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Finanzwissenschaftliche Diskussionsbeiträge

Status Quo on Fiscal Decentralisation in Mongolia

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Status Quo on Fiscal Decentralisation in Mongolia

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Abstract

This paper gives a review on the theoretical foundation for fiscal decentralisation and a status quo analysis of the intergovernmental relations in Mongolia. It consists of two parts. Part I briefly reviews the theories of fiscal decentralisation and its impact on the nations' welfare considering the major challenges for a transition economy. Part II of the paper describes the general structure and scope of the government and examines the current fiscal autonomy in Mongolia focusing on the four main areas of intergovernmental relations. This paper concludes that local governments in Mongolia are still far away from having the political, administrative and fiscal autonomy. New approaches for the assignments of expenditures and revenues in Mongolia are urgently needed.

Keywords:

Fiscal decentralisation, fiscal federalism, intergovernmental relations, local and regional autonomy, revenue sharing, economic transformation.

JEL codes:

H70, H71, H72, H76, H77

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INTRODUCTION

Fiscal federalism has been an important topic among public finance theorists in the last four decades. The interest on intergovernmental fiscal relations has been prompted by the recent developments in the European Union, countries in transition, and developing economies. Numerous discussions in fiscal federalism produced a number of arguments, both pro and contra, some of which have become “conventional wisdom” in policy work. There is a line of the arguments that decentralization of the governments enhances growth by improving allocative efficiency. However, there is no theory that shows a strong relationship between decentralization and economic growth. The empirical studies show mixed results on industrialized and developing countries and some of them state that there is a threshold level of economic development below which decentralization is not effective. Nevertheless, one can find a clear trend toward decentralization in the developing world.

Developing countries have built a variety of forms of fiscal decentralization as one possible way to achieve effective and efficient government. Transition countries are also setting a new system of intergovernmental finance. There is no generalized principle of decentralization because the countries have a different political and economic structure, geography, history and culture. Thereby, decentralization has taken many different forms in different countries at different times, even exactly the same variety of decentralization may have different effects under the different conditions (see Bird and Vaillancourt, 1998).

Therefore, this paper makes a review of the theoretical foundation and status quo-analysis of the fiscal decentralization in Mongolia. First, it briefly reviews the theories about fiscal decentralization and its impact on economic growth considering the major challenges in a transition economy in part I. Part II describes general structures and the scope of the government and examines the current fiscal autonomy in Mongolia focusing on four main areas of intergovernmental fiscal relation: expenditure assignment, taxing power, intergovernmental fiscal transfer and local government borrowing. Finally some conclusions are drawn.

1. Theoretical Review on Fiscal Decentralization

This section addresses the question how scholars define “fiscal decentralization” and assesses its impact on economic growth or nations’ welfare. In doing such a theoretical review on fiscal decentralization, the paper will consider the basic challenges for the countries in transition.

1.1 Definition and Assessment of Fiscal Decentralization

There are many definitions for decentralization but generally the term “decentralization” is defined as the transfer of responsibilities for planning, management as well as resource raising and allocation from the central government and its agencies to the lower levels of government. With regards to the degree of independent decision making at the sub-national level we distinguish three forms of decentralization that include deconcentration, delegation and devolution. First, *deconcentration* means the dispersion of responsibilities within the central government to the local administrative units. Deconcentration may take part in the administration where local administrative units have a responsibility for service delivery but the staff remains under the direction and control of the center, or the local administration has more responsibilities for policy implementation but are still under the technical supervision of the central ministries. Second, *delegation* refers to a situation in which local government acts as an agent of the central government, executing a certain function on its behalf, which means that the local government basically has the responsibility for the function and remains accountable to the center. Third, *devolution* refers to a situation in which not only implementation but also the authority to decide what is done is in the hands of the local governments.

The assessment of decentralization will clearly depend on what in reality has occurred: deconcentration, delegation or devolution. Besides, there is also a distinction between administrative, political, fiscal and economic decentralization (see Litvack and Seddon, 1999). Administrative decentralization is the hierarchical and functional transfer of executive powers between different levels of government. Political decentralization means that citizens or their elected officials have the power to influence the policy decision-making at the local level. Fiscal decentralization refers to the fact that local authorities become responsible for the expenditure and revenue assignment, while economic decentralization implies the transfer of the certain function from the public to the private sector.

Table 1.1 Form of Decentralization

| | Privatisation | Deconcentration | Delegation | Devolution |
|----------------|---------------|-----------------|------------|------------|
| Economic | X | | | |
| Administrative | | X | X | X |
| Political | | | | X |
| Fiscal | | | | X |

Source: Steiner, 2005, p. 10.

The discussion above and Figure 1.1 show that deconcentration and delegation correspond to the administrative decentralization and devolution to the political and fiscal decentralization. This paper considers that devolution is the most far-reaching form of decentralization containing of the transfer of political, administrative and fiscal powers whereas deconcentration and delegation only include the transfer of administrative power. Therefore devolution is the form of decentralization and especially the fiscal decentralization will be analyzed within this study.

Bird (1998) argued that the evaluation also depends upon the decentralization approach, which can be top down and bottom up. The *bottom up* decentralization stresses generally political values as improved governance in the sense of local responsiveness and political participation. This approach will produce not only efficient and equitable service delivery through better information but also lead to a greater participation, hence improved political stability. In addition the bottom up decentralization results in increased resource mobilization, greater accountability and more responsive and responsible government (see Bird, 1998).

In case of the top down approach for decentralization the central government's perspective may be to shift deficits downwards, or to achieve the allocative goal more efficiently or even to increase the level of national welfare by delegating autonomy to the local governments. Bird (1998) stated that the bottom up approach is good in the countries where heterogeneity among different territorial units is high whereas the top down approach is more suitable for the developing countries.

In the analysis of the fiscal decentralization it is important to determine what a "good" degree of fiscal decentralization is. Whether it is one, which better achieves central government goals or one, which frees local governments from the central government dictates. The choice of perspective is thus essential when speaking about the issue of fiscal decentralization.

1.2 The Theoretical Background for Fiscal Decentralisation

Since Tiebout's article "A pure theory of local expenditure" was published, the field of fiscal federalism has developed substantially and many literatures on fiscal decentralisation has been contributed. In Oates' (2005) terminology, the "first generation theory" of fiscal federalism was well established in the view of public finance. Tiebout (1956) argued that fiscal decentralization would result in the improvement of production efficiency by altering perfect mobility of citizens and overcome the free rider problem in public goods. Musgrave (1959) in his volume on Public Finance described the role of the government sector in terms of correcting the market failure. When private markets failed to supply such goods then government should introduce policy measures correcting this failure in the field of macroeconomic stabilization and income redistribution. He also emphasized that allocative efficiency will be achieved when local tastes and preferences have been met. In addition Oates (1972) argued that the regions have different tastes and preferences for public goods so that local government will provide better services for their citizens because they have better information than central government about the preferences of the local citizens. The Oates' decentralization theorem states that economic efficiency will be achieved through decentralized provision of public goods.

1.2.1 The General Theory

From the above discussion on public economics literature one can conclude that the central government should be responsible on national policy and provide efficient levels of national public goods. The sub-national governments' role is the provision of efficient levels of local public goods for their constituencies. With a proper assignment and the needed fiscal tools at their disposal, local agent could implement welfare maximizing policies (Oates, 2005). Thereby the analysis will be focused on the assignment of expenditure responsibilities and revenues between different levels of government and this issue will be discussed in the next part.

The economic theories view of the public sector has disregarded that the bureaucrats have a rent seeking behaviour. Oates (2005) argues that new literature on fiscal federalism draws on two basic sources which are a) public choice and political economy, which focus on political processes and behaviour of political agents, and b) information problems (asymmetric information). According to this view the assessment of fiscal decentralization will have some different perspectives. For instance in case of developing and transition countries in a setting of asymmetric information and control with utility maximizing incentives the budget

maximizing behaviour of the political agents are very strong. The main principle of the public-choice approach is that public decision makers are utility maximizers with their own objective functions. Niskanen build a model, which explained the budget maximizing behaviour of the public agents. Niskanen listed a certain number of variables in his utility function such as salary, reputation, power and patronage. Brennan and Buchanan (1980) extended this view and stated that the public sector is a monopolistic agent. Therefore fiscal decentralization will be a mechanism to constraint the expansionary tendency of the government (“Leviathan”) through the competition between local governments.

Cremer, Estache and Seabright (1996) argue that central governments fail to get information about the local tastes and preferences. Hence, fiscal decentralization will have a good result because it allows local government to provide efficient supply of local public goods for their constituents. Qian and Weingast (1997) are of the opinion that decentralization is the mechanism for controlling over intrusive and expansive tendencies of the public sector and supports effective operation of the private markets. So, from the public choice and political economy perspective, the fiscal decentralization will constrain the budget expansion through competition and enhance controlling and accountability, which results in an efficient supply of local public goods and support of the private markets.

However, local political agents are keen to expand their programs and expenditures beyond the mean and also try to increase local public goods by the expense of other jurisdictions. Rodden (2003) argues that it is a matter what form fiscal decentralization takes. If fiscal decentralization relies on own tax sources smaller government results and if transfers financed by the center an overall increase within the budget occurs. Public choice perspective does not examine the structure of fiscal institutions, which is an important component for fiscal decentralization and the effect of fiscal decentralization will certainly depend on the fiscal institutional structure.

From the economic and political science perspective, the fiscal decentralization has many benefits, however, decentralization is not a panacea, and it also does have costs. The decentralization can result in the loss of economies of scale and of control over the scarce resources; inefficiency in service delivery and complexity in policy coordination may happen if decentralisation implemented in a wrong way (<http://www.worldbank.org/publicsector/>).

Thus, centralization and decentralization are not alternatives. Hence, the countries should find the appropriate balance of centralization and decentralization in order to achieve an efficient

and effective structure of the public sector. Countries differ in circumstances to be successful in decentralization; each country should develop an own strategy, which considers its specific conditions. However, there is also a general principle that finance should follow the functions. The main mistake in former socialist countries as well as in Mongolia was that they devolved the revenue assignment before implementing the expenditure assignment.

1.2.2 Specific Conditions for Transition Countries

Former socialist countries have had a highly centralized political and economic decision-making and administration. Changing the inherited over-centralized system in order to achieve efficient and effective government was a difficult challenge for transition countries. Making structural change in public finance and getting it right along is a difficult task (see Jackson, 2001). Therefore, developing an effective government sector and implementing fiscal decentralisation would be double as difficult for countries in transition.

Transition countries have faced many other difficulties such as macroeconomic crisis and have had a very distorted initial situation, which made fiscal decentralization more complicated than for other countries. For instance, most transition countries experienced a fiscal crisis, which resulted in the decrease of revenues and increase of expenditures. Major revenue sources of the former socialist countries were the state owned enterprises, which most of them became loss makers or the profits were “privatized”. In addition, the increase of tax arrears and social security contributions became a major problem (see Jackson, 2001). Finally many countries in transition faced the conflicts between old communists and new democrats, as well as ethnic problems.

The UNDP (2005) research paper on ‘Fiscal decentralization in transition economies: case studies from the Balkans and Caucasus’ defined the number of differences in the current status of fiscal decentralization in those countries and it also points to a number of similarities. These similarities are predominantly to be seen in weaknesses in intergovernmental fiscal relations, such as inadequacy of local government structures, unclear expenditure assignments, lack of revenue autonomy, and poorly administered intergovernmental transfers. As a result of these shortcomings, transition countries faced a number of problems in fiscal decentralization.

Firstly they had a bad sequencing in the decentralization strategies mainly because of the lack of comprehensive decentralization strategy. Secondly, most transition countries had a weak central government coordination mechanism for fiscal decentralization and too fragmented

local governments. Finally, these countries had a lack of political commitment, which is an important factor for the success of decentralization. Therefore, the risk of getting fiscal decentralization wrong was high in transition countries.

1.3 Intergovernmental Fiscal Relation

The theoretical trade-off reflects various pros and cons of a decentralized government structure. Since 1990 there were six empirical studies and most of them used the endogenous growth model (see Breuss and Eller, 2004). The empirical studies do not show strong and automatic relations between fiscal decentralization and economic growth and only partly support the theoretical hypothesis on fiscal decentralization and economic growth. Both theoretical and empirical analysis tend to have inconclusive and ambiguous results.

Thereby it is difficult to draw a clear recommendation regarding the optimal degree of decentralization and each country should define an own country-specific model of fiscal decentralization, which will contribute to the welfare of the country by improving the provision of public goods. Following the Oates' decentralisation theorem mentioned above, discussions on fiscal decentralization will be focused on four main areas: the assignment of expenditure responsibilities, revenue assignment, intergovernmental fiscal transfers and sub-national borrowing.

1.3.1 Expenditures

It is well known that regions and local communities have a wide variation in tastes and preferences; hence, efficiency in the provision of the public services can be achieved at best by decentralization. Within this perspective almost all public services other than national public goods should be delivered at the local level and local political agents should decide the service types, quantity, quality and local taxpayers pay for that service. Hence, local governments would be responsible and accountable for their citizens and charge them for their services.

To achieve accountability at the local level, it is important to establish a clear line of responsibilities. Attaining full clarity on the expenditure assignment is very difficult because public actors from different jurisdictional levels may be involved in the supply of the respective service.

Expenditure assignment is a very important base line for the design of the revenue assignment and transfers. In the case of Latin America and other transition countries the revenue were

assigned before the decision was made to transfer the expenditure responsibilities from central to local government (see Martinez-Vazquez, 1998) and Mongolia was not an exception. Thus, expenditure assignment should be the first fundamental step to fiscal decentralization. The efficiency in the provision of the public services could be achieved at best with the concrete assignment of public task and the respected expenditures. There is no general principle for the optimal expenditure assignment but the adequacy could be evaluated with regard to the three basic functions of public finance or the goal set by the governments' decentralization strategy.

Following the principle of subsidiarity, efficient expenditure assignment is to assign each function to the lowest level of government, which is able to fulfil this task in an efficient manor. But it also can be that local government is too small to carry out the responsibility efficiently (see Rodden, 2003). Therefore assigning the expenditures, central government should focus on who is exactly responsible and is doing precisely what. In addition the duplication and overlapping of the functions will hurt the accountability. However these goals are not fully attainable because different level of governments can be appropriately involved in the provision of the same service. For example, on the delivery of the education and health services, central, intermediate and local governments have their respective functions such as central government setting policy and standards, whereas local government are providing school and kindergarten services directly to the residents. In the case of transition countries the expenditures were mandated to local governments without providing revenue sources. The consequence was not a better service delivery but the increase of the budget deficits at the lower level of government. So, the public deficits at the local level increased, thus a shift of the deficits downwards by the process of decentralisation was the result (see Shah, 2004).

1.3.2 Revenues

For the implementation of the assigned functions sub-national governments should have sufficient own revenue sources. The question of revenue assignment is called the "tax assignment problem". In this section the question will be addressed, which type of taxes is the most suitable for each jurisdictional level.

Bird (2000) defines a sub-national tax as one, which is assessed, decided at rates and collected by sub-national governments. However, in reality there are no such taxes, which have all above mentioned characteristics. Local taxes include user fee, property tax, trade tax and sales tax, which, however, are not sufficient to cover the total costs of the assigned expenditures.

As public finance theory suggests (see Musgrave, 1959), the government has three functions: stabilization, redistribution and allocative efficiency. Consequently taxes with predominant stabilization and redistribution effects such as corporate income taxes and progressive income taxes should be assigned to the central government. The allocation function is related to the quality of service provisions, hence taxes should be assigned following their benefits. Example of these taxes is those levied on motor vehicles and fuel. Thus the proper tax assignment to the benefits depends on the expenditure assignments (see McLure, 2001).

The assignment of taxes to the different levels of government has to consider four general principles (see Shah, 2004). First, in order to keep efficiency of the internal common market, taxes on mobile factors (labour, capital etc.) and tradable goods should be assigned to the central government. Second, progressive taxes should be assigned to the centre with the purpose for national equity. Third, taxes should be assigned to the jurisdictional level according to the ability to assess them. Fourth, to ensure accountability, ability to raise own revenue sources should be matched with expenditure needs as closely as possible.

In the public finance perspective and with regard to the above mentioned principles on tax assignment one can conclude that to achieve fiscal autonomy of sub-national government is a difficult task. The main problem for tax assignment is to be seen in the fact that it usually does not provide sufficient revenue for the local governments to cover the costs of the assigned public tasks.

1.3.3 Transfers

The intergovernmental transfers are an important element of fiscal decentralization, which address vertical and horizontal imbalances as well as local government spending behaviour. Regarding the intergovernmental transfer, their effects on the policy objectives are more important than the question of who give them or who get them (see Bird, 2000). Transfers must be designed to satisfy efficiency in the provision of the public services and in addition be transparent and simple. Basically the transfer system is implemented by revenue sharing or forms of grants.

The important characteristics of any grants system are stability and flexibility, which are contradictory to each other. In order to achieve these characteristics of the transfer system, basically three methods are used, which are fixed in relation to central government revenues, paid on an ad hoc basis or formula driven. A sound transfer system distributes funds among different level of the governments on the basis of a distributive *formula* which takes into

account the needs of the respective jurisdictional level. There are two quite different approaches used to define the transfers. First, simple unconditional lump-sum transfers ensure that local governments are able to provide a minimum standard of service provision. Second, central government use local government as an agent to execute national policies by *conditional transfers* with specific objectives. Expenditure conditionality requires that grants are spent on specified services while performance conditionality focuses on outputs rather than inputs.

1.3.4 Sub-national Public Debt

Public debt and borrowing traditionally has been as an important source to finance long-term infrastructure projects because it enhances intergenerational equity. Such type of intergenerational sharing enables local government to undertake the large-scale infrastructure investments (see Shah, 1999). However countries in transition and some developing countries have imposed strict restrictions on local borrowing because of insufficient revenue capacity of the local governments. More importantly, rapidly growing local debt will endanger macroeconomic stability.

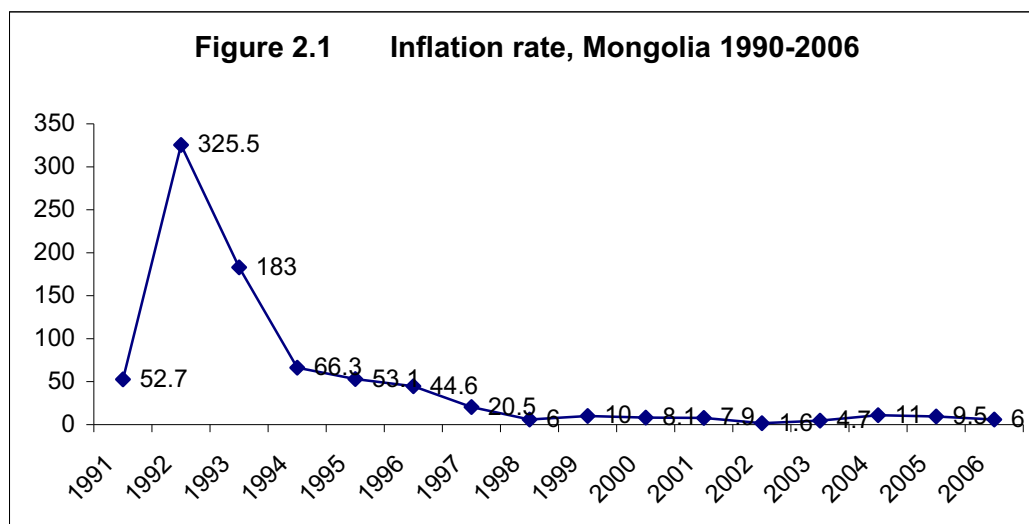
There are four basic debt controls which are applied in practice a) primary reliance on a market; b) negotiation among the different levels of government for debt control; c) rule based debt controls, which are specified in the constitution or by specific law; and d) direct administration of the central government over the local borrowings.

2. Intergovernmental Fiscal Relation in Mongolia

2.1 General Background

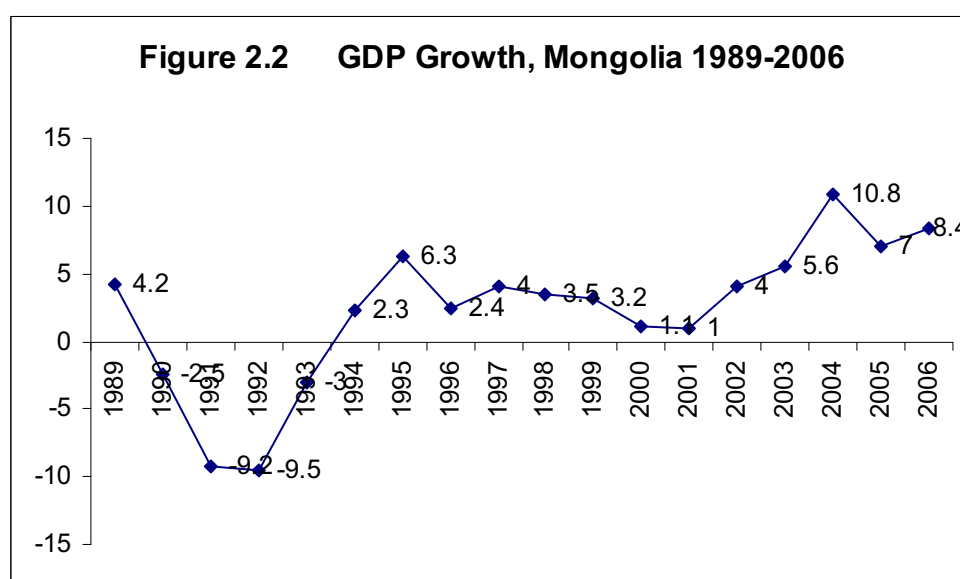
2.1.1 Economic Development

Mongolia is a large landlocked country covering an area of 1.5 million square kilometres with a population of about 2.6 millions people, being almost homogenous with some small ethnic minorities. Since 1990 Mongolia has started the transformation towards market economy and democracy, and during the first five years of the transition the macroeconomic situation was unstable and economy was in recession. It has implemented a number of policy efforts to improve governance as well as economic growth and is currently recognized as one of the “rapid reformers” in the group of the transition economies.



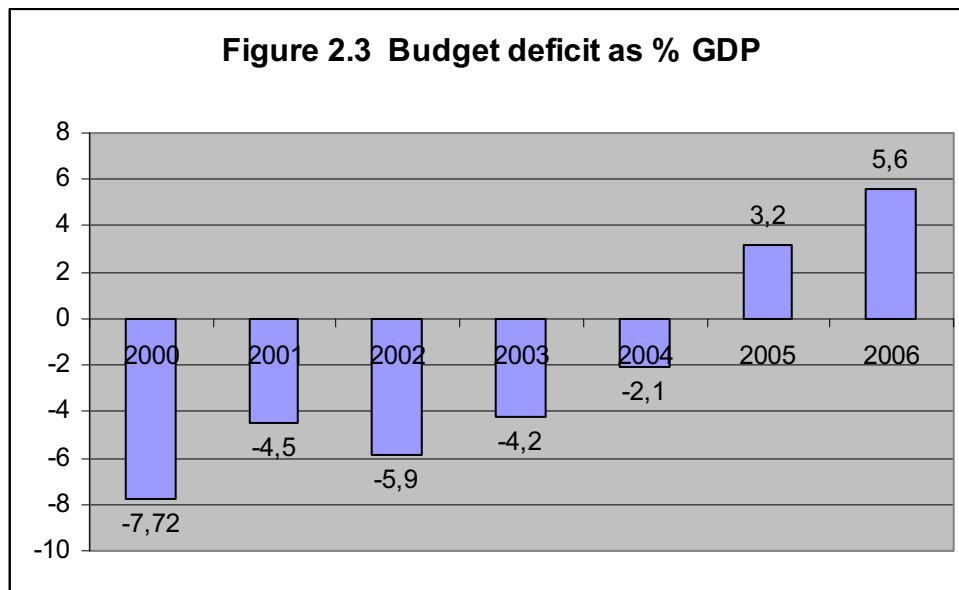
Source: Own calculation based on the monthly bulletin of Mongol Bank.

In 1991-1993 prices were liberalized, trade barriers lowered, state owned enterprises privatized and undertook a tight fiscal and monetary policy. As a result the economy was stabilized: a growth process took place and inflation dropped from 325 percent in 1992 to 57 percent in 1995 and 10 percent since 2000 (see figure 2.1 and figure 2.2).



Source: Own based on data from yearly statistical books of Mongolia, 2000-2006.

The size of the public sector dropped from 51.8 percent of GDP in 1993 to about 34.4 percent in 2000. Mongolia’s real GDP growth turned positive at 2.3 percent in 1994 and peaked at 10.8 percent in 2004 (see figure 2.2). The overall deficit dropped from 14.7 percent of GDP in 1993 to 2.1 percent in 2004, and in 2005 and 2006 a surplus can be observed (see figure 2.3). The debt to GDP ratio more than doubled from 41.1 percent in 1995 to 93.9 percent in 1999 but it is currently decreasing as a consequence of the surplus.



Source: Own based on data from yearly statistical books of Mongolia, 2000-2006.

Mongolia's macroeconomic transition to a market economy was quiet successful in the first five years. However, unfavourable external condition, harsh weather and weak public expenditure management eroded most of the stabilization gains (see Government of Mongolia, 2003). The size of public sector remained too large and continued to expand (see figure 2.4 on page 20 below). The resource allocation of the public sector has concentrated on cash transfers to the population and was inefficient in terms of service provision.

For restoring growth and improving public sector outcome Mongolia was confronted with triple challenges, which are to sustain deficits by strengthening public finance, to discipline the allocation of public spending across the jurisdictions, and to improve efficiency and effectiveness of the public service provision (see Sandagdorj, 2004).

2.1.2 Decentralization Efforts

Since 1990 decentralization has been part of Mongolia's reform agenda. The "Management Development Program" of 1992 decentralized the political system and created management capacity at the local level of government. The "Public Service Law" of 1999 defined the tasks and directions of the public service system and Mongolia's reform policy on the "Trends and Structure of Government Activities" clarified the structure of authorities and functions of the central government. All these decentralization efforts have been concentrated on the administrative side of the government and little efforts have been made for fiscal decentralization. As a result Mongolia became a decentralized state with fiscal centralization.

Despite the elaborate rules and regulations for the management of public resources, informal practices were significantly different before the reform of 2003. Both, International Monetary Fund (IMF) and World Bank (WB), recognized in the studies a weak financial discipline in Mongolia and identified many causes including lack of commitment to achieve such a discipline: an unreliable, unstable and unpredictable budget management framework, the violation of budget rules, a weak budget preparation process lacking hard budget constraints, and the lack of control of the government cash payments by the ministry of finance (MoF).

In order to address these issues, Mongolian government undertook the next stage of reforms, which includes series of measures to enhance the budgeting process, increase transparency, linking policy priorities with budget resources, rationalization of the system of norms, introducing a single treasury account system (TAS), and improving the reporting system. These reform measures were based on the “Public Sector Finance and Management Law” (PSFML), which was passed in 2002 by Parliament. Consequently, local governments neither had significant revenue raising powers nor control over the intergovernmental transfer system.

In total, decentralization in general and fiscal decentralization in specific followed a top down approach being implemented only slowly and without any integrated decentralization strategy. So far decentralisation has remained incomplete.

2.2 Structure and Scope of the Government Sector in Mongolia

Mongolia’s constitution, which was adopted on 13 January 1992, provides the legal foundation for the government structure. Mongolia is a unitary state with central government and three levels of sub-national governments. The intermediate level of sub-national government has a provincial status for the aimag and the capital city. The provinces are subdivided into regions called *soum* (rural districts) and the capital city divided into districts, which are local governments. The lower level of local governments consists of communities, which are *bag* (rural sub-districts) and *horoo* (urban sub-districts). In summary, Mongolia has 21 provinces with 329 *soum* and 1520 *bag*; the capital city has 9 districts and 117 sub-districts. The capital city and provinces are intermediate tiers of government, and communities are local governments. *Bag* and *horoo* are the lowest formal administrative units (see table 2.1 below).

According to the Constitution, the administrative and territorial units of Mongolia are organized on the basis of both, self-governance and state management. As a result, Mongolia has a dual system in which each administrative and territorial unit has both a Governor and a

Parliament (hural). While the former ultimately report to central government and in a way represent the central government throughout the territory, the latter act as true representative institutions.

The basic functions of aimags and soums assemblies are as following:

- to serve as representative bodies of the local people;
- to pass regulations for their respective political and administrative jurisdictions;
- to monitor the local administrative bodies;
- to approve the budgets of their respective aimag and sum as well as control their execution.

Aimag and soum governors run the local administrative organizations and play the role of local representatives of the central government. Governors make, implement, monitor, and evaluate local policies. In addition, governors' offices also provide administrative services such as civil registration, notary services, and expedition of licenses as well as permits. Bag and sub-district assemblies are self-governing organizations based on the direct involvement of residents, whose main function is to solve common local issues. Bag and sub-districts also have governors who mainly act as a liaison between citizens and soum authorities.

The local residents elect assemblies. Aimag and soum vary greatly in size and population and the size of each assembly varies with its population (see table 2.1). In respect to the selection of governors, assembly submits nominees for the post to the governor to the next level of government who makes the appointment. Thus, aimag governors are nominated by the aimag assembly and appointed by the prime minister. Soum governors are nominated by the soum assembly and appointed by aimag governor, and bag governors are nominated by the bag assembly and appointed by the respective soum governor.

According to the current legislation, Mongolia has a large number of extremely small local government jurisdictions and this fragmentation could be detrimental for the ability of local government to deliver public services effectively. The average size of a Mongolian community is 5000 people and there are also communities with a population less than 1500 people. It should be noticed that most people in communities are living in nomadic life style and few small entrepreneurs and public servants are living at the community centres. To address this issue, the government of Mongolia is presently discussing a regional development plan that aims to reduce the number of sub-national units in the country.

Table 2.1 Structure and Size of Government (by Number of Populations)

| Level of government | | Population | Number of representatives |
|-------------------------|---------------------|---------------|---------------------------|
| Upper | Central government | | |
| Intermediate | Province (aimag) | 0-50,000 | 25 members |
| | | 50,001-90,000 | 30 members |
| | | 90,001 more | 35 members |
| | Capital city | | 40 members |
| Local self government | Region (soum) | 0-2,000 | 15 members |
| | | 2,001-9,000 | 20 members |
| | | 9,001 more | 25 members |
| | district | 0-20,000 | 21 members |
| | | 20,000-80,000 | 25 members |
| | | 80,000 more | 35 members |
| Lower (self government) | Bag Sub-district | | |

Source: Own based on the Constitution and Law of Territorial and Administrative Units of Mongolia.

2.3 Assignment of the Expenditures in Mongolia

The expenditure assignment is a first and fundamental step for decentralisation. It also would be a main criterion for the assessment of the revenue and tax assignment as well as the needs and effectiveness of the transfers. The basic question regarding the expenditure assignment is “What level of government should be responsible for the delivering of which functions and services?” The answer should be related to the efficient resource allocation via responsible and accountable government or how well it serves the objectives of the government decentralisation strategy.

2.3.1 Description of the Expenditure Assignment

The Constitution of Mongolia provides a legal framework for the parliament and government authorities, latter having an authority to debate and approve the budget and the former being responsible for the formulation and submitting of the budget. The Consolidated Budget Law (CBL) defines general regulations on budget revenue collection, expenditure types, portfolio manager’s authority, budget accounting and reporting. The Public Sector Finance and Management Law (PSFML) makes detailed regulations connected with authorities and responsibilities of budget entities and officials with regard to the budget cycle and personnel management. The CBL and PSFML clearly recognize the separation between state and local budgets.

PSFML provides the assignment of responsibilities for the budget institutions and disposers of all level of government (see table 2.2). The law distinguishes between pure responsibilities of local governments and those of central government responsibilities as well as delegated

responsibilities to the local level by the central government. Local government own expenditure responsibilities are financed from the local budget and delegated responsibilities by contracts are financed by the central government.

The portfolio ministers¹ determine the output based budgets and expenditures in accordance with the government action plan and general guidelines for socio-economic development. The general manager who is head of the state budgetary bodies delivers outputs and receives fund from the state budget in accordance with the contract made by the portfolio ministers.

The provincial governors raise revenue from local sources, deliver core local outputs and outputs financed from the central budget of the government on a contractual basis. Governors of the regions are responsible for the delivery of the core local outputs and deliver central budget financed output to the province governor by contract. The functions contracted out to the local government level comprise the support for central government policies and key social services: education, health care, culture, labour, social welfare, and social security.

Among these broad areas of responsibilities, core local government responsibilities by PSFML include:

- Sanitation and garbage collection,
- environment protection, furnishment, renewal and maintenance,
- pest eradication and control,
- local road maintenance,
- sewage,
- flood barrier and soil protection,
- fire protection, prevention and mitigation,
- local public infrastructure facilities,
- fight and prevent from infectious diseases of animal.

¹ As stated in PSFML the portfolio ministers are line ministers and governor of the provinces and regions.

Province governors have an authority to manage activities of the budgetary bodies and monitor the delivery of the output by contract while they do not have financial authority because the expenditures on social services are earmarked and it is prohibited by law to use the funds for contracted output for other purposes (for details see table 2.2).

Table 2.2 Expenditure Assignment in Mongolia

| Functions | Roles and responsibilities by government level | | |
|------------------------------------------------------|------------------------------------------------|---------------|-------------------|
| | Regulation | Funding | Service provision |
| General public services | Central | Central/local | Central/local |
| Parliament | Central | Central | Central |
| Government | Central | Central | Central |
| Local government | Central/Local | Local | Local |
| Foreign relation | Central | Central | Central |
| Defence | Central | Central | Central |
| Public order and safety | Central | Central/local | Central/local |
| Court and prosecutor | Central | Central/local | Central/local |
| Justice | Central | Central/local | Central/local |
| Economic affairs | | | |
| Finance and economic activities | Central | Central/local | Central/local |
| Agriculture | Central | Central/local | Central/local |
| Fuel and energy | Central | Central | Central/local |
| Mineral mining and prospecting | Central | Central | Central |
| Construction, road, transportation and communication | Central | Central/local | Central/local |
| Trade and manufactures | Central | Central | Central |
| Other economic activities | Central | Central | Central |
| | Central | Central/local | Central/local |
| Environment protection | Central/local | Central/local | Central/local |
| Housing, community and amenity services | Central | Central | Central/local |
| Health | Central | Central | Central/local |
| Culture, recreation, art and sport | Central | Central | Central/local |
| Education | Central | Central | Central/local |
| Social security and welfare services | Central | Central | Central/local |
| Unclassified services | Central | Central | Central |

Source: Own based on PSFML and other government resolutions.

As a result of this expenditure assignment Mongolia has become a fiscally centralized country. This fiscal centralization may be explained that Mongolia has a very fragmented administrative structure and extremely small size of jurisdictions, which does not allow economies of scale and benefits. In addition, the lack of administrative capacity and limited experience of local officials to respond to local needs would be premature for the devolution of the major social expenditure responsibilities. Previous practices with the inefficient delivery by the local governments of such social services also notify the above mentioned arguments.

The efficient provision of public services can be achieved at best by the “subsidiarity principle” where the responsibility for the service delivery should be assigned to the lowest level of government compatible with the size of benefit in the respective area. In case of Mongolia benefit area related services are assigned to the local government, which is in accordance with the principle of subsidiarity. However, most social services are under the responsibility of the line ministries and delegated to the local governments on the basis of contracts. Stabilization and redistribution objectives assigned to the central government are following the public finance principle mentioned above.

With regards to capital expenditure responsibilities the investment decisions are made at the central level and maintenance, operation of facilities organised at the local level, which created many problems² at the local level and lead to inefficient service delivery. Another problem in expenditure assignment is the dual subordination of the general managers for education, health and culture. General manager of these departments at the local level are funded directly from the respective line ministries³ but accountable to the locals governors³ by contract. In this case local authority is limited because of the dual subordination and lack of financial control.

2.3.2 Degree of Expenditure Decentralization

Scholars used different measures of decentralization to investigate the degree of the centralization in the respective country. It is difficult to choose a fully satisfactory measure of the extent of decentralization because of data availability limitations. In the following the fiscal share of the local government in the central-local sector⁴ is used, expressed by central and local expenditures as percentage of GDP to measure fiscal decentralization in Mongolia.

Table 2.3 shows the increasing trend of fiscal centralization in Mongolia from 2000 to 2006. The central government share of central-local spending was 69 percent in 2000; by 2006 this figure had risen to 92.2 percent. The main reason of this change was the shift of social service delivery from local to central government by the new expenditure assignment according to the PSFML in 2003.

² Local governors complained about the facilities that are expensive and incompatible for local needs, but built according to central procurement.

³ Transfers to the budgetary bodies of the education, health and culture sectors are earmarked or conditional transfer.

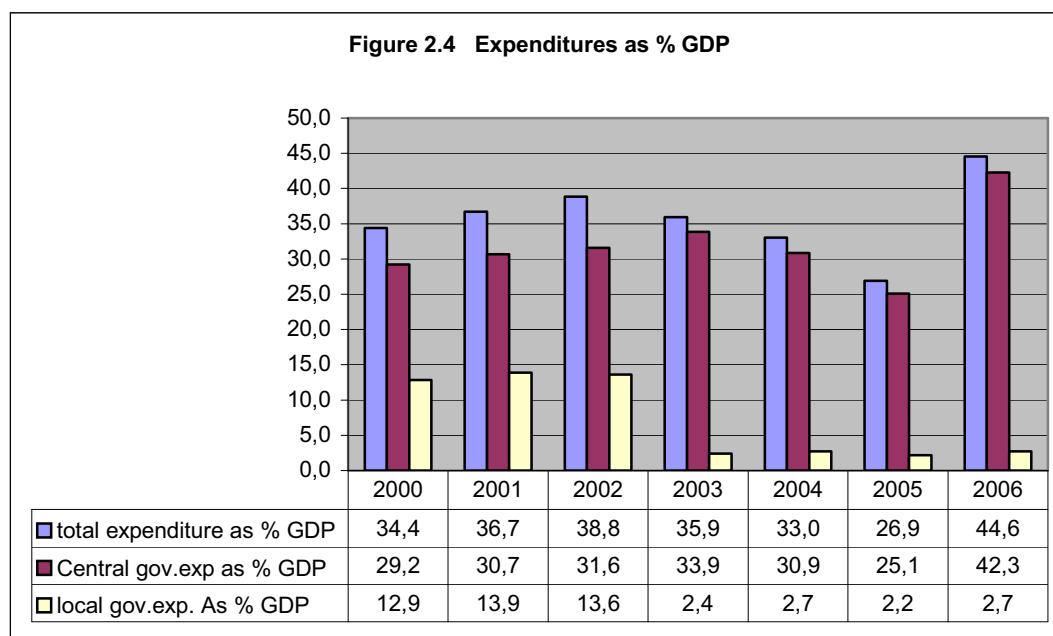
⁴ This ratio is adopted from Wallis and Oates in Rosen (1988), *Fiscal Federalism: Quantitative studies*, Chicago and London.

Table 2.3 Central and Local Government Shares in Central-local Expenditures in 2000-2006

| Year | Central share | Local share |
|------|---------------|-------------|
| 2000 | 69.4 | 30.6 |
| 2001 | 68.9 | 31.1 |
| 2002 | 69.9 | 30.1 |
| 2003 | 90.8 | 9.2 |
| 2004 | 89.5 | 10.5 |
| 2005 | 89.0 | 11.0 |
| 2006 | 92.2 | 7.8 |

Source: Statistical Bulletin of the National Statistical Office of Mongolia, 2000-2006.

As shown in figure 2.4, the share of total expenditure in GDP is relatively unstable. It decreased from 36 percent in 2003 to 27 percent in 2005, then increased to 44.6 percent in 2006. The share of sub-national expenditure in GDP was about 13 percent of GDP from 2000 to 2002, then it dramatically decreased to 2.5 percent in average from 2003 to 2006. Consequently, the share of central government expenditure in GDP increased in general but with some fluctuations. As a result of the new reform and implementation of the PSFML, local governments have an extremely small financial resource base, which correspond to the decrease of the role of the local government on public service delivery.



Source: Own calculation based on the Monthly Statistical Bulletin of the National Statistical Office of Mongolia, 2000-2006.

Table 2.4 presents the expenditures by economic classification of selected soum and aimag, which illustrates that a large portion of the local expenditures is assigned to current spending. It is important to note that own revenues of the soum and aimag are only sufficient to cover

the expenses of the respected governor's offices. The rest of the local government operational expenses are covered by the aimag or the central government transfers, respectively. The provision of social services financed from central government and total social expenditures are about 85 percent of soum budget expenditure (see Center of Mongol Management, 2005, Research Report).

Table 2.4 Aimag and Soum Expenditure 2002-2004 (Average Percent of Total)

| Types of expenditure | Bulgan Aimag | Uvs Aimag | Khentii Aimag | Dundgobi Aimag | Average Aimag | Average Soum* |
|----------------------------------|--------------|-----------|---------------|----------------|---------------|---------------|
| A. CURRENT EXPENDITURE | 93.1 | 97.4 | 94.6 | 97.4 | 95.6 | 100.0 |
| 1. Goods and services | 89.3 | 95.7 | 93.6 | 96.2 | 93.7 | 100.0 |
| a. Wages and salaries | 42 | 39.8 | 40.2 | 43.5 | 41.4 | 47.3 |
| b. Social security contributions | 10.8 | 10.2 | 9.8 | 10.5 | 10.3 | 12.0 |
| c. Purchase of goods and service | 36.2 | 45.7 | 43.6 | 42.2 | 41.9 | 31.8 |
| c.1. Heating | 10.8 | 11.2 | 14 | 12.6 | 12.1 | 9.3 |
| c.2. Fuel and transportation | 5.6 | 4.9 | 3.8 | 3.5 | 4.5 | 2.2 |
| 2. Subsidies and transfers | 4.1 | 1.7 | 1 | 1.2 | 2 | 0 |
| B. CAPITAL EXPENDITURE | 6.9 | 2.6 | 5.4 | 2.6 | 4.4 | 0 |
| a. Investment | 3.2 | 2.6 | 3.4 | 1.1 | 2.6 | 0 |
| b. Capital Repairs | 0.4 | 0 | 1.6 | 1.5 | 0.9 | 0 |
| c. Assets | 1.3 | 0 | 0.4 | 0 | 0.4 | 0 |
| d. Road Building and Repairing | 2 | 0 | 0 | 0 | 0.5 | 0 |
| TOTAL EXPENDITURE (A+B) | 100 | 100 | 100 | 100 | 100 | 100 |

Source: CMM, 2005, p. 32.

With regard to capital expenditures the responsibilities should be assigned to the level of government, which is responsible for the delivery of specific services and maintenance of facilities to achieve an efficient use of resources.

2.4 Revenue Assignment

Once local governments are assigned to certain expenditure responsibilities, the second question to be addressed regarding intergovernmental fiscal relations focuses on the revenue assignment. Governments rely on a wide variety of tax instruments for their revenue needs and the decision on tax assignment is important for the efficiency and effectiveness of the service provision. The important concept for the effectiveness of decentralization is the link between revenue raised and services provided by the local level. This section will assess the revenue assignment problem in Mongolia.

2.4.1 Description of the Revenue Assignment

The General Tax Law (GTL) defines the state and local taxes, the tax base and rates, and fixes ceilings for local taxes. State taxes are introduced by parliament and the central government,

collected on a nationwide basis and include corporate income taxes, custom duties, value-added tax (VAT), excise taxes, gasoline and fuel taxes as well as payments for the use of mineral resources. Local taxes are introduced by local assemblies of provinces and the capital city and collected in their respected territories. According to Consolidated Budget Law (CBL), local revenues comprise from tax revenue and non-tax revenue. In addition, CBL determines shared taxes and financial transfer from the central to the local level or vice versa.

Local government budget revenues comprise from budget sources and non-budget sources. The latter consist of funding from international organizations and donations from citizens and enterprises; the budget sources consist of own revenue, financial equalisation transfers and conditional transfers. The system of intergovernmental transfers will be discussed in the next section. Local government own revenues consist of local taxes and shared taxes.

Table 2.5 Share of Local Government Revenue, 2000-2006

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---------------------------------------------|-------|-------|-------|-------|-------|-------|-------|
| Total rev. as % of GDP | 33,4 | 37,2 | 33,9 | 37,3 | 35,9 | 32,5 | 52,0 |
| Local gov. rev. as % of GDP | 6.5 | 7.6 | 8.5 | 3.3 | 3.1 | 2.8 | 3.4 |
| Total local gov. rev. as % of total rev. | 19,2 | 20,0 | 21,6 | 8,7 | 8,6 | 8,6 | 6,5 |
| Total local exp./total local gov. rev. in % | 196.8 | 183.4 | 161.1 | 104.6 | 116.0 | 110.3 | 105.6 |

Source: Own calculation based on National Statistical Office of Mongolia, 2006, Monthly Statistical Bulletin.

According to this legal framework most revenue bases are concentrated on the national government, while local governments have only very limited revenue autonomy. As table 2.5 illustrates, the aggregated local governments revenues accounted for 6.5 percent of general government total revenues and were equivalent to 105,6 percent of total local government expenditures in 2006. Local government revenue share of GDP decreased to 3.3 percent in 2003 due to the removal of the excise and corporate income tax sharing (see table 2.7 below). Until 2003 the corporate income tax and excise taxes were shared between the central and the province government. Since 2003 these taxes were removed from local revenue sources and shifted to the central government budget revenue.

2.4.2 Tax Sharing

Under this approach sub-national governments receive a fixed fraction of revenues from certain national taxes originating within their own boundaries. The CBL introduced tax sharing in the Mongolian budgetary system and established that the revenues from personal income taxes, royalty and license payment for prospecting minerals should be shared with the

provinces (aimag) and regions (soum). By the government resolution of 2002 the value added tax (VAT) and excise taxes were shared in between central and local governments, but in 2003 the excise tax sharing was removed. The total revenue of VAT conducted at aimag and soum level is concentrated in the national budget. Afterwards a proportion of that collection is shared with aimag according to a population pro rata formula⁵. Soum do not directly receive any share of the VAT. The system of VAT revenue sharing is unclear and unstable and fluctuates from year to year. In 2000 the relation was 70:30 for state and province budgets respectively, however provinces received only 7 percent of the VAT revenue from 2001 to 2004, and since 2005 the share of VAT is 80 percent for the state and 20 percent for the local budgets. The fluctuation in tax revenue sharing generates uncertainty and reduces predictability for local budgeting and planning. The details on the tax sharing since 2005 are represented in table 2.6.

Table 2.6 Tax Sharing in Mongolia (percentage)

| Tax | Central government | Local government | Details |
|----------------------------------------------------------------------|----------------------------|---------------------------------|------------|
| VAT | 80 | 20 | Since 2005 |
| Personal income tax | Other than livestock taxes | Livestock tax | |
| Royalty | 70 | 20% for aimag 10 % for soum | Since 2006 |
| Licence fee for exploration and prosecution of the mineral resources | 50 | 25 % for aimag 25 % for soum | Since 2006 |

Source: Own based on government resolutions.

2.4.3 Own local revenue sources

The General Tax Law (GTL) and consolidated budget law define the local taxes and neither soum nor aimag can introduce new taxes. As defined in GTL, the tax base and rate setting responsibilities are shared between the state parliament and the local assemblies. The state parliament decides on all the tax rates and the local assemblies are allowed to set tax rates within the limits defined by state parliament. According to CBL the sources of revenue for local governments include the following taxes:

- Gun tax,
- city tax,
- dog tax,
- inheritance and gift tax,
- immovable property tax,

⁵ VAT revenue shared according to the population size of the respective jurisdiction.

- transport and vehicle tax,
- stamp duty,
- payment for water and mineral springs,
- license fee for the use of natural resources other than minerals,
- payment for using natural plants,
- payment for exploration of widely spread minerals,
- payment for hunting, license fee for hunting and catching animals,
- land payment,
- payment for using timber from forest.

The tax assignment leaves little space for local taxes, which have a very small magnitude. There are also tax assignment differentiation between provinces and regions. At the aimag level tax include: city tax, land payment, immoveable property tax, transport and vehicle tax. Soum level taxes include: livestock taxes, gun tax, stamp duty, taxes on self employment, payment for hunting and use of natural resources (except minerals), natural plants, timber and water.

Table 2.7 Local Government Tax Revenue Structure (in %), 2000-2006

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|----------------------------------|-------|-------|-------|-------|-------|-------|-------|
| Corporate income tax | 23.2 | 23.6 | 0.01 | 0 | 0 | 0 | 0 |
| Personal income tax ⁶ | 27.6 | 29.6 | 30.50 | 12.9 | 16.6 | 17.7 | 18.6 |
| Property tax | 0.6 | 1.9 | 3.73 | 13.2 | 11.8 | 10.6 | 8.9 |
| VAT | 16.7 | 10.0 | 42.49 | 26.1 | 20.6 | 20.0 | 21.4 |
| Excise tax | 10.2 | 14.4 | 3.96 | 0.0 | 0.0 | 0.0 | 0.0 |
| Special tax | 0.0 | 0.0 | 0.00 | 11.5 | 10.1 | 8.6 | 7.0 |
| Other taxes ⁷ | 21.7 | 20.7 | 19.44 | 36.7 | 41.0 | 43.1 | 44.1 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Source: National Statistical Office of Mongolia, 2000-2006, Statistical Bulletin.

Table 2.7 illustrates aggregated local tax revenue structure and about 40 percent of tax revenue consists from own local taxes. Shared value added tax and the livestock tax are also important revenue sources accounting about 20 and 17 percent respectively in total tax revenues of the local government. As mentioned before, the corporate income tax and excise taxes were shared then this sharing was removed since 2003.

⁶ According to the Consolidated Budget Law personal income taxes other than livestock tax are defined as the state tax, so the figures on the table under the personal income tax are represent the livestock tax.

⁷ Other taxes are the revenue sources of the local governments, which mentioned above.

The tax collection in Mongolia is centralized at the General Department of National Taxation (GDNT) under the Ministry of Finance (MoF). GDNT has branch offices at the aimag level and tax managers at the soum level. All types of taxes are collected at the local level and the local taxes would be transferred to the budget account at the aimag level. Other than local tax revenues would be transferred to the central treasury.

Concerning the local revenue there a number of associated issues. Despite the fact that soum and aimag have access to the own tax revenues, the revenue proceeds of these taxes are limited. The environmental hardships of Mongolia sometimes have negative impacts on local farmers, which have an influence on the collection of livestock taxes and land payments. According to the rules established by CBL, subsidies should be transferred to the aimag and capital city budgets. Thus the financial position of the lower level of governments, soum and districts depends mostly on transfers from the aimag government.

Within the current system local governments have no incentives to increase revenue collection. In fact, any increase in local revenues is equalised by reductions in either the tax sharing or transfers. Therefore the current system encourages local governments to find extra-budgetary sources of income and under-estimation of tax revenues.

As discussed here local governments have very limited sources of revenues, which increases the dependency of local governments from the central government. This reliance on central transfers weakens local incentives for fiscal self-control, which is high in Mongolia (World Bank, 2002). Conceptually greater fiscal autonomy will strengthen the link between services and cost as well as local autonomy.

2.5 Intergovernmental Fiscal Transfers in Mongolia

Intergovernmental fiscal transfers are the third pillar of intergovernmental fiscal relations and the main form of sub-national government financing in developing and transition countries (see UNDP, 2005). There are a number of different instruments under the general term of “transfers” which include: intergovernmental grants, subsidies, subventions, donations and sharing of tax revenues. Transfers help to address imbalances that result from the mismatch between local expenditure responsibilities and revenue raising capacity.

The CBL determines the level of transfers to local governments and those transfers are the most important component of sub-national finance in Mongolia. There are regional

disparities in both per capita expenditures and per capita revenue in Mongolia. Most of local revenue sources are insufficient to cover all the local expenditure requirements.

Transfers represented about 60 percent of local government revenues in most aimag until 2003, and the ratio dropped to less than 30 percent of local revenues after 2003. In 2006 transfers from central to local governments varied from 6 percent of total local revenues in Dornod and Selenge aimag to 48 percent in Gobi-Altai aimag (see table 2.8). Thus there are substantial equity and intergovernmental transfer issues that must be addressed by the central government for the improvement of the service delivery on the local level. However, since 2004 in some aimag the budget position has been improved because of increasing economic growth and the capital city, Bulgan, Dornogobi, Darkhan-Uul and Orkhon aimag became self-sufficient in terms of their own revenues.

Table 2.8 Share of Central Government Transfers in Total Local Government Revenue, 2000-2006

| Aimags and the capital | Transfers as share of total revenue | | | | | | |
|------------------------|-------------------------------------|------------|------|-------------|-------------|-------------|-------------|
| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
| Arkhangai | 0.62 | 0.62 | n/a | 0.07 | 0.27 | 0.16 | 0.22 |
| Bayan-Ulgii | 0.71 | 0.69 | n/a | 0.20 | 0.32 | 0.24 | 0.24 |
| Bayankhongor | 0.7 | 0.65 | n/a | 0.39 | 0.47 | 0.37 | 0.38 |
| Bulgan | 0.62 | 0.57 | n/a | 0.08 | 0.3 | 0 | 0 |
| Gobi-Altai | 0.76 | 0.77 | n/a | 0.43 | 0.55 | 0.51 | 0.48 |
| Dornogobi | 0.55 | 0.53 | n/a | 0.00 | 0 | 0 | 0 |
| Dornod | 0.61 | 0.56 | n/a | 0.00 | 0.14 | 0.01 | 0.06 |
| Dundgobi | 0.66 | 0.61 | n/a | 0.23 | 0.4 | 0.37 | 0.39 |
| Zavkhan | 0.68 | 0.66 | n/a | 0.23 | 0.44 | 0.35 | 0.37 |
| Uburkhangai | 0.6 | 0.56 | n/a | 0.25 | 0.35 | 0.23 | 0.27 |
| Umnugobi | 0.67 | 0.61 | n/a | 0.18 | 0.29 | 0.12 | 0 |
| Sukhbaatar | 0.76 | 0.74 | n/a | 0.27 | 0.36 | 0.28 | 0 |
| Selenge | 0.22 | 0.3 | n/a | 0.00 | 0 | 0.01 | 0.06 |
| Tov | 0.33 | 0.44 | n/a | 0.08 | 0.37 | 0.1 | 0.17 |
| Uvs | 0.69 | 0.65 | n/a | 0.27 | 0.4 | 0.38 | 0.42 |
| Khovd | 0.7 | 0.66 | n/a | 0.08 | 0.38 | 0.32 | 0.28 |
| Khubsgul | 0.67 | 0.63 | n/a | 0.10 | 0.2 | 0.13 | 0.13 |
| Khentii | 0.64 | 0.6 | n/a | 0.06 | 0.29 | 0.26 | 0.3 |
| Darkhan-Uul | 0.22 | 0.15 | n/a | 0.00 | 0 | 0 | 0 |
| Ulaanbaatar | 0 | 0.05 | n/a | 0.00 | 0 | 0 | 0 |
| Orkhon | 0.17 | 0.06 | n/a | 0.00 | 0 | 0 | 0 |
| Gobi-Sumber | 0.55 | 0.37 | n/a | 0.15 | 0.3 | 0.2 | 0.12 |
| Average | 0.6 | 0.5 | n/a | 0.14 | 0.26 | 0.18 | 0.18 |

Source: National Statistical Office of Mongolia, 2000-2006, Monthly Statistical Bulletin.

Transfers from central to local governments consist of equalization transfers or subsidies and conditional grants. *Financial equalization transfers* are unconditional transfers receive by the local governments to close the gap between total own revenue and expenditures, which are also called subsidies. Local governments submit the expenditure and revenue estimates to the MoF, from which they then request central government transfers. Consolidated requests from the aimag are reviewed, analyzed and recommendations on budget projections are made by the MoF. Based on these estimates, the MoF calculates the subsidy level for each jurisdiction. The state parliament and the province assemblies approve the transfers. Soum receive their transfers in a similar way directly from the aimag. The assignment of transfers based on expenditure and revenue projections are more or less ad hoc and give incentive to under-project the revenues.⁸

The second type of transfer is the *conditional transfer* to local government to finance centrally agreed contractual outputs. At the aimag level these transfers cover all costs of the Food and Agricultural Department and Veterinary Department and also contribute to the provision of education, health and cultural services. At the soum level those transfers are used to finance schools, kindergartens, hospitals and cultural centers. These transfers flow directly from the central government budget to the respective general managers⁹ at the aimag level.

In addition to transfers, local governments have non-budget revenues, which consist of aid from international organizations and contributions from local citizens. These revenues are not always registered in the official budget records and are often the only financial source for local capital expenses.

As the discussion above have illustrated, the intergovernmental transfer system is not transparent, follows no clear rules and tends to provide revenue disincentive to the local governments. The determination of an overall amount of transfers to local governments based on expenditure and revenue projections results in an incentive for under-projecting revenues. Therefore, one final problem associated with intergovernmental transfers is that there is not a stable, predictable and transparent system of transfer allocation.

The reform of the transfer system should be closely linked with expenditure and revenue assignments because the isolation will have a negative impact. In order to achieve flexibility

⁸ MoF statistics show that actual revenues always exceeded the estimated one.

⁹ According to the PSFML general managers are the head of the departments at the aimag level (education, health etc.).

and stability in the Mongolian transfer system, it is important to set the total level of transfers as a fixed proportion of total central revenues and introduce transparent and simple formulas.

2.6 Sub-national Borrowing

The final pillar of fiscal decentralization is local government borrowing, which is a consequence of the first three pillars. In case when local government's revenue are exceeded by their expenditures, this would result in a sub-national budget deficit and incurrence of debt.

Due to the rules of the PSFML, local governments must obtain approval from the central government through the MoF for borrowing and only aimag governors have a right to borrow. Aimag and soum governors and general managers of the budgetary bodies are forbidden to spend above appropriation and overdraw the bank account. In the short term borrowing is limited because of its impact on macroeconomic stabilisation. Generally, financing the current expenditure by debt leads to an increase of the public debt and has a crowding-out effect on the private investments. So the local governments are only allowed to borrow for financing the capital expenditure in Mongolia. Long and medium term borrowing is restricted to finance the infrastructure and central government has a strong control on the overall levels of borrowing. Sub-national borrowing is also currently limited because of the underdevelopment of the capital markets.

Concluding Remarks

In general decentralisation is connected with the transfer of responsibilities for planning, management, resource raising and allocation from the central government to the lower levels of government. In particular fiscal decentralisation means that local authorities become responsible for the expenditure and revenue assignment. From the economic and political science perspectives fiscal decentralisation will improve resource allocation and accountability, which results in an efficient and effective supply of public goods and supports private markets. However, decentralisation is not a panacea. If implemented in a wrong way, new problems and costs are created. Thus centralisation and decentralisation are not alternatives. Hence, countries should find the appropriate balance of centralisation and decentralisation to achieve efficient and effective public service provision.

Because of the distorted initial situation within centrally planned socialism, decentralisation was much more complicated in transition countries. Most countries in transition had similar shortcomings in intergovernmental fiscal relations, which are inadequate local government

structures, unclear expenditure assignments, lack of revenue autonomy and poorly administered transfers. As a result of these weaknesses, transition countries faced a number of problems in fiscal decentralisation, such as bad sequencing and lack of comprehensive decentralisation strategies so that today a process of decentralisation is still missing.

In the last decade Mongolia has introduced a number of decentralisation measures, which followed a top down approach and were slowly implemented without any integrated decentralisation strategy. Consequently Mongolia became a de-concentrated state with fiscal centralisation. The process of fiscal decentralisation was stopped with the introduction of the single treasury account system and the PSFML. This paper has identified the existing problems associated with the current system of intergovernmental relations in Mongolia.

First, there is lack of information and transparency in budget execution for the citizens. Specific budget information is not available or inadequately provided to citizens and other information on the government activities is not available to the public. Local budgets are prepared by local governments without any consultation with members of local assemblies. Thus the whole budgetary process must be transparent and the citizen's access to government activities should be enhanced.

Second local governments fulfil only very basic municipal functions and important local functions such as education, health and culture are under the command of the central portfolio ministers. The current expenditure assignment creates dual subordination of general managers for the social sector, limits the influence of local authorities and leads to inefficient service delivery. With regard to capital expenditure responsibilities the investment decisions are at the central level, while maintenance for and operation of facilities are with the local level, which also has a negative impact on an efficient service delivery.

The third critical problem is that local governments have limited revenue autonomy and there is too little or even no link between taxation and service provision. In addition the system of tax sharing is unclear and unstable, which generates uncertainty and reduces predictability for local budgeting and planning. As a result, local governments do not have sufficient financial resources to provide the assigned responsibilities efficiently. Centralised tax collection also does not create incentives to increase revenues, as any increase in local revenues is equalised by one to one reductions in either the tax sharing or transfer amounts. Therefore the system encourages local governments to find extra-budgetary sources of income and under-estimate their tax revenues.

Fourth the intergovernmental transfer system is not transparent. The determination of an overall amount of transfers to local governments based on expenditure and revenue projections results in under-projecting revenues. Therefore one final problem associated with intergovernmental transfers is that there is not a stable, predictable and transparent system of transfer allocation.

In total, local governments are still far away from having the political, administrative and fiscal autonomy to manage their own affairs. Current expenditure assignments and limited revenue raising possibilities became major obstacles for the development of local self-government and the promotion of fiscal decentralisation. In order to improve intergovernmental fiscal relations, the system needs new approaches for the assignments of expenditures and revenues.

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