informal sector, especially in the ger areas, a number of structural limitations were identified in the Foundation's research—most notably, limitations relating to protection of workers. In total, 7.17% of respondents reported having a monthly income of less than 200,000 MNT (\$106),<sup>44</sup> and 51.6% lacked social security coverage. Access to finance was also reported as a major issue for informal business owners, with only 20% having accessed commercial loans.

### 3.2 IN-DEPTH INTERVIEW RESPONSES

In order to explore the individual experiences of some ger area business owners, the challenges they face and strategies for coping with them, the Foundation and M.A.D. Mongolia also conducted qualitative, semi-structured, open-ended interviews with 10 business owners. Of these, one was a café owner, one was a coal and wood trader, two were involved in trading bottles and metal, and six were involved in technical services (sales or repairs of vehicles and machinery). These discussions covered seven issue areas which this paper discusses one by one under the following headings:

- A. Legal and Regulatory Framework
- B. Working Arrangements
- C. Barriers to Business
- D. Customers
- E. Travel for Business
- F. The Role of the Khashaa
- G. Redevelopment of the Ger Areas

These seven issues provide some insights into the attitudes and perceived needs of informal business owners, as well as their ambitions and business models. Across the respondents, there was clearly an entrepreneurial spirit and a desire to expand their businesses, but they had limited views on what the role of the government might be in that regard. They also expressed a desire for independence and fear of losing their flexibility, but balanced against these concerns, was recognition of their need to improve their capacity and access to finance and other types of support that could help to 'grow' their businesses. This study did not try to assess the financial viability of interviewees' businesses and their growth prospects, so it is difficult to judge whether their ambitions were reasonable, but it is likely that the opinions they expressed are commonly held among informal business owners.

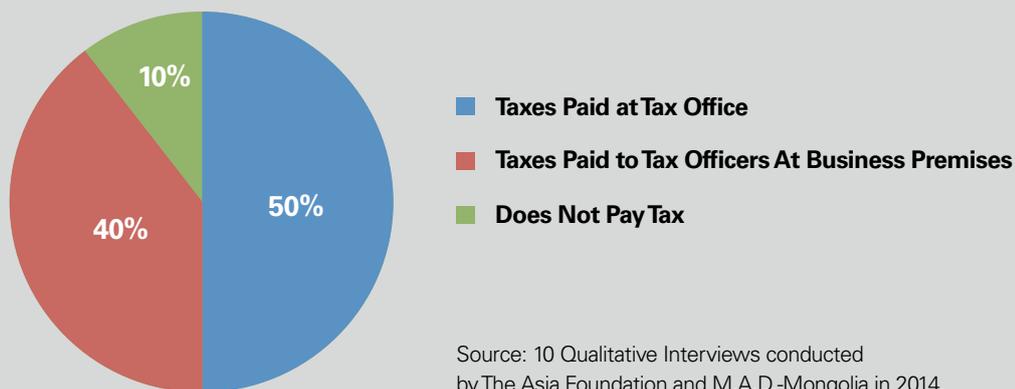
44. Using exchange rate of January 1, 2015 which was approximately MNT1,876 to \$1.

## A. LEGAL & REGULATORY FRAMEWORK

**Legal Registration:** As expected, discussions on legal registration showed that informal businesses predominate in ger areas. Of the 10 interviewees, 8 were registered as individual traders, while 2 (1 auto repair company and 1 trader in bottles and metal) were registered businesses. When the eight interviewees were asked why they had registered as individuals, most replied that they work alone. However, two noted that not registering

as a company saves money and increases profits. The extra work required to register as a company was mentioned by only one respondent—the cafe owner—who told the interviewer “I would have to be involved in lots of reports and paper work [if I were a company].” As for the two respondents who had registered as economic entities, the car parts trader stated that he had to do so since his transactions go through official bank accounts, while the bottles and metal trader said that registration was necessary because of the size of his business.

**Figure 6: How Business Owners Pay Taxes**



**Relationship with the Authorities:** Interview respondents had a more or less common experience with government authorities—almost all interactions were related to taxation. Both registered entrepreneurs reported that they pay tax through monthly visits to the tax office, but the individual traders’ responses were more varied. Four said that tax officers visited their premises monthly in order to collect what they owed, while three others said they visited the tax office to pay. The remaining trader, who deals in coal, told the interviewer that he does not pay tax at all. In terms of interaction with the tax authorities, all of the respondents, with the exception of the coal trader, dealt with tax authorities at least monthly. The coal trader, by contrast, stated that: “I had no inspections from the city, district, or even from the khoroo since I started this coal trading business.”

Concerning interaction with authorities, other than those responsible for taxation, including inspectors, responses were again varied. The cafe operator told the interviewer that her business premises was regularly visited by health inspectors to ensure compliance with the relevant legislation, while three of the auto traders said that their workplaces were visited by district inspectors. Of the remaining four respondents, one had been inspected once, and two indicated that their only interaction with other government agents occurred when the police visited after nearby robberies. The coal trader stated that he had had no interaction with other authorities.

**Laws & Regulations:** As a result of limited engagement with government authorities, interviewees appeared to lack knowledge about laws and regulations that applied to them. Eight of the 10 respondents stated that laws and regulations were not a burden to them. Of the two interviewees that had concerns, these were more to do with taxation than regulations. Both of these were car traders, and one stated that customs duty on imported cars is too high, and to be fairer, duties should be lower. As for the other trader, his complaint was that his taxes were too high. Interestingly, many of those who denied that laws and regulations were a burden, professed their ignorance of them. One trader in bottles and metal, for example, told the interviewer: “I have no knowledge at all of the laws and regulations.” A car trader and repairman similarly said “I do not know anything about laws.” This apparent lack of knowledge about laws and regulations that govern small and medium-sized enterprises in the informal sector indicate just how easy it is to start a legal, but informal, business in Mongolia. This also might indicate that most of those interviewed have not made an effort to formalize their enterprise, as doing so could require greater engagement with government authorities.

This finding is unsurprising in some ways, but it shows that if new regulations regarding informal SMEs and individual enterprises are introduced, they will need careful implementation to ensure that they have a positive, rather than a negative impact. Based on the interviews, it appears that business owners know little about regulations and if new ones are introduced, information campaigns and other capacity building will be necessary to help SMEs and individual informal enterprises to comply with the new rules and regulations. Such an information campaign could also inform business owners about the benefits they could achieve by registering their companies as formal businesses and the processes for doing so.

**Social and Health Insurance:** Interviewees clearly indicated that the prevalence of informal businesses could be a social security concern, given the lack of a social safety net for those working in informal businesses. The two interviewees with formally-registered businesses reported paying insurance contributions for themselves and their staff. Of the individual traders, four made their own contributions to the system and four did not, suggesting that the social safety net does not cover many informal enterprises. This finding matches those of the perceptions survey—51.6% of survey respondents reported not being covered by social insurance. Concerning the type of payments that those who are contributing make, one bottle trader stated that he is paying 30,000 MNT (\$16)<sup>45</sup> monthly in order to receive a monthly pension of 250,000 MNT (\$133)<sup>46</sup> when he reaches retirement age.

**Support Programs:** Although they expressed interest in them, interviewees indicated that they knew little or nothing about any of the support programs offered to small and informal businesses by NGOs and government. When asked about these, one respondent replied that he knew about such schemes, but his company did not participate. Two interviewees said that they do not need such schemes, and three interviewees said they did not know of any support programs, but they would participate if they could. Of the 10 interviewees, only one mentioned having benefitted from a support program (microfinance). Of those who were interested in participating, the bottles and metal trader said: “No, we do not have any support and we do need it. There is no assistance and support for people who want... [to do business] and develop.” The cafe operator, who was the most interested in any available support schemes, stated “We do not receive any support or help. If we have the opportunity, of course, we would not miss this chance. This cafe is our life. We would do anything we

can to improve our livelihood.” Finally, the coal trader stated that: “No help or support is available for me. I agree something should be done to support individuals who trade in coal.”

These responses suggest that there is considerable latent demand for training and other support programs, but this does not necessarily reflect a lack of quality programs or that interviewees had tried support programs and failed to benefit from them. Rather, this study suggests that entrepreneurs likely have limited knowledge of the opportunities they could access.

## B. WORKING ARRANGEMENTS

**Financing:** Unsurprisingly, interviewees stressed the critical importance of access to finance. In addition to answering questions specifically on financing, interviewees brought the subject up repeatedly in answering other questions. When asked how they had initially financed their business, six respondents answered that they had used personal or family savings; two said they had used a combination of personal funds and a bank loan, and two interviewees had only used a bank loan. The fact that 6 out of 10 interviewees had only used personal or family savings suggests that the cost of borrowing from a financial institution is prohibitively high. For example, the cafe operator stated: “I started [my business] by borrowing 1 million MNT (\$533).<sup>47</sup> Thankfully, I am almost finished [paying this back]...I used to pay back 150,000 MNT (\$80)<sup>48</sup> every two weeks, which was difficult for me. I requested and begged [the lender] to extend the payment duration to two weeks, so that I would not have to make the payment every week.”

**Employees:** Informal financing from family was complimented by complimented by informal recruitment and use of labor. Friends and family members were crucial in supplying labor, often on irregular and flexible schedules. Four of the respondents reported working alone, with the rest employing between 1 and 16 employees (the 16 work for the bottles and metal trader). Of those respondents who had employees, all but one relied on relatives and friends; the respondent who reported hiring employees stated that he hired mutual friends. Indeed, family and social networks still play a very important role in the economic life of the ger districts, and above all for small informal businesses. For example, the survey found that 28% of respondents rely on friends and family when looking for a job. Similarly, 17% of survey respondents had used loans from friends and family to start their businesses, a figure only slightly lower than that for commercial loans.

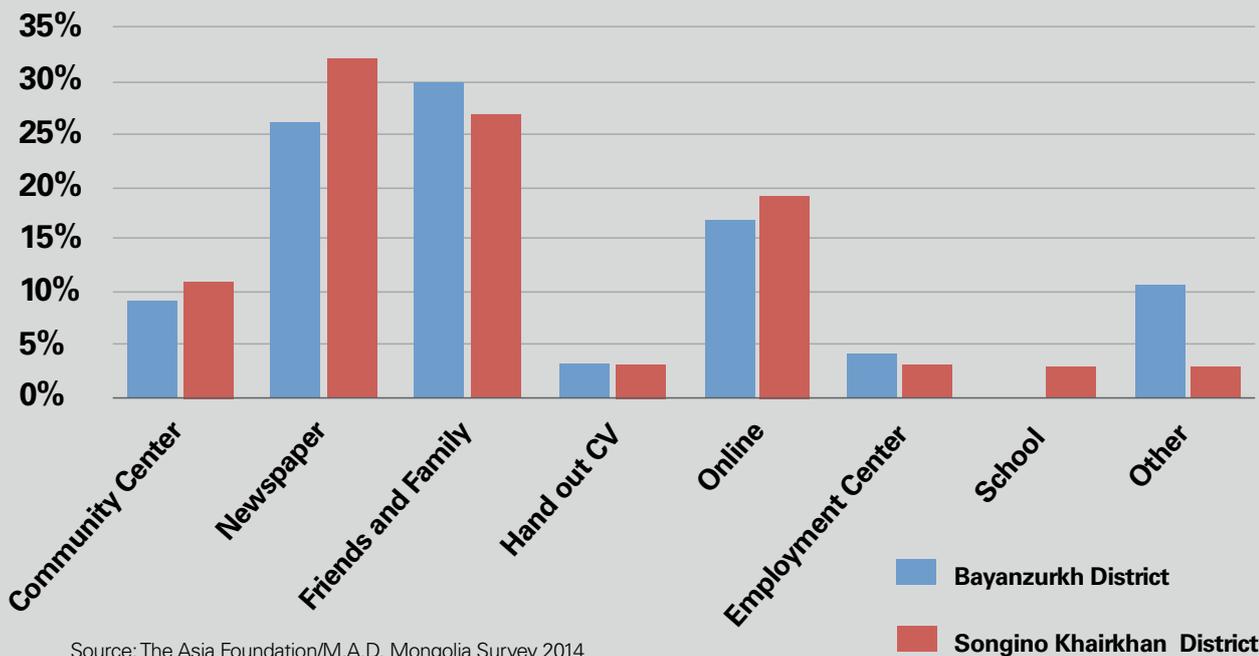
45. Using exchange rate of January 1, 2015 which was approximately MNT1,876 to \$1.

46. Using exchange rate of January 1, 2015 which was approximately MNT1,876 to \$1.

47. Using exchange rate of January 1, 2015 which was approximately MNT1,876 to \$1.

48. Using exchange rate of January 1, 2015 which was approximately MNT1,876 to \$1.

**Figure 7: How Survey Respondents Search for Work**



Source: The Asia Foundation/M.A.D. Mongolia Survey 2014

With regard to employment arrangements, all of those respondents with employees said that their staff worked full time and that their labor arrangements were organized informally rather than according to the labor law (this also applied to the two formally-registered companies). The only external restrictions imposed on the respondents applied to the auto traders who were limited to operating during the opening times of the auto market. The traders operating in this market work 6 days a week, while the other respondents all reported working 7 days a week, with working hours often running from 8 am to 10 pm. As one of the bottles and metal traders said: “We work from 8 am in the morning to 8 pm in the evening. If we have demand, the employees come here to help us after work hours too. Unfortunately, we do not have that many factory reservations [confirmed orders] at the moment... We do not have holidays. We work 7 days a week.” Finally, with regard to the business premises, rental was the norm, with seven of the respondents renting their business premises, and two owning them.

**C. BARRIERS TO BUSINESS**

The main barriers to business that SMEs face, and interviewees’ suggestions on how to address these barriers, was a significant strand in the discussions. Two themes recurred frequently when discussing each individual’s experience and perceived barriers to growth—access to finance and inadequate demand for their products or services—both a consequence of the

ongoing economic crisis. Interviewees listed a number of other challenges as well, with the costs of inputs being discussed at some length.

**Cost of Inputs:** Two respondents cited the cost of supplies and one the cost of rent as problems. Within the auto market, one trader cited competition and low profit margins as his main challenges in doing business. The cafe owner, for whom the cost of supplies was the biggest issue, stated: “Supplies, products and food materials are much too expensive. We can barely pay the costs, especially of meat. Meat is the number one product used in the meals [we serve], but based on its price, we barely make a profit from it and there are times that we make no profit at all.”

One of the car traders also cited supplies as a major issue, declaring: “I need additional equipment...my lifting jack always breaks. The new lifting jack costs 160,000 MNT (\$85)<sup>49</sup> and I cannot afford it.” He then went on to discuss the high cost of his loan payments: “My loan payment is too difficult for me. Even though I think of hiring someone, I cannot afford their wages. All the profit I gain is spent on my bank loan...the loan interest is too high and the payment duration too short...I have even thought of selling my cars and doing meat trading instead.” A bottles and metal trader confirmed the importance of financing, stating simply: “We are unable to find any loans.”

49. Using exchange rate of January 1, 2015 which was approximately MNT1,876 to \$1.

A further comment emphasizes the difficulties faced by traders due to low profit margins because of the high cost of supplies; one trader said: “We trade our products and look for just 100 to 200 MNT (\$0.05 to \$0.10)<sup>50</sup> of profit [on each item].” While the subject did not come up in the interviews, discussions on the impact of currency fluctuations, inflation and a generally volatile economic context have been continuous in Mongolia in recent years. All businesses, not just informal ones, have been affected and have suffered from unpredictable costs for their inputs.

**Inadequate Demand:** With regard to inadequate demand, many of the interviewees lamented the economic slowdown. A bottles and metal trader, for example, said: “My goods are not selling as well as I wish. Also, I am having problems trading my stock of metals because the Darkhan metal factory has stopped operating due to financial problems and also stopped collecting iron...A problem with raw materials recycling is that payments are delayed most of the time.”

Similarly, an auto trader declared that: “Compared to 2013, this year was worse. We were granted small loans, but could not obtain SME loans or the like. These are difficult to obtain as the requirements are high. But in the future, we wish to open another business such as a mini market, and this should be an improvement.” On the prospects for the Da Khuree market moving to the outskirts of the city, he said: “Moving the market may be useful for car traders so they can park their cars, but not for spare parts traders like us. No one will waste their time and money to drive that far to buy small parts for their cars...Also it is too far for us to drive back and forth between home and business. Kids’ schools are in the city too, and there is no one to look after them except for us. Most small traders live near the market to save on gas, so they can run their business from home, and to be closer to their customers. If they move the market, families will lose their work, independence and livelihood.” This theme came up later in the interviews when respondents were asked to discuss the redevelopment of the ger districts and how this would impact their business. Clearly redevelopment is a concern for many traders.

**Finance:** One interview respondent cited the high cost of financing his loan, while two others stated that lack of access to loans is their most critical barrier. Overall,

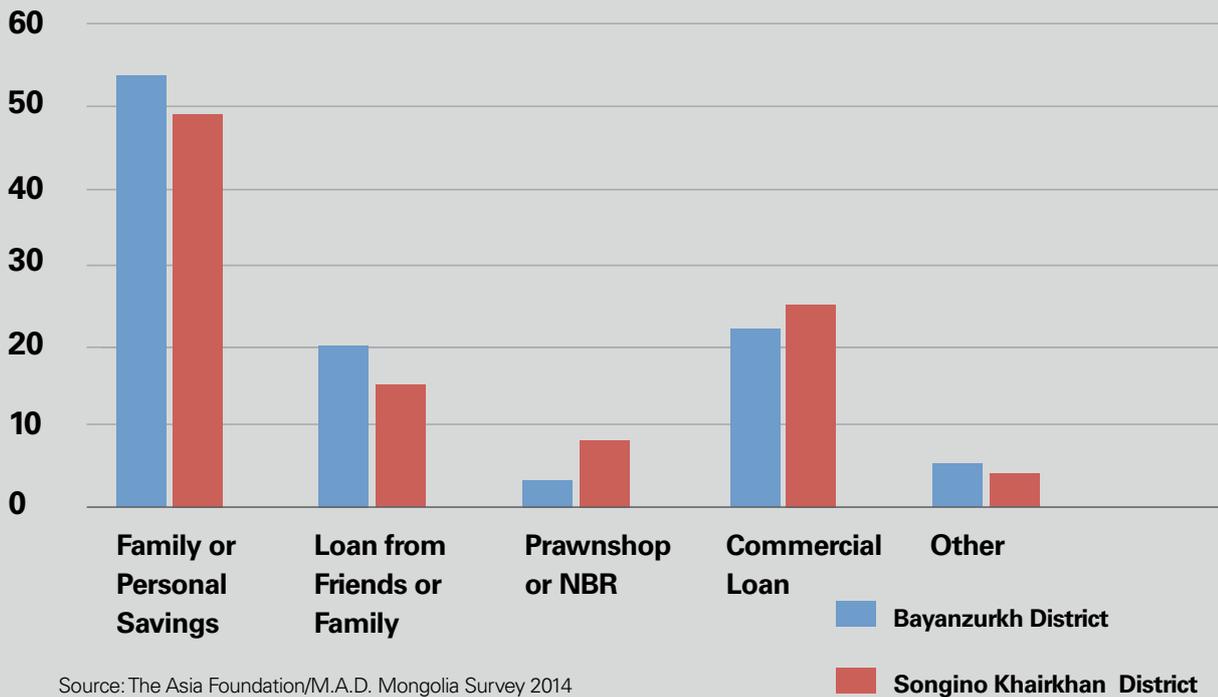
as indicated previously, lack of financing was one of the most consistently-cited barriers to business. Only 19% of the quantitative survey of 600 respondents survey respondents had financed their business through commercial loans, and most of these were in the 45–55 year age group, suggesting that young people are affected disproportionately by the structural limitations of financial markets in Mongolia, including rules on collateral, and high interest rates caused by both weaknesses in the lending sector as well as macro-economic challenges like inflation and currency fluctuation. Half of business owners (51%) said they had used family or personal savings to start their venture, while 17% had done so through a loan from friends and family—figures that again emphasize the important role of family and social networks within the informal economy.

It is therefore not surprising that when asked about what support SMEs need most, the majority of respondents talked about loans—improved access to finance and lower interest rates for loans. Two respondents were unwilling or unable to provide responses on how to improve their business opportunities, but six respondents cited improving access to finance as the best thing that could be done to help them. The cafe owner, for example, stated: “Finance is the initial barrier. We need more money. My goal is to start from small things and turn into big things. If I have another chance to receive another loan for the long term, I would like to help my employees learn more and give them the chance to do more.” A car trader spoke in a similar manner: “I would like to receive a discounted loan so I could work on so much more.” Another car trader, speaking in an exasperated tone, said: “We wish to obtain a bank loan and purchase this place for ourselves. Unfortunately, we have nothing to mortgage or deposit, and because of this, we have no opportunities [to borrow from a bank].”

One of the bottles and metal traders explained the need for more people to know about loans, saying: “I think we have to give out a lot more information and details about loans to every single citizen and spread that information sufficiently.” Industry sources queried on the provision of financing in the ger areas cited the difficulty of obtaining suitable collateral and the higher risk of lending as their main concerns. These are legitimate concerns, but they have not been adequately communicated to both potential borrowers and those who have actually applied and failed to get loans from commercial banks.

50. Using exchange rate of January 1, 2015 which was approximately MNT1,876 to \$1.

**Figure 8: Methods of Financing Used by Ger Area Business Owners**



Two other issues emerged while discussing financing and what more might be done to support small businesses that might not directly relate to financing issues, but are worth noting. First, varied opinions on the appropriate role for government in supporting businesses started to emerge—something that continued in later interviews. One car parts trader stressed that government should not be involved: “We do not need the government to be involved. When it is involved, it bankrupts the private sector.” The cafe owner, in contrast, called for government support programs: “We need business knowledge, we want to participate in workshops... We want knowledge on continuing our business in the future. We are losing time and opportunities to expand our businesses because of lack of knowledge.”

Second, rather than offering broadly applicable suggestions for how small businesses could be better supported, interviewees often mentioned industry-specific solutions. One car trader, for example, suggested that the car market should not be moved (something which has been proposed). That, he said, would be the best way to help his business. One of the bottles and metal traders cited improving relationships with his purchaser (a large company which often changed purchase terms without informing the supplier, as well as frequently delaying payment).

#### **D. CUSTOMERS: FROM NEAR AND FAR**

The questions on customers were answered perfunctorily, with almost all the traders reporting having a mix of regular and occasional customers. The cafe owner and the coal and the bottles and metal traders reported having regular customers because their market was primarily proximity based. The customers of the coal trader and the cafe owner come on a daily basis, while the customers of the other respondents differed markedly, with the car traders and repairmen having customers who came back the least frequently.

However, questioning did yield some interesting information on how the economic situation was impacting customers. Three traders noted that citizens are finding it harder and harder to make a living—a negative trend which is clearly impacting their business. One car parts trader stated: “It is obvious that the whole society is falling into economic crisis.” A bottles and metal trader said: “Nowadays people are beginning to think of cutting costs even on raw materials—no matter what the product is as long as they can save money.” The coal trader noted that: “Citizens’ living conditions have deteriorated. They can barely afford to purchase their coal.”

**E. TRAVEL FOR BUSINESS: SURPRISING SUPPLY CHAINS**

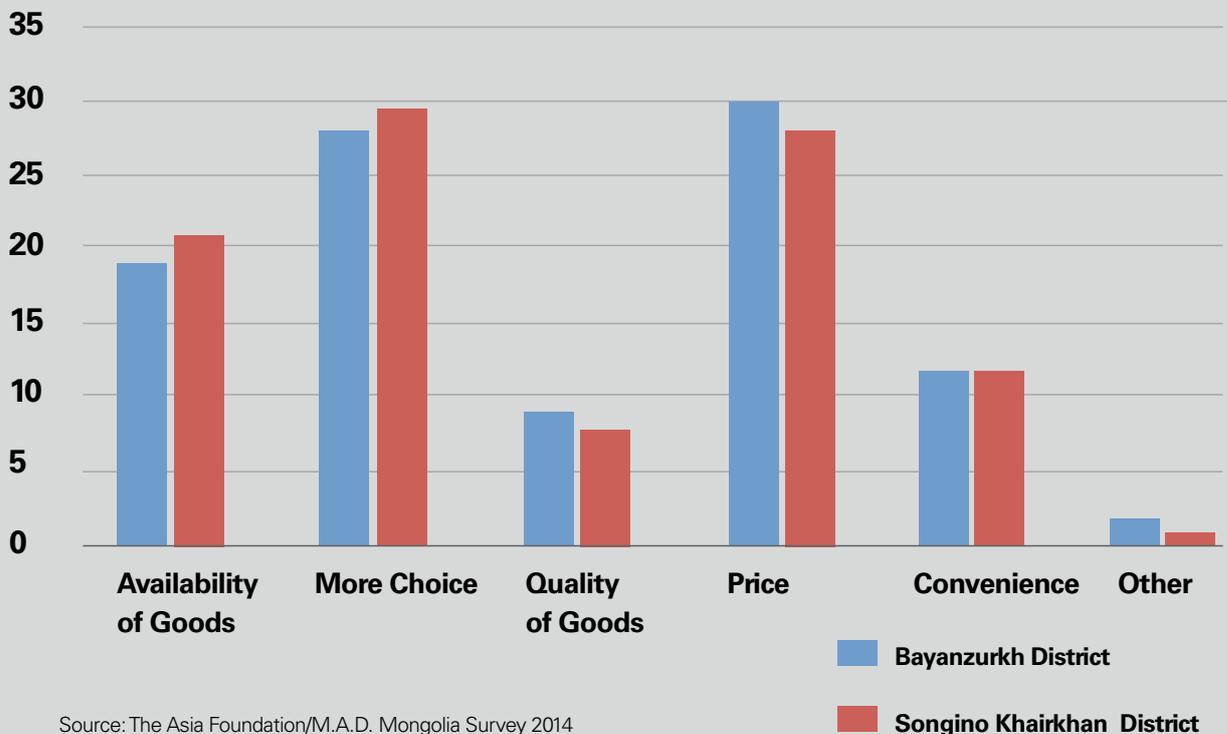
Respondents travelled surprisingly frequently for business, with only one saying that he did not travel for business. The rest travelled frequently, and some even daily. Of course the frequency of travel depended on the destination.

**International and Local Travel are Important for Small and Informal Businesses:** The car traders indicated that they travel daily in, and around, the car market, but only once a season would they go out of the country. This was an interesting point, as many of the respondents travelled far afield for business purposes. The car traders, for example, visit China, Japan, Hong Kong, and Korea to purchase parts, while other traders travel to the countryside to sell their products. A bottles and metal trader often goes to Darkhan to meet purchasers. Within Ulaanbaatar, respondents’ destinations to buy supplies included the Khanghai Market, Ugumuur Market, Narantuul Market, and Khuchit Shonkhor Market. The traders also went to the auto plaza and Nalaikh district to sell their goods. In summary, it is clear that traders travel frequently for business purposes, and do so for a variety of reasons. Travel to purchase supplies and sell goods were the most frequently cited reasons (seven respondents), but many also cited the need to visit the authorities. Only one trader reported not travelling for business.

**Economic Integration of Ger Areas:** The quantitative survey included questions on travel as a means of assessing the economic relationship between the ger areas and the wider economy of Ulaanbaatar. In total, 32.8% of respondents worked outside of the khoros where the surveys took place. Respondents were also asked what goods they cannot buy locally. In total, 33% reported leaving the khoroo to buy clothes, 20% leave to buy household goods, and 15% leave to buy certain food products. When asked why they do not shop locally, 29% of respondents cited higher costs and lack of choice. These figures suggest both that ger area residents work and spend income throughout the city and that retail is relatively underdeveloped in the ger areas. This is significant, as it shows a supply gap that could be filled by new businesses.

Taken together, these responses suggest that the informal economy in the ger areas is more sophisticated and connected to the wider economy than is generally thought. Supply chains, for example, are complex and, in some cases, international. In addition, there is clearly a feedback loop between the informal and the formal economies, with informal traders both purchasing from, and supplying to, the formal sector. It is often assumed that the formal and informal sectors exist in relative isolation but, in fact, they are two important and mutually reinforcing parts of the city economy. At the national level, the example of the agriculture sector

**Figure 9: Survey Respondents’ Reasons for Shopping Outside of their Khoroo**



highlights this. Agriculture is one of the mainstays of the Mongolian economy, and herders frequently sell their produce to processing companies. These, in turn, serve as a link between the market and the producer, providing goods to the former and income to the latter. Within the city, the Da Khuree auto market has similar dynamics. Larger car dealerships and import-export businesses coexist alongside individual traders selling parts out of containers and repairmen providing services, both to individual clients and to larger businesses. Similar examples of integration and interdependence can be found throughout the city.

## F. THE ROLE OF THE KHASHAA PLOT IN BUSINESS

The ger areas are made up of individually owned plots of varying sizes that are fenced off by the owners. These plots (khashaas) generally have enough space for multiple families to build small buildings or put up gers (traditional tents). Some build a family house and leave space for gardening or other income generation activities. However, interestingly, more and more ger area khashaas are rented out partially or entirely for business activities. Of the respondents surveyed, seven had khashaa-based businesses. Of those seven, three respondents lived on the same khashaa, while the other four rented one for their business. Of the other three respondents, two had fixed business premises, while the coal trader rented a container on the side of the road to store his goods (at a price of 90,000 MNT [\$49]<sup>51</sup> per month).

**Role of the Khashaa:** When asked to discuss the role of the khashaa in business, almost all respondents discussed the benefits of not paying additional rent for their business premises. Similarly, living in the same khashaa in which they work saves both time and money in terms of transport. One car trader, for example, stated that: “First, home and work distance is, of course, closer. I do not have to spend anything on driving costs, and lose time going between work and home.” Two respondents argued that having a khashaa-based business makes it easier to locate their business, and also to attract and maintain local customers. However, the main reason respondents gave for using a khashaa for business was saving on costs, and most respondents seemed to see their khashaa-based businesses as a positive thing, with the khashaa playing an important role in their economic activities.

One bottles and metal trader said of the khashaa: “It has a very important effect on my business. I collect the raw materials at this khashaa and the people I connect

with are familiar with my khashaa and come here to commission their products.” The second bottles and metal trader said a similar thing: “Khashaas play an important role in our lives. We collect the raw materials here and customers and traders come here to purchase and drop off goods because they know our place well.” Given such comments, and the plans for redeveloping some ger areas, the subject of the next question could have a major impact on the economy in the ger districts.

**Redevelopment of the Ger Districts:** Despite the responses given above, attitudes towards the redevelopment of the ger districts—a big topic in Ulaanbaatar in recent years—were not uniformly negative. The challenges for businesses, and especially for those that are proximity based, would likely be significant if their area is redeveloped. However, this does not mean that all of the small business owners surveyed were worried, or entirely opposed to change. Instead, opinions were decidedly mixed. The cafe owner, for example, seemed ambivalent, responding: “I do not know exactly. This place is rented so we might have to leave...That would be difficult for us.” One car trader seemed less worried: “It will not affect us much. I have my customers and they know how to contact me and where to find me. I can be operating again within a month or two if I move somewhere else.”

Others, however, believed that redevelopment would threaten their livelihood. One car trader who is renting a khashaa for his work stated: “They asked me if I will be able to buy this rental khashaa, and I said no. I think the owner is waiting for redevelopment. I will have difficulties if my place is included in the redevelopment area. If it is not included, it will be my luck to stay here and keep working.” This is a particularly sensitive issue as many of the ger area businesses that make up the informal sector have local customers, and being forced to give up their khashaa and move would make it difficult to successfully reestablish their business. However, it must be noted that most residents seem to believe that ger area redevelopment would make the area entirely residential. In fact, of course, redevelopment would include retail space and new opportunities for business growth—opportunities that need to be emphasized. But whether these economic opportunities will go to ger area residents, or whether increased development will see formal businesses displace local informal ones remains to be seen.

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51. Using exchange rate of January 1, 2015 which was approximately MNT1,876 to \$1.

A Bayanzurkh welder's comments demonstrate the misconception that ger areas will become residential: "I guess it will affect me negatively. I will lose my business. Even if they promise an apartment for me, I prefer the khashaa plot because of my business. This is my living. A khashaa-based business just costs me electricity and tax money. There is no need for me to pay other expenses." He then discussed his reluctance to move into an apartment: "There is no plan to build more

will be filled with trash." This implies another criticism of redeveloping the ger areas: namely that land prices would increase in the redeveloped areas, forcing many small traders and business owners to relocate, creating a poorer fringe on the outskirts of the city.

In summary, responses to this question reflect the complexity of issues. Some respondents were incredibly hostile to the idea, while others were ambivalent. None of the respondents seemed enthusiastic about redevelopment, but many accepted that it was necessary, although they would prefer that it not happen in their area. Overall, it is clear that the spatial design of the city and approaches to land use policies are closely linked to economic opportunity. Any consideration of the overall business environment must take these issues into account.

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**MANY RESIDENTS DO  
AGREE WITH THE IDEA OF  
REDEVELOPMENT OF THE GER  
AREAS, BUT THEY APPROACH  
THE ISSUE WITH A NIMBY  
("NOT IN MY BACKYARD")  
ATTITUDE AS THEY JUST DO NOT  
WANT REDEVELOPMENT  
WHERE THEY LIVE.**

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**3.3 KEY POINTS FROM THE  
INTERVIEWS: THE NEED TO BALANCE  
SUPPORT WITH INDEPENDENCE**

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apartments here because the first few apartments were terrible, with no water for the toilets, and after a couple years, the buildings were badly damaged. It is terrible to see how they live in these apartments." Similar concerns were expressed in other research studies on attitudes towards redevelopment of the ger areas. The biggest concerns were either that apartments will not be built or that they will be of very poor quality.

The final questions used in the interviews concerned improving the functioning of SMEs and how best to support them. As in earlier sections, the majority of attention was given to finance, and six respondents cited getting loans and securing investment as the biggest priority for their business. Exasperation about not being able to get a loan was also expressed. One of the bottles and metal traders, for example, stressed that: "Citizens have to be able to compete fairly for government subsidized loans. The Mongolian government is not supporting us...Honestly we have been seeking a loan for 5 whole years." Similarly, an auto trader stated that his top priority was to "get a bank loan, purchase this place, and expand it."

Many residents do agree with the idea of redevelopment of the ger areas, but they approach the issue with a NIMBY ("not in my backyard") attitude as they just do not want redevelopment where they live. One of the car traders said: "We believe it is a good change, but we will disagree if this area or location will be redeveloped. Where will our business move to?" A second trader said: "Of course, we would prefer an apartment. But where would we keep our products?" He went on to say: "If someone really comes and demands that we move in order for reconstruction to occur, then I guess we will have no choice. We will move our products and pay rent or do some other business so that we can make a living."

The same respondents stated that discounted loans were the best way that the government could support SMEs. For example, one of the bottles and metal traders said: "They should grant discounted loans. Although I tried applying for a loan, I had no luck. There are no opportunities for people who want to develop their livelihood. The banks do not consider that the raw materials we have collected are assets, even though we have purchased them with our own money." A car trader spoke in a similar vein, arguing "I think if I could obtain a loan, I would do well. The loan interest has to be lower though." A recurring theme was the need for greater information about loans and how to obtain loans, as well as transparency regarding why certain decisions were made. Clearly many of the respondents felt discriminated against because their applications had been rejected for no good reason or that the interest rates were exorbitantly high. As one car trader explained: "We have to have enough detailed information, and full transparency. We do not currently have full information about support. With this situation, how can we be involved in loans?"

Under the theme of conditional agreement, one bottles and metal trader said: "I believe redevelopment is good. However, he agreed with others that redevelopment of the ger districts would have negative effects on businesses such as his: "I disagree with legislation moving raw materials recyclers out of the city. If that happens, the city will be covered in trash. No one will drive that far out of the city to buy or sell materials." This sentiment was repeated by the second bottles and metal trader: "Moving this collection point out of the city is disagreeable...traders will not travel that far...the city

An interesting view on the need for support concerned industrial production, with two respondents suggesting that the government should build up national industrial

A final trend that stood out in interviewees' responses in this study was ambivalence towards the role of the government. As previously mentioned, one respondent,

for example, suggested that government should stay out of the way if it wanted to help SMEs. Similarly, most respondents blamed the government for the lack of loans, the lack of information about loans, and their high interest rates. At the same time, however, some respondents called for government to develop better policy on rent. The cafe owner, for example, stated: "We want to pay rent to the government. We think this will prevent rents from rising higher as they would under private ownership. We cannot make a profit with expensive rent, supplies, and materials." A Bayanzurkh auto trader expressed a similar sentiment, arguing that there should be fewer or no privately-

owned rental garages. "If the government builds and owns the garages, we might not have to pay rent." Thus, as in many parts of the world, there seems to be ambivalence towards government, with entrepreneurs both distrusting government and holding it responsible for failings in coordination, while at the same time calling for more government intervention and action.

## BOX 5. A SNAPSHOT OF INFORMALITY IN ULAANBAATAR

Informal businesses:

- Operate throughout the city
- Are mostly run by an individual, however, family or friends may work on an irregular basis
- Often make use of a khashaa as it is an important location for them
- Register with tax authorities and pay tax on a monthly basis
- Know little about enterprise-related laws and regulations
- Take payment in cash or trade for goods and services they need
- Lack social insurance coverage for most workers
- Rely almost entirely on family and personal networks for sourcing workers
- Rely almost entirely on family and personal networks for finance
- Receive little financing from financial institutions (only 1/5 have loans from banks)
- Have few business support programs or training schemes available to them
- Are integrated within the city and with the formal economy, both for supply and demand

capacity. One of the bottles and metal traders, for example, felt that bottles and metals could be processed in Mongolia instead of distributors having to buy bottles from China. With regard to seminars and workshops on aspects of business management, only one respondent mentioned the need for this (the cafe owner). She argued that such programs are necessary to improve knowledge about how to run a business—a major concern for her.

# Section 4: Supporting Business, Improving Efficiency – Recommendations

The survey and interview results discussed in this paper were designed to provide a snapshot of informality and economic life in the ger areas and, in doing so, they offered a number of insights into a sector that is a mainstay of economic life in Mongolia, but still relatively unexplored. There are clear limitations to the primary data included in this paper, and further research and analysis are needed to gain greater understanding of the dynamics of this complex sector. However, this preliminary study does raise a number of questions for further examination, as well as relevant points for policy consideration. As this

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**IN THE CURRENT MONGOLIAN CONTEXT, IT IS IMPORTANT FOR CONSTRUCTIVE POLICY DEVELOPMENT, TO START FROM THE POSITION THAT A THRIVING INFORMAL SECTOR IS NORMAL AND POSITIVE FOR THE ECONOMIC WELL-BEING OF MANY CITIZENS.**

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paper has demonstrated, the ger areas are a critical source of employment and income, as well as dynamic entrepreneurialism. However, the ger areas are not being fully considered in economic policy making and planning and, as a result, lack social protection and commercial finance, among others. While policies could provide new opportunities for informal business to grow, plans need to be implemented carefully so that they do not stifle the entrepreneurial spirit that reduces inequality and encourages growth.

In the current Mongolian context, it is important for constructive policy development, to start from the position that a thriving informal sector is normal and positive for the economic well-being of many citizens. If this basic starting point is accepted, then any repressive measures to reduce informality must be weighed carefully against the significant risks they entail. Such actions risk pushing the sector underground and making it even harder to shape through policy and regulation, as well as causing undue economic damage to many of the citizens facing the most difficult economic situations. The ambivalence that informal business owners say they feel towards the government further highlights the need for a delicate approach with them. During the interviews conducted for this study, respondents called on government both to do more for them and to stay out of their business—and sometimes both points were made in the same interview. Ultimately, the aim of government should be to create a business environment that facilitates the generation of employment and wealth, while at the same time encourages businesses with growth potential to formalize.

There is no consensus among economists regarding the correct way to view and engage with the informal sector. Indeed, recommended approaches range from stamping out informal economic activity to leaving the sector alone because it will naturally phase out over time. But these are often abstract recommendations that do not consider the context of the informal sector in a particular country. For government policies on informality to be successful, they must be context-specific, considering both the realities of the local sector, as well what the government wants to achieve.

In Ulaanbaatar today, the question of how to engage with the informal sector needs to start with the perceived challenges. The informal sector should not be seen only as a problem, but rather government should consider how to stimulate informal enterprise development and growth. Significant data from around the world suggest that informal businesses are less productive and, ultimately, less profitable than formal ones.<sup>52</sup> However, this does not mean that all informal businesses can increase their productivity and become profitable, formal sector businesses. The burdens that result from labor laws, taxation, and financing costs dictate that some informal entities will not be able to transform themselves into formal ones but, over time, they may be replaced by larger, formal entities or conglomerates that achieve efficiencies through scale or conglomeration. However, this should not diminish the important role that informal businesses with little or no growth potential can play in poverty alleviation and income generation. They should also be valued for their flexibility in responding to changing market needs, and if it is easy to establish them, informal businesses can be a valuable training ground for entrepreneurs and a low risk means of testing innovative ideas to see if they could grow into more productive businesses.<sup>53</sup>

If this broad characterization of the informal sector is accepted, it suggests the broad policy objectives of creating opportunities, stimulating informal businesses with growth potential, and incentivizing them to formalize. Such objectives require proactively dismantling barriers to formalization. At the same time, policy should allow tolerance of informal businesses that are not likely to grow beyond an individual or a few irregular employees, while at the same time ensuring that they are covered by social protection. Ultimately, policy should not prop up unproductive businesses, but should still allow space for businesses to respond nimbly and flexibly to the market and allow small-scale economic activities to launch with limited barriers to entry. The aim, overall, is not to push informal businesses in one direction or another, but to create an environment in which they can grow, expand, or scale up and thereby continue to contribute to employment and wealth generation.

Asserting that the informal sector in Ulaanbaatar has not been studied enough, does not imply, however, that there is a complete absence of relevant policy or legislation on this topic. Some of the measures which this paper recommends have already been articulated by government, and are well known. The State Policy on Informal Economy, passed in 2006, and to be implemented through 2015, lists a number of measures to support

and improve the sector, including increasing access to finance, incentivizing formalization, and extending social security coverage. These measures, though, are general in nature, and lack detailed implementation measures. The National Council of Labor has also developed a policy to support self-employment through increased access to finance, but this policy is in its infancy.

There are risks though when the government considers policy improvements that will affect small, informal businesses, without clear analysis and consultation with those who could be affected. The current plans to amend the Labor Law could be a concern for informal business owners as the preliminary draft [at the time of writing] shows that government could require payroll records and introduce restrictions on the number of hours students can work and other measures that would restrict labor flexibility for small, informal businesses.<sup>54</sup> Although the amendments are only a draft, and the proposed changes may not proceed, there appears to have been little or no dialogue with those whose businesses would be affected to find out whether the amendments to the draft law would negatively impact them.

## 4.1 RECOMMENDATIONS FOR DEVELOPING THE INFORMAL SECTOR IN ULAANBAATAR

Long-term and short-term measures for government to consider in order to support the informal economy and encourage formalization are listed below, including the identification of information gaps that further research could fill:

### 1. Implement strategies that promote entrepreneurship and economic growth

- Set up a sovereign wealth fund that could promote economic diversification and enterprise growth
- Increase information and transparency about available loans and the requirements for obtaining a loan
- Adopt innovative approaches to expand access to finance
- Expand small businesses' opportunities for skill development and participation in business incubators
- Incorporate business skill development into the secondary school curriculum

52. La Porta and Shleifer 2008 p. 344.

53. This line of thinking is closely associated with an article on the 'Dual Economy' which Harris and Todaro wrote in 1970 for the journal, *American Economic Review* pp. 126-42.

54. Khash-Erdene 2015.

## 2. Improve the regulatory environment and incentivize formalization

- Widely communicate the benefits of formalization
- Offer tax relief to businesses to encourage them to formalize
- Monitor and evaluate the results of informal sector policies

## 3. Improve informal sector representation and dialogue opportunities

- Establish a body to represent the informal sector and articulate its views
- Make greater efforts to consult with informal businesses

## 4. Improve equality in ger areas

- Mainstream gender in all policies on the informal economy
- Reduce inequalities between the more affluent apartment areas and the ger areas

## 5. Improve physical planning in ger areas

- Take account of the economic importance of the khashaas in making plans for redevelopment in ger areas,
- Develop and introduce local development strategies that offer a activities, and provide information for local business owners to take into account when making their plans.

## 6. Improve social protection and equitably distribute public goods

- Encourage informal businesses to make voluntary contributions in order to obtain social insurance
- Update the tax law governing informal traders to incentivize voluntary contributions to social insurance

## A. GROWTH STRATEGIES FOR THE BROADER ECONOMY AND ENTREPRENEURSHIP:

At the broadest level, it is clear that the future of the informal economy will depend on macroeconomic development. Research shows that the current economic crisis is having negative effects on both consumers and suppliers. Among others, the symptoms of this include inflation, which reached 11% in December 2014, and depreciation of the currency, the Mongolian Tugrik (MNT), which dropped from 1,300 MNT to the dollar in 2012 to approximately 1,980 MNT at the end of 2014.<sup>55</sup> This has reduced incomes, purchasing power, profit margins, and opportunities.

Of course additional factors apply to small businesses and prospective entrepreneurs, and since they were the focus of this study, most of the recommendations above apply to them. While the Foundation's survey shows that access to finance has increased over the last decade, this has clearly not been enough to meet business owners' needs. This study estimates that only 20% of informal businesses have been able to gain a loan to develop their business, and this is not for want of trying, as interviewees made clear. Given the high level of informal entrepreneurial activity that this paper highlights, increasing access to finance could have a major impact on the economy, allowing businesspeople to expand, diversify, and/or move up the value chain. Given Mongolia's macroeconomic idiosyncrasies, this impact would be particularly beneficial. As previously discussed, at present, most of the country's wealth is generated by natural resource extraction, and while capital intensive, this does not employ large numbers of people.

SMEs, in contrast, in both developed and developing countries, are labor intensive and if support is provided to help SMEs grow, this could have the greatest impact on job creation. Lack of finance is clearly a major obstacle to SME expansion. Not only are loans of short duration, definitions of collateral mean that lenders usually accept only fixed assets such as land and buildings, and interest rates are prohibitively high (usually around 24% for a year). These conditions exclude many potential entrepreneurs, perhaps most notably young people who are the most likely to establish innovative, new businesses. Improving access to finance should therefore be a priority. However, the authors of this study would not recommend that the government subsidize lending as the cost would be unsustainable for a government already under financial strain. Instead, as this paper has discussed, ger area

55. Despite significant fluctuation in 2015, current levels during the Summer of 2015 are still around 1900 MNT to the dollar.

residents need information about where and how to apply for financing, and transparency about the terms.

With regard to broader macroeconomic policy, the authors offer the following five recommendations to support entrepreneurship.

**1a) Provide a sovereign wealth fund to promote economic diversification and smoother growth.** While resolution of the current macroeconomic difficulties would be one of the best ways to foster enterprise formalization, the authors realize this would not be easy to do. Although the mining sector which led growth of the last few decades has clearly resulted in material improvements in the ger areas, recovery of the mining sector would not guarantee equitable distribution of the benefits of future growth. It is therefore critical that the government use the proceeds of future growth to support non-mining sectors of the economy. Handouts, a previous policy favorite, clearly do not work as they do not create decent employment opportunities, nor do they make the economy of the ger areas or their residents any more resilient. A more beneficial strategy at the national level would be to manage revenues through the use of a Sovereign Wealth Fund as a counter-cyclical policy instrument that would smooth out public spending. So in boom periods, excess public income would be deposited into the fund, and when income dropped, the fund could be drawn down to prevent drastic cuts in the public sector budget that would have negative impacts on the overall economy.

Such a fund would also provide a mechanism that could be a source of funding for the stimulation of the non-mining sectors of the economy. Investment in these sectors would help moderate growth cycles, and potentially help address one of the core concerns of the interviewees—lack of employment opportunities. Indeed the development of other sources of growth would create a self-sustaining circle in which growth prompts further investment and consumption. This would support diversification and development, as well as allow the private sector to grow without being crowded out by expansion of the public sector—a problem that frequently occurs in resource dependent countries where public sector budgets rapidly expand when taxes from mining or profits from partial national ownership of mines and other investments, generate massive income.

**1b) Increase information and transparency regarding the process and conditions for getting a loan:** Providing information on accessing finance would dispel the impression that loans are granted according to the personal preferences of those arranging the loans rather

than according to objective criteria. Also, in the long run, financing needs to be more affordable. Unfortunately, as explained above, under current economic conditions, the government does not have the money to provide discounted loans and, given the current macroeconomic context, high inflation that is a primary cause for high bank interest rates, will not likely decrease significantly.

**1c) Expand access to finance through innovative approaches:** Innovative solutions to increasing access to finance include accepting a wider range of collateral than only land and buildings. For example, in some countries lenders will accept a business' equipment, vehicles or even their accounts receivable as collateral.

Another innovative approach to providing financing without collateral is that of lending to a group of borrowers who share the money and guarantee to repay if a member defaults. Lending to individuals and groups could be facilitated by local development organizations, other civil society groups, and at times local governments. These actors could also ensure that business owners know about the availability of financing, how to apply for it, and the terms of the financing. In addition, given the important economic role that family networks continue to play in the informal sector, considering how to incorporate them into financing arrangements might offer some opportunity as well. Finally, it is crucial to involve financial institutions from the outset in any new approaches to financing in order to understand their perceptions about risk, and to ensure that they will support the new mechanisms being proposed.

**1d) Offer small businesses training in business skills as well as opportunities to join in a business incubator:** In addition to financing, it is clear that greater knowledge of business skills and economics would benefit traders and informal business owners. Most traders suggested in their interviews that they need some sort of support for business development, and some explicitly called for it. The need for such schemes appears likely as none of the interviewees had participated in, or even heard of, a government, international organization, or NGO scheme that develops business skills. Relevant topics for instruction that could help ger area businesses to professionalize and become more profitable include accounting, financial management, communication strategies, marketing, organizational development, and administration. Skills which could be developed through vocational training include accounting and general business management. Unlike the technical training that donors currently prefer to support, this training could enable informal business operators to improve their operations and maximize efficiency.

The development of more sophisticated record keeping and better understanding of the benefits of taxation (e.g. Value Added Tax) could be achieved through training. This could also narrow the gap between the informal and formal sectors by making it easier for a business operator to transition to formality. Such programs could be implemented through the khoroo administrative offices across Ulaanbaatar as these know the extent and types of informal activity within their boundaries. Providing business development training through the khoros should have the added advantage of familiarizing informal traders with local government officials and vice-versa.

Another major obstacle to the growth of any business is its fixed costs, and the smaller the business, the greater the challenge. In Ulaanbaatar, there are few ways for a business to reduce its overheads, and this stifles growth. However, by linking up small but promising businesses to share resources through a business incubator could help encourage their growth and formalization. Business services such as accounting, advertising, and advice on how to develop a business could all be offered on a more affordable basis through business incubators. Incubators can offer the additional benefit of making it possible for budding individual entrepreneurs and small companies to exchange ideas and collaborate.

1e) *Incorporate business skills training into the secondary school curriculum:* One of the findings of this study was that almost all respondents had completed secondary school, and this was especially the case with younger business owners. Thus, incorporating instruction on economics and business skills into the high school curriculum could help prepare students to work in, and run small businesses, and thereby facilitate the startup and growth of businesses, job creation and the expansion of informal traders' enterprises into larger formal ones.

**B. REGULATORY ENVIRONMENT:** When Mongolia is compared to other countries at a similar stage of economic development, the country scores well on labor protection and rights.<sup>56</sup>

However, it must be said that the main issue with the regulatory environment in Mongolia is one of enforcement. Lawmakers have shown themselves to be active in Mongolia's 25 years of democracy, often passing well-designed laws and policies, but implementation of those laws has frequently been lacking. The most obvious example at the national level is the self-imposed

sovereign debt limit (set at 40% of GDP). This has been repeatedly ignored, and the national debt is now 49.9% of GDP.<sup>57</sup> With regard to the informal sector, while this study shows that the State Policy on [the] Informal Economy lists some key measures that need to be taken to support the informal economy, implementation of these has lagged.

## BOX 6. STATE POLICY ON THE INFORMAL ECONOMY

The State Policy on [the] Informal Economy was promulgated in 2006 and was designed to be implemented in three stages between then and 2015. The main aims of this policy are to encourage formalization, expand social protection, and increase state tax income. The main thrusts of the policy include:

- Increasing access to investment, technology, and finance, while expanding registration and taxation.
- Improving the legal environment of the informal sector and protecting employees' rights
- Supporting operations in order to increase income and employment
- Improving the social security of informal sector workers
- Increasing enterprise participation in encouraging formalization

However, because the State Policy on [the] Informal Economy has not been effectively implemented, it would be a mistake to 'crack-down' on informal enterprises. As discussed above, this could have significant negative impacts. Instead, the informal economy should be monitored regularly to better understand the sector and efforts should be made to ensure that informal enterprises are covered by social security. This could be combined with introducing positive incentives for businesses to formalize rather than punitive measures for operating informally which would hurt businesses. Negative measures could be considered, but careful analysis should be undertaken to ensure that this would be an appropriate approach. A starting point for introducing punitive measures could be by penalizing informal enterprises that have over a certain number of employees and/or are earning over a certain amount in annual revenues.

56. There are concerns about the rights of foreign migrant workers—especially those from North Korea, but migrant rights were not investigated in this study.

57. Khash-Erdene 2015.

It is worth noting that this study did not identify specific regulatory burdens that prevented the informal actors interviewed from formalizing their businesses. Although, it appears that entrepreneurs in Ulaanbaatar view the process of registration as a barrier, solutions to this problem did not emerge from the survey or interviews.

**2a) *Communicate effectively about the benefits of formalization:*** Along with offering incentives to formalize, it is important to communicate about the benefits of formalization. At present, most informal traders believe that registering as a company would lead only to paperwork and taxes; while in reality it offers important opportunities to grow. These opportunities include obtaining financing more easily and even better terms, enhanced legal protection for contracts and other agreements, less vulnerability to bribery and other forms of harassment, participating in business-related training offered by government and other agencies, potentially joining a business incubator for mutual support and lower-cost business services, accessing a more educated labor pool, and opportunities for higher-value trade with the formal economy. Reaching informal business owners and explaining the benefits of formalization will require concerted effort. Among others, tax and khoroo officials could be trained to provide information on formalization, have the necessary documents available, and even help in preparing them.

**2b) *Consider tax relief to incentivize formalization:*** In addition to communicating about the benefits of formalization, offering tax relief to informal entrepreneurs could encourage business registration. As discussed, the authors strongly believe formalization should be encouraged through positive incentives that give business owners reasons to formalize, rather than punishing those who do not. A punitive approach could damage poorer households and business owners who are already struggling to make a living. Along with increasing access to finance through approaches such as those discussed above under 1c, consider offering newly-incorporated companies tax exemptions or deductions for a certain number of years.

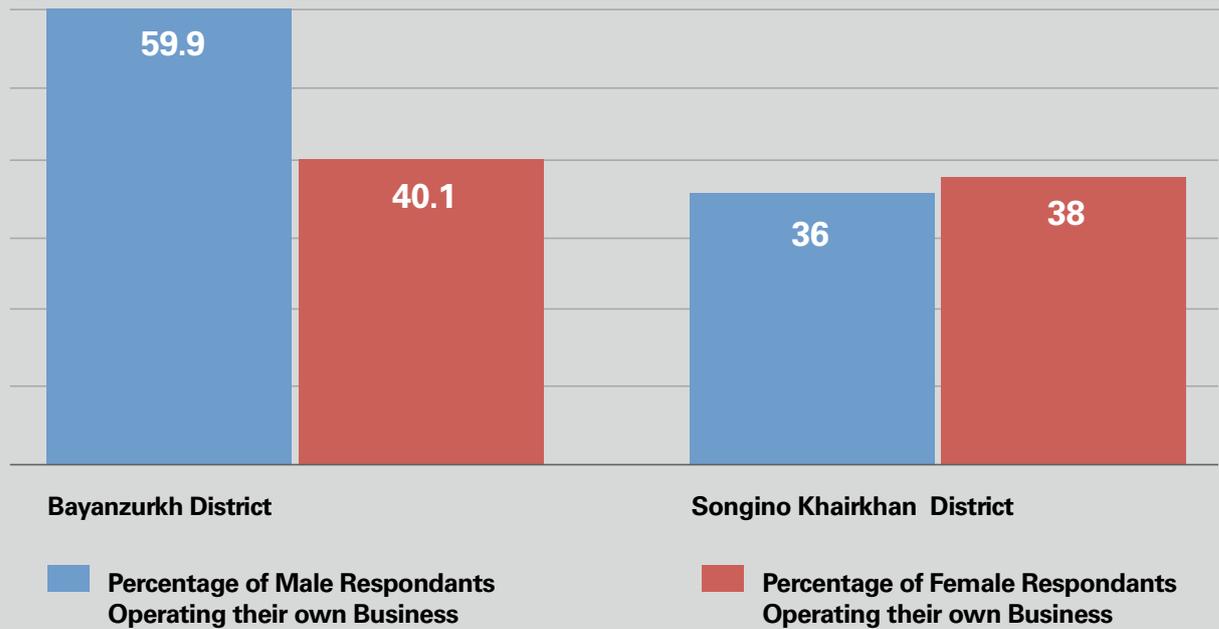
**2c) *Focus on monitoring and evaluating adherence to labor regulations:*** As found in research for this paper, none of the interviewees, including those with registered businesses, follow labor regulations and have not been inspected by labor authorities. Although 9 out of the 10

interviewees reported interacting frequently with tax authorities, and sometimes with police, they had almost no other interaction with government. As an initial step forward, it is recommended that a greater effort be made to monitor labor practices and develop information on the extent to which rules are being followed. Understanding the reasons for non-compliance, and the potential economic implications of much greater enforcement are needed. Given that tax authorities seem to be the most regular point of contact for all businesses, they could take on a greater role in disseminating information on labor regulations and monitoring businesses' compliance.

### **C. ORGANIZATION, REPRESENTATION AND DIALOGUE:**

At no point in this study did the authors come across a formal civil society organization representing the informal economy. While some organizations such as the Mongolian Employers' Federation (MONEF) and the Confederation of Mongolian Trade Unions (CMTU) cover some in the informal sector and offer services and representation to informal enterprises if they belong, the MONEF and the CMTU do not specifically represent informal enterprises or articulate their views.

**3a) *Establish a body to represent the informal sector and articulate its views:*** The creation of a new organization for the informal sector, or improving their representation through existing organizations such as the CMTU and MONEF, could benefit both informal sector participants, as well as government by giving government a means of communicating with the sector. This organization could also be a sub-chamber under the Ulaanbaatar Chamber of Commerce. While interviewees did not stress the need for an organization to represent them, they did speak of issues which a business membership organization could address (e.g. improving access to finance, seeking solutions to issues arising from redevelopment of the ger areas, and improving access to the services that businesses need). Given their usually small size, it is difficult to imagine an organization of informal businesses being funded by dues. Nor should government finance these because to be effective, business membership organizations need to be independent from government. Instead, donors or existing civil society actors might be the best positioned to provide support.

**Figure 10: Business Ownership by Gender**

Source: The Asia Foundation/M.A.D. Mongolia Survey 2014

3b). *Government should make greater efforts to consult with informal businesses:* Whether an association for informal businesses is established or not, government needs to engage more effectively with informal businesses. This requires that government recognize the important role of informal businesses, both as a mechanism for poverty alleviation and as an engine of economic growth. Recognition should then be followed by government articulating a clear vision for the informal economy, and how to support it in ways that fit in with the overall economic planning for Ulaanbaatar.

The lack of interaction between government and businesses mentioned above means that policy interventions are likely to be either misconstrued or ineffective. Mongolia is in a good position in this regard as much of the informal sector is legal. In many other countries, informal businesses are entirely invisible to authorities, they avoid paying tax, and thus have no incentive to interact with government. Mongolia's unique governance of informal activity means that developing channels for business/government interaction would not only foster greater transparency and confidence in policy measures, but also create an opportunity for informal businesses to discuss their problems with government. This would enable government to gain much better understanding of the informal sector than is currently the case. Much of the information on the sector is anecdotal or out of date. Interaction between informal enterprises and government could not only improve relations

between the two but give government the information it needs for effective policy interventions.

**D. EQUALITY:** The research summarized in this paper did not focus on gender issues and, as such, the authors cannot comment extensively on this. Nevertheless, survey results indicate that female respondents had higher-than-average education levels, but lower-than-average incomes. In terms of business ownership, the role of women in the informal sector is clearly significant. While the survey conducted for this study showed fewer women overall owning businesses, the difference can largely be explained in one surveyed khoroo in Bayanzurkh District where many businesses are related to the automobile market, a sector where women are less likely to be engaged. In the other khoroo, surveyed women were actually more likely to own a business than men in that khoroo.

As Mongolian women are still responsible for most of their household's domestic work, formal businesses and other places of employment usually have policies or informal practices that limit women's ability to advance at work, or to have the flexibility they need to manage both work and household responsibilities. In practice, in the formal economy, this has limited many working women to lower level jobs. The informal economy, with its inherent flexibility and low barriers to entry, offers an alternative for women who want to earn money while also meeting family responsibilities.

4a) *Mainstream gender into all policies on the informal economy:* Based on women’s current role in the informal economy, two policies could be considered. The first policy would encourage formal businesses to hire women in jobs with opportunities for advancement that also give them flexibility to manage their household roles. This could be a critical step in drawing women out of the informal sector and into work in formal businesses. Secondly, punitive measures that try to stamp out informal activity could disproportionately affect women if women cannot get appropriately meaningful and flexible employment. So to achieve success in adopting policies that discourage informality through regulatory enforcement, it is crucial to consider how these policies could impact women.

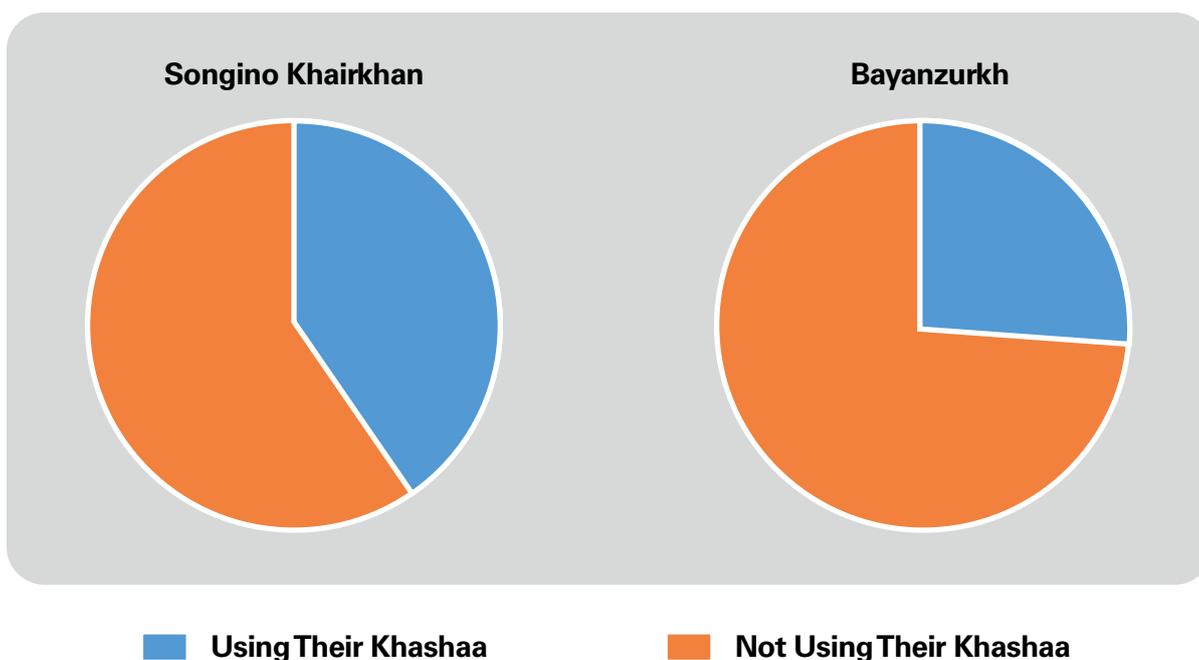
4b) *Focus on inequalities between the apartment and ger areas:* A major challenge for Ulaanbaatar is trying to attain equality between those living in the affluent apartment areas and ger area residents. As previously explained, the ger areas, where most informal businesses are concentrated, face challenges that are not found in the city’s apartment areas. Addressing these differences to achieve greater equality of opportunity could go a long way to resolving the socioeconomic issues facing ger area residents, encourage growth of ger area businesses, and increase their formalization. Expanding power and water infrastructure, for example, would put an end to the high costs that ger area businesses and residents currently face because they have to buy coal and water. Achieving true equality of opportunity, though, is incredibly challenging as the problems facing ger area residents are wide and multi-faceted. As redevelopment and extension of services does take place in the ger areas, the cost implications for residents should be

a careful consideration that will effect local business dynamics and possibilities for formalization.

**E. REDEVELOPMENT OF THE GER AREAS:** Diversity in land use, architecture, services, and income levels is essential for the development of sustainable communities and cities. While increasing density is a worthwhile goal, economic consequences must be given equal weight. If one goal is prioritized above all others, marginalization, negative externalities, and new pressures on urban infrastructure and services might result if ger area residents and businesses are simply forced to relocate to new, more distant areas on the outskirts of the city. Thus, while redevelopment of the ger areas is seen by many international financial institutions and policymakers as the best means to improve and integrate these areas of the city, they must first consider and take into account the economic and social implications. In terms of efficient service delivery and optimum urban planning, these perspectives are defensible, but with regard to economic activity, this research has reiterated some of the complications that have already been discussed in many formats.

The economic and social life of the ger areas is based on their low-density, khashaa plots. Redevelopment to make the area denser would therefore fundamentally alter economic and social relations, as well as likely create new problems (such as the relocation of important, low margin industries such as trash collection or recycling). It is therefore critical that any attempts to redevelop the ger areas be preceded by comprehensive cost-benefit analyses and that solutions are tailored to needs in the areas concerned.

**Figure 11: Khashaa Plot Use by Business Owners**



Source: The Asia Foundation/M.A.D. Mongolia Survey 2014

5a) *Ensure consideration of the economic importance of khashaas in any redevelopment planning.* With most informal, khashaa-based businesses serving their nearby area, it is important to consider innovative solutions such as providing communal space for warehousing which businesses could rent, and thus continue to operate in their area after redevelopment. Other options include zoning, which is more or less absent in the ger areas. Zoning could concentrate retail and services around transport junctions or along transport corridors to help develop the economy of ger areas, while allowing for denser development near these hubs. By setting out where businesses could operate and grow, zoning would permit densification without damaging the economic life of ger areas. As discussed, before redevelopment takes place, information on where informal economic activity is clustered and on businesses' needs must be gathered so effective and locally-specific strategies can be developed.

However, it may be that densification and redevelopment will not be necessary citywide. Just as the informal economy fulfills a necessary economic role and should be supported rather than prohibited, ger districts fulfill important social and economic needs, and that might justify their continued existence or improvement rather than wholesale redevelopment. As stated previously, one of the main findings to emerge from this study is that informal businesses and the ger areas are integral rather than peripheral parts of the city's economic life.

5b) *Design and implement local development strategies:* Local development strategies could help encourage the growth of businesses and incentivize their formalization. In the case of Ulaanbaatar, this study suggests that retail businesses are relatively underdeveloped in the ger districts, perhaps because of the low density of these areas. This study shows that most residents regularly go to the city center and major markets to shop for clothes, food, and household supplies because of lower cost, greater choice, and because goods are more regularly available. Redevelopment strategies that support the creation of sub-centers and local retail networks could offer an important business opportunity both to informal entrepreneurs and to residents. Small businesses could fill the gap in supply, and residents would save time and money by not having to travel across the city to shop. In addition, economic development of the ger districts would support the informal businesses that operate there, allowing them to save and invest, and perhaps formalize and move up the value chain.

This kind of approach would also allow more nuanced thinking about redevelopment, zoning, and other issues relating to ger area development and how they relate to the local economy. Upgrading of informal settlements around the world has demonstrated that success is the result of collective investments in local areas by community members, government and the private sector. Generating wealth in the ger areas is the most important aspect of any strategy to improve living conditions, as residents will spend money themselves to improve their situations. Thus, carefully examining local economic conditions could help to foster self-help in the ger areas.

#### **F. Extension of Social Protection and Managing Public Goods:**

One obvious priority emerging from this study is the expansion of social protection 'floors' and social security systems. This study shows that a large percentage of survey respondents were not covered by social security, largely because legislation covering individual traders does not require contributions to social security funds. While many individuals do contribute voluntarily, this study suggests that they are in a minority. This clearly is a problem as those working in the informal sector are the people most likely to need social security. Given the volatility of the economy, ensuring that society's most vulnerable have at least a minimal income should be a priority.

6a) *Encourage informal businesses to voluntarily make contributions to social insurance:* As a first step towards greater social protection for informal businesses, information should be disseminated about why social security is important, how it works and the provisions of the social security law. A publicity campaign could be launched on this, perhaps alongside one about how to access finance.

6b) *Update the tax laws governing traders to incentivize voluntary contributions to social insurance:* Social security provisions could be incorporated into the informal trader law, for example, by offering a reduced tax rate in exchange for voluntary contributions. Another possibility for expanding coverage would be for tax agents to solicit and collect social security contributions. As previously explained, these are the government officials who most frequently interact with informal businesses.

# Section 5:

# Conclusion

The purpose of this paper has been to highlight some of the dynamics of informality in Ulaanbaatar and, in so doing, encourage a reassessment of this sector. Ultimately, the informal sector is a key driver of growth and employment and one that, despite its limitation, forms an integral component of the citywide economy. As a source of wealth generation, it offers social mobility and an outlet for entrepreneurial energy, as well as providing inputs and services to the formal economy. As such, the first step in addressing informality is recognizing its positive contribution. The second step

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**THE INFORMAL SECTOR IS BOTH PERVASIVE AND MADE UP OF LARGE NUMBERS OF PARTICIPANTS, WITH THE RESULT BEING THAT SMALL INCREMENTAL IMPROVEMENTS IN THE WAY IT OPERATES COULD GENERATE BENEFITS THAT WOULD BE SHARED EQUITABLY.**

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is to consider how best to allow this sector to flourish. This means both encouraging the growth of businesses that formalize as well as maintaining flexible and irregular employment and income earning opportunities for those that need them.

The recommendations outlined previously in this paper primarily focus on supporting the informal sector, while also aiming to encourage formalization and social security extension. In order to achieve these aims, it is clear that policymakers must rely on a number of small initiatives and incentives that will gradually reshape the overall context in which the sector operates. These measures must include a combination of communication, policy incentives, and support. The ultimate aim is to create an optimal business environment in which informal businesses with growth potential can transition as seamlessly as possible to formality. At the same time, those small traders who are unable or unwilling to formalize could still operate efficiently in an equitable business environment and also benefit from social insurance and protection.

Luckily, the idiosyncrasies of informality in Ulaanbaatar are such that the prospects for improving the overall operating environment are favorable. Unlike in most countries, informal traders in Mongolia operate legally and are known to the authorities. As a result, communication channels can be established and maintained, and policy, if well crafted, can be articulated and implemented effectively. What is more, the structure of local governance is such that a network of offices already exists at the local level that can play a critical intermediary role between the informal sector and central or city government. This network could also take responsibility for the communication and implementation of any policy initiatives. Government is not the only relevant actor, though, and other private sector stakeholders, in particular banks and other financial institutions, will also have an important role to play. Their interaction with the informal sector will, to a large extent, be shaped by the macroeconomic context, but policy should focus on incentivizing them to offer creative solutions to financing problems and, where this is not possible, on communicating as openly and transparently as possible about the mechanisms and processes through which decisions on financing are made.

The informal economy has been a mainstay of Mongolia's social and economic life since the transition to market-based democracy begun, and there is no reason to expect that this vibrant sector will disappear any time soon. Instead, with a challenging macroeconomic environment set to persist, its relative importance will most likely grow. The presence of such a sector is beneficial as it acts as both an economic 'shock absorber', but also as a source of employment and income when such opportunities are limited in the formal sector. Nevertheless, there is a tendency amongst policymakers to ignore or marginalize the informal sector and focus instead on grander policy designs or lynchpin projects. While this is understandable, the informal sector is both pervasive and made up of large numbers of participants, with the result being that small incremental improvements in the way it operates could generate benefits that would be shared equitably. Realizing these benefits will require a combination of policy adjustment, communication, and incentives, but it is a goal that is eminently achievable and one that would be hugely cost-effective. Postponing efforts to support this sector would be both a missed opportunity, but more importantly, a disservice to the entrepreneurs who make it up.

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