

Circulation Draft

Rethinking State-Local Relations in Mongolia Today: Possible Directions for Local Government Reform*

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I. Introduction

This paper is the product of a three week assessment mission that I conducted in May 2008 on behalf of the UNDP's Local Government Support Programme (LGSP). The purpose of the mission was to analyze the current situation of local governments in Mongolia, and to develop some ideas about reforms that might strengthen them. The timing of the mission was designed to develop at least the outlines of these reform ideas before the election of a new parliament, and in the hope that they might serve to motivate discussion and action by the new government in the first year of its mandate.

Proposing reforms from the outside and on the basis of such a short mission is always a difficult and a dangerous task. This is particularly so in a country whose demography, topography, and history are as unusual as Mongolia's. And even more so for a consultant, who not only has never worked in the region, but who knew relatively little about Mongolia before taking on the assignment.

Given these difficulties I have chosen to write this report in a more personal style and less technical style than I am accustomed to. I have done this in part because I want the report to be accessible to the lay reader, and in part because I do not want to my ideas for reform in Mongolia to hide behind a façade of technical expertise.

In saying this, I do not mean to suggest that I cannot claim to have some technical expertise in the area of local government reform: For the last 15 years, I have been working on precisely these issues in post-communist Europe, particularly in Poland, Hungary, Serbia, Macedonia, Bosnia, and Ukraine. Moreover, it is clear to me that at least some of the experiences of local government reform in post-communist Europe are relevant to Mongolia today.

At the same time however, I want to stress that my judgments about what reform in Mongolia might look like are not only coming from outside but remain deeply subjective whatever grounding they have in "technical expertise". And I want the reader to be conscious of this subjectivity because local government reforms are always political and always raise profound questions about what kind of state structure a country "should have", and what kind of society a country "wants to be". These questions can obviously only be answered by Mongolians.

The structure of the paper is straightforward and divided into four sections. The first section briefly reviews the reasons why local governments are important. Here, I stress reasons for creating independent local governments that are often overlooked in both the literature on the subject, and in reform debates themselves.

The second section presents an overview of what I think are the most important lessons that post-communist Europe can offer Mongolia. The presentation of these lessons is not intended to suggest that there is anything like a post-communist model of local government reform that can be copied in Mongolia. Indeed, I do not believe in models of public sector organization and management –post-communist or otherwise—that can be copied from one country to another. Instead, these lessons are designed to give the reader a better idea of the principles and goals that have

underwritten successful reform initiatives, as well as the practical problems –both political and technical-- these initiatives are likely to encounter.

The third section outlines the status and problems of local governments in Mongolia today, as well as some of the implications of those problems for Mongolia in the future. Here, my basic feeling is that the current understanding of what a “unitary state” means in Mongolia today combined with the Public Sector Management and Finance Law, have made it very difficult to talk clearly about what local government are or should be. Moreover, I think that until the current understanding of what a unitary state is, and until at least some elements of the Public Sector Management and Finance Law are reformulated it will be very difficult to create the kind of local governments I think Mongolia needs, and which its citizens deserve.

Finally, in concluding section of the paper, I outline a possible direction for local government reform. Here I argue that the goal of the reform should be to clearly separate state and local government functions at all levels of governance and to designate Soums as the country’s basic institution of local self-government. As a result, Aimag or Regional governments would become the territorial arms of the national government, while Soums would become truly independent local governments.

In the initial phase of reform only the country’s larger Soums would be endowed with the rights and responsibilities of local-self governments. Over time however, these rights and responsibilities would be extended to all Soums. At the same, to guarantee that these rights and responsibilities were accompanied by real money a new Law on Local Government Finance would be developed. This law, by specifying in framework legislation the own revenues, shared taxes and grants that local governments are entitled to, would endow them with the independent budgets and the adequate, predictable and transparent revenues they need to rationally plan and execute the tasks they have been assigned by the national legislature.

I have tried to keep the paper free of jargon and technical details. But because coherent reform requires that people understand the same thing from the same terms –something that is often not the case—there are a few places in the paper where I take some pains to clarify terminology, and to specify some important technical details. More importantly, the purpose of this paper is not to present a technical blue print for reform. Rather it is to explain why reform is important, what is impeding reform in Mongolia today, and the broad outlines of possible strategies for overcoming those impediments.

The paper however is accompanied by a technical annex that outlines in greater detail the organizational, analytical, and legislative steps that would be needed to prepare a comprehensive local government reform strategy. This annex is should be considered a work in progress and is designed to give policy makers a better understanding of the research and policy analysis that must precede the development of new laws and amendments to existing ones, as well as to give policy makers some idea of what these new laws and amendments might contain. Despite its greater detail however, the purpose of the annex is not to present a technical blue print for reform. Rather its purpose is lay-out in greater detail a possible reform

process and how the most important policy questions might be addressed within that process.

II. Why are Local Governments Important

Much of the literature on local governments concentrates on their importance for the efficient and effective delivery of public services. The basic idea here is that if democratically elected local leaders are endowed with the power and money necessary to provide local public services they will do a better job of it than the national government for two fundamental reasons.

First, democratically elected local officials know the needs and preferences of their electorates better than the national government and thus are more likely to spend money on improving those services which are of greatest importance to their voters.

Second, and by extension, democratically elected local officials will be more concerned than national government bureaucrats in ensuring that this money is spent well because if it isn't, they will be voted out of office.

In other words, the argument is that democratically elected local governments will spend public money more effectively and more efficiently on local public services because the people responsible for spending this money are directly and politically accountable to the people who are receiving the services. In fact, the argument here is that local governments create a virtuous circle in which democratic accountability increases the efficiency and effectiveness of public spending, and better public spending legitimates and strengthens democracy.

Obviously, this virtuous circle only works if local governments are really democratically elected; have the skills and resources necessary to manage the public services they have been assigned; and if local voters really have the information and the motivation to actively monitor the performance of the officials they have elected. Thus, much of the literature on local governments focuses on ways to strengthen this virtuous circle, by improving electoral processes, increasing the managerial capacities of local government officials, and by making sure citizens get accurate and timely information about what these officials are doing¹.

Nonetheless, most of this literature focuses on the importance of ensuring that local government officials are not only responsible for spending public money on local public services, but that they are responsible for raising it through locally imposed fees, charges and taxes. In other words, the argument is that citizens will be most concerned with the performance of the local governments they elect, if those local governments are actually taxing them for the money needed to provide local public services. Or put another way, the virtuous circle of democratic accountability will be

¹Jonathan T. Hiskey, *Principals, Agents and Decentralized Democratic Development, a conceptual Framework for Democratic Local Government*, USAID, October 2006, pp. 1-24

strongest, if the spending of local governments is clearly and unambiguously linked to the way local governments tax their voters².

This is a powerful and compelling argument. But it encounters a number of practical problems in the real world, particularly in poor and developing countries. The first problem is that most taxes are more efficiently and effectively administered by the national government. The second problem is that local governments should not be given control over taxes where the tax base can be easily moved around because this creates tax competition between jurisdictions and generally results in what tax specialists call a race to the bottom³.

As a result, there are few high yield taxes that local governments can reasonably be given control over. Worse, the high-yield tax that is considered most appropriate for local governments –market-based property tax—has proved notoriously difficult to implement in developing countries for a number of reasons that we won't go into here⁴.

Third and finally the wealth of most developing countries –particularly small ones-- tends to be very concentrated in large cities in general, and capital cities in particular. This means that the tax bases of most jurisdictions in the country are very weak, and that even if local governments were given considerable tax powers most of them would still be unable to pay for the public services they have been assigned out of locally controlled taxes.

Taken together these problems have two fundamental implications for the creation of viable local governments in developing countries. The first is simply that the revenues of local governments in most countries, and particularly in developing ones, must be heavily based on grants and transfers from the national budget if local governments are to be pay for the provision of local public service. Indeed, this is a problem that we will return to repeatedly later on in the paper.

The second is that the argument for local governments based on the virtuous circle between democratic accountability and the efficient and effective spending of public money it is not as strong in practice as theorists would like because it is very difficult to align local expenditure responsibilities with local tax powers in developing countries. I say this not because I think the virtuous circle argument is wrong or unimportant. On the contrary, I think it is essentially correct and very important.

Nonetheless, the literature on local governments often focuses so exclusively on the issue of aligning local tax powers with local spending responsibilities that both the practical difficulties of actually achieving this alignment in developing countries is

² Barry R. Weingast, *Second Generation Fiscal Federalism: Implications for Decentralized Democratic Governance and Economic Development*, USAID, November 2006. pp. 1-70

³ For example, if local governments are given the right to tax businesses, business will choose to locate in jurisdictions that tax them less, putting pressure on those with higher rates to lower them. This can very quickly erode the value of the tax for the country as a whole.

⁴ See Ann Paugam, *Ad Valorem Property Taxation and Transition Economies*, World Bank, ESCIN Working Paper #9, June 1999.

ignored, and other equally important arguments for the creation of strong local governments are passed over. It is to these arguments that we now turn.

Strangely, the relation of democratic local governments to the health and sustainability of democracies in general is under theorized and to my mind under appreciated. To be sure, people often mention in passing that democratic local governments help legitimize the idea of democracy as a whole by giving people greater control of the issues that effect their daily lives. And this role in helping to legitimizing the idea democracy is certainly important.

But democratically elected local governments play a variety of more tangible, structural roles in the creation and reproduction of democratic societies. Many of these roles were clearly understood by the leaders of the Polish Trade Union, Solidarity in 1989 when they were negotiating a peaceful transition to a multiparty system with the Communist Party. Obviously, the opposition wanted free and fair national elections. At the same time, they realized that as a trade union, the opposition had no political parties of its own and no leaders with any skills in managing public sector functions.

Thus at the so-called Roundtable Talks, Solidarity leaders insisted on the immediate creation of powerful and independent local governments. They clearly saw these local governments as a training ground for future political elites. Moreover they explicitly wanted to make local governments attractive enough political prizes to ensure that electoral competition for control over them would foster the growth of political parties from the ground up. Indeed, they understood that by distributing political power horizontally across the society as a whole, local governments would help to ensure that even within parties there would be multiple sources of powers that would work against the creation of national oligarchies⁵.

Similarly, Solidarity leaders believed that the creation of strong local governments would provide something like a safety valve for democracy as whole by ensuring that national electoral competition was not the only meaningful political game in town. In other words they wanted to create a situation in which ruling parties had less reason to try to hold on to power by all possible means when the lost national elections because there would always be “somewhere else to go.” In short, the leaders of Solidarity saw local governments not only as a way to build a healthy party system and train future political elites, but as a way to reduce the risk that a ruling party refused to relinquish control over the state following an electoral defeat.

Finally, strong independent local governments create multiple arenas in which people can experiment with different ways of getting things done. As such, they increase “the potential gene pool” for figuring out better ways of governing. Indeed, when one the striking features of Poland today is how fast local governments are learning from each other, and how quickly successful technological and organizational solutions are spreading across the country as whole, be these ways of

⁵ See, Tony Levitas *The Political Economy of Fiscal Decentralization and Local Government Finance Reform in Poland, 1989-1999*, East European Regional Housing Sector Assistance Project, Project 180-00034, Urban Institute, July 1999, Washington, pp. 1-58

controlling parking in big cities, or building solid waste dumps that produce methane gas in small towns and indeed villages.

Local governments are also important for balanced economic growth, though for them to fulfill their promise in this respect it is critical that the intergovernmental finance system provides poorer jurisdictions with additional revenues through grants and transfers. If this is done correctly, then local governments can help build the infrastructure needed to attract investment, be this by improving local roads, water supply systems, or public markets. At the same time, they can play a crucial role in the promotion of tourism and in the branding and marketing of local goods.

Strong local governments are also important for country's ability to effectively absorb external support. Unfortunately, the history of foreign aid is littered with cases in which donors build infrastructure that local communities don't really want –or want less than other things-- but which they will take because they have no real alternative. Sadder still, are the almost endless stories of things getting built, and then falling into disuse because the communities in which they have been constructed either have other more important priorities or don't have the resources to maintain them.

If, on the other hand, local governments have money which they can contribute to donor funded projects, then both donors and locals have a mechanism that can be used to ensure that only projects that are really considered a priority get built. And by extension, there are much greater chances that what gets built will be maintained if local communities contribute to the cost of the investment in first place, and have the resources to operate it downstream.

Indeed, it is quite clear that in post-communist Europe the countries that have succeeded in creating strong local governments have done much better in absorbing European Union grant funds than those with weak ones. Moreover, the ability of local governments to financially contribute to projects funded largely by external grants is not only important for making better use of foreign aid but for making better use of investment monies spent on local infrastructure by the national government.

Finally, dynamic local governments can be very important institutions in the effort to slow out-migration from rural areas and the overly rapid growth of urban centers, particularly capital cities. In short, by providing public sector jobs, facilitating private sector growth, and creating opportunities for local political careers, local governments create reasons and opportunities for people to stay at home.

III. What We Have Learned from Post Communist Europe

The development of local governments in post-communist Europe has been an uneven process that in many countries is still incomplete. Dynamic local governments emerged fastest and most successfully in East-Central Europe (e.g. Poland, Hungary, Czech) and slower in the countries that only became independent after the collapse of the Soviet Union and the disintegration of Yugoslavia.

The simplest explanation for this is probably that in the newly independent countries of the region nationalism, and the challenge building sovereign states overshadowed and in some ways inhibited the growth of local governments. This can be illustrated by comparing the development of local governments in East-Central Europe with those in the countries that emerged out of Yugoslavia.

In Poland, as in Czech and Hungary reformers saw local governments a way to both break-down the monopoly power of the communist state and to build --from the bottom up-- a new political order. As result, in all of these countries there was a strong political commitment to creating democratically-elected local governments, and endowing them with important public sector responsibilities and large shares of the fiscal pie.

In the inheritor states of the former Yugoslavia, however, the tendency ran --at least initially and paradoxically-- in the other direction. I say paradoxically because prior to the collapse of communism the cities and towns of Yugoslavia were much more powerful and independent than their counterparts elsewhere in the socialist world. Nonetheless, when Yugoslavia fell apart, the political elites of the states that emerged out of the ruins, recentralized power and radically constrained the rights and powers local governments. Indeed, it is only in the last ten years that this initial tendency as begun to be reversed⁶.

In any case, what is clear from comparing the experiences of the countries of post-communist Europe is that for local governments to fulfill their promise they must have:

- Legal identities and the right to enter into contracts in their own name.
- The right to own property as well as the actual ownership of at least some of the publicly-owned land and buildings located in their jurisdictions.
- Administrative independence, including the right to hire and fire their own personnel and to have their decisions subject to review by higher level authorities *only with respect to their legality and not their substance*.
- Clearly defined responsibilities for the management and finance of public services.
- Independent budgets with adequate, predictable, and transparent revenues.

All of these issues have been problematic. But the ones that have been most difficult to resolve concern determining which public service local governments should be assigned and how they should be paid for. In other words, the two questions that

⁶ On Bosnia see, Tony Levitas, *The Role of Intergovernmental Finance Reform in Building a Sustainable Democracy in Bosnia-Herzegovina*, DG Alternatives, Fall, 2006 pp. 1-8; on Serbia see, Tony Levitas and Dusan Vasiljevic, *Genesis of a Long Awaited Reform: The Serbian Law on Local Government Finance of 2006(with D. Vasiljevic)*, Standing Conference of Serbian Towns and Cities/LGI. (Forthcoming, DG Alternatives) pp. 1-10)

have proved most difficult to answer have been: What should local government do? And how should they get the money they need to actually do it?

It should come as no surprise that that these have been the most difficult questions to answer in practice. After all, they are the ones most directly connected to both power and money and trying to address them not only produces political resistance but requires the political will and commitment to overcome this resistance.

But the problems are not only political. Answering these questions present technical challenges that are not easily resolved. Indeed, throughout post-communist Europe these technical challenges have interacted with political ones in ways that almost inevitably delayed or comprised reform efforts. It is therefore good to have a clear idea about what sorts of technical challenges these questions typically raise.

Determining which public sector responsibilities should be assigned to local governments is difficult for a number of reasons. First, there are always real questions about the capacity of local governments to manage particular functions. The more costly and complicated the functions are the more reason there is to worry about whether local governments will have the human capital to competently administer them –particularly in small, rural jurisdictions. As result, there may be good reasons not to assign a particular function to all local governments at the same time, or to assign it first as delegated function and only later as an own function once local governments have proved they can manage it⁷.

Second, responsibility for most modern public services must in practice be “shared” or “divided” between levels of government. Indeed, many public services can be rationally divided or shared between levels of government in a number of different ways.

Take for example education. In most countries, responsibility for determining curricula, selecting text books, and setting standards for both how the teaching process is conducted and the conditions in which schooling takes place rests clearly with the national government. In many countries however, lower level governments have very substantial roles in the financing and management of pre-University education.

In some countries, they not only own school facilities and are responsible for their physical maintenance and improvement, but they pay for the wages of all school personnel and set school budgets. In these countries, local governments are almost totally responsible for managing and financing pre-university education. And because pre-university education in general (and teachers pay in particular) is one

⁷ A delegated function is a function that a national government entrusts local governments to manage on behalf of the state and which is usually financed by a categorical or earmarked grant. (see page 14 for more on this.) Local governments can be given more or less freedom to manage the function. But the assumption is that if they fail to manage it properly, the national government can the function back or order them to change their behavior. With own functions, local governments are entirely free to manage the function as the see fit and are generally expected to finance it out of their general revenues.

the largest single public expenditures of the modern nation state, local governments in such systems almost automatically became extremely important.

In other countries however, teachers' wages continue to be paid by the national government, but local governments maintain school facilities and may or may not be made responsible for paying the wages of non-pedagogical staff. Here, in other words local governments are given important roles in the sector, but not the most expensive (and usually politically sensitive) role of setting teachers' wages, paying for them, and determining levels of employment in the sector⁸.

Similarly, consider culture. In most countries, culture is considered a shared responsibility. But it is not sufficient for the legal system to simply to say this. On the contrary, if both levels of government are to really know what they are supposed to manage and finance, responsibility for particular types of cultural institutions and functions must be specifically assigned to each. For example, local cultural centers, libraries, theatres and museums should probably be given to local governments. But the National Theatre, the National Opera, the National Orchestra and various National Museums should remain under control of the Ministry of Culture no matter where they are located. Or put another way, somebody has to decide which cultural institutions are national and which are local.

Moreover, rational decisions about these questions are inevitably influenced by the historic, demographic and topographic characteristics of individual countries. For example, when the Berlin Wall came down, a number of countries in post-communist Europe decided to make every settlement an independent local government because it seemed like this was the best way to bring democracy to the people.

As a result, literally thousands of new jurisdictions were created over night, many with less than 1500 people and each with their own mayor, council and administrative structures. Their size has, in turn, made it difficult to assign them many important responsibilities because they often lack the human capital to administer complex public services and because their tax bases are so weak that they can only survive if virtually all of their revenues come from central government grants and transfers.

Worse, not only do these jurisdictions have high administrative costs but they are too small to achieve economies of scale in the delivery of public services. As a result, the level of transfers that must come from the state budget to support them is extremely high. So high that many countries in post-communist Europe are now trying to address their historically understandable mistake of creating local governments too small to deliver many public services. Unfortunately, however consolidating jurisdictions is always extremely difficult politically because nowhere in the world do people like to see their mayors, councils and town halls "eliminated".

Moreover, jurisdictional consolidation may simply be impossible for good demographic and topographic reasons. Mountainous countries often have large numbers of villages that are close to each other as the bird flies but cannot be

⁸ See for example, Jan Werner, Anwar Shah, *Financing Education: Experiences from Ten European Countries*, Institute of Local Public Finance, Working Paper 02-2006

reasonably consolidated give the existing road network. Similarly, jurisdictional consolidation may be impossible (or irrational) in countries –like Finland and Mongolia-- that have territorially large but very sparsely populated jurisdictions.

In any case, the point here is that not only must responsibilities in most sectors be shared between national and local governments, and that there are many ways this sharing can be done, but that how this sharing should best be defined will differ from country because of historic, demographic, and topographical reasons. In short there is no general model that can be applied across countries with respect to which specific functions should be assigned to local governments.

Moreover, figuring out the details of this is never easy because it requires first determining which specific types of services are currently being managed and financed by particular line ministries; then deciding which ones should be transferred to local governments; and finally; determining how local government should be “given” the money to pay for them. Indeed, it is to this problem that we now turn.

If local governments are to fulfill their democratic, economic and indeed their public finance promise, they must be provided with adequate, predictable and transparent revenues. If revenues are inadequate then they will obviously not be able to deliver the services they have been made responsible for and the very idea of local government will be discredited. If their revenues are unpredictable and their budgets are dependent upon bargaining with the national government every year, then money will be wasted because there can be no rational planning. And if their revenues are not transparent, then there is no way that local governments can be held accountable for their performance either by their citizens or by the national government.

But designing intergovernmental finance systems that provide local governments with adequate, predictable and transparent revenues is difficult, particularly in developing and transitional countries. There are many reasons for this.

First, developing and transitional countries often have very serious budget problems because tax collection is too low and public spending is too high. They then come under pressure from international lenders, particularly the IMF and the World Bank, to put their fiscal houses in order, typically through the implementation of what were once known as structural adjustment programs. These programs require cuts in public spending, improvement in tax collection and the creation of national treasury systems so as to better monitor and control the public sector⁹.

In Mongolia, as in other countries, these programs have typically resulted in the (re)centralization of public finances and work against efforts to devolve power and money to local governments. This indeed happens, despite the fact that both the IMF and the World Bank officially recognize that at least theoretically, decentralization should improve the efficiency and effectiveness of public sector management. In any case, it is clear from the experience of post-communist Europe

⁹ See for example, Wallace Oates, “An Economic Approach to Federalism, in S. Baker and C. Elliot, Readings in Public Sector Economics (Lexington MA, Heath) 1990, pp 554-565

that it is very hard to create viable local governments when the primary focus of the national government and the Ministry of Finance is on structural adjustment.

Second, even if there is a consensus among national politicians about which specific functions should be transferred to local governments, it is always difficult to determine how much money should be given to local governments when responsibility for the services is actually transferred to them. The general rule of thumb is that local governments should get the same amount of money that was spent on the services as the national government was spending on them prior to their devolution. So the first step in the process is to figure out what the national government has been spending on the services that will be devolved.

Given the state of budget preparation and reporting in many countries this can be a very challenging task. For example, in culture, budget reports of the Ministry of Culture may not allow for the easy separation of national government spending on national institutions and on local institutions. Moreover, in many areas, money may be coming from a number of different Ministries at once, meaning that to get a picture of total spending on a service or sector, information from multiple budgets have to be pieced together.

This is particularly true of investment spending, where money going for the improvement of waters systems, schools, cultural institutions, and other typically local functions is both dispersed across various agencies of the national government and “lumpy”, meaning it can change radically from year to year. As such, piecing together a picture of how much the national government has been spending on the services that are to be devolved to local governments is often a best guess sort of game which requires a coherent team of researchers and the active support of at least the Ministry of Finance.

Unfortunately, however, these are not the only problems. In theory, one of the virtues of having the national government being responsible for the delivery of public services is that it can ensure that all citizens are treated equally and fairly, and that public services are provided throughout the country at a similar standard. But in practice this is rarely the case, either in terms of current spending, or in terms of past investments.

As a result, the quality of public services and the institutions that are associated with them are typically very unevenly distributed. For example, some jurisdictions may have local cultural centers and libraries, while others do not. In fact, such “inequities” –either in terms of the existence of the necessary infrastructure or its quality-- probably exist across the entire spectrum of public services that might be assigned to local governments.

In an ideal world, the national government would make the investments necessary for all local governments to take over service responsibilities of similar quality, and with similar infrastructure endowments. This however, only very rarely happens, and if so, only partially. Indeed, if local government reformers in post-communist Europe had waited for this to happen, we probably wouldn't have local governments there at all.

In any case, the fact that some jurisdictions have institutions associated with a given public service, and others do not, or have less of them in worse condition, creates a tension between whether the national government should assign responsibility to local governments for the maintenance and operation of existing institutions, or whether they should be assigning responsibility to local governments for the delivery of the service itself.

In the former case, only local governments that already had the institutions would be given responsibility for them and the national government would simply give them the money that it had been spending on these institutions before devolution. This ensures that they will be able to at least maintain service quality at the same level of as the national government had done before. But this solution is obviously unfair to the people living in jurisdictions where these institutions don't exist, or are of much worse quality.

The more equitable solution is therefore to divide the money currently spent by the national government on these institutions by the total population of the country and then to give each local government its fair share based on the number of people living in it. But this solution, while undoubtedly more equitable, runs into serious practical problems. On the one hand, the jurisdictions that had the institutions will now get less money to run them than national government was previously spending on them. On the other hand, the jurisdictions that didn't have the institutions before will now get some money for the service, but probably not enough to create the missing institutions.

Not surprisingly then, reforms aimed at decentralizing public services are almost inevitably accompanied by pressures on the national government to give local governments more money to spend on these public services than it was spending on them prior to devolution. And not surprisingly this creates further tensions between macroeconomic management efforts and efforts to create viable local governments.

Worse, there is no elegant solution to this dilemma. But that does not mean it cannot be resolved, though in my experience it does usually require that more money be provided to local governments than the national government was previously spending on the public services it intends to assign them. Or to put it in the language of the IMF, the creation of viable local governments is rarely "fiscally neutral."

So far we have described the kinds of problems reformers in post-communist Europe confronted when trying to decide what functions should be given to local governments, as well as the problems they face when trying to estimate how much money local governments would need to have in order to pay for the functions that they were to be assigned. And so far we have done so without providing any detailed model describing exactly how these tasks should be undertaken, let alone what their outcome should be.

This is for the simple reason that while the major problems confronting reformers in post-communist countries can be relatively easily described, how reformers went about solving them is not. This is because the functions that made sense to devolve to local governments differed from country to country; because the kinds of inequities we have described above appeared differently in different places, and because the

quality of the data needed to estimate the expenditure needs of local governments varied significantly from one country to the next.

Unfortunately, there are similar issues surround the critical question of how local governments should be provided with the money they need to pay for the functions that will be assigned to them once the costs of these functions have been estimated. To understand these issues it is necessary to look in a little bit of technical detail at the five basic mechanisms through which local governments can be given revenues. These are own revenues, shared taxes, earmarked or categorical grants, and general grants¹⁰.

- Own Revenues, are fees, charges, and taxes over which local governments are politically responsible for setting the rate of the tax or the level of the fee or charge. For a revenue to be considered an own revenue it is not necessary that local governments be responsible for administering or collecting the fee, charge, or tax, or even that they define the base of the tax. What is critical is that citizens know that political responsibility for determining how much they must pay is set by locally elected officials.

A special class of own revenues are revenues that local governments derive from the sale or rental of local government property. In general, own revenues are freely disposable, meaning that local governments can spend these revenues as they see fit. An important exception to this general rule is usually made for revenues for the sale of locally owned property. Unlike other own revenues, these monies are typically categorized as capital revenues that must be used by a local government for investment purposes. Sometimes similar rules are imposed on the revenues that local governments may or may not be allowed to charge for the development of privately owned land.

- Shared taxes are taxes whose base and rate are set by the national government, and which are generally collected by it, but whose yield is shared partially or entirely with local governments. In Mongolia, for example, the mineral tax, the livestock tax and the property tax are all shared taxes, despite the fact that in the case of both the livestock and the property tax a 100 percent of the yield is given to local governments.

One of the most common confusions in post-communist Europe has been to consider shared taxes whose yield is given entirely to local governments as “own revenues” or “local taxes”. This confusion is clearly present in Mongolia today, and has profound implications for the construction of a sound intergovernmental finance system, implications that we will discuss in a moment.

- Earmarked or categorical grants are grants given by the national government or its agencies to local governments for specific purposes. These may be for programs that are supposed to run for a limited period of time, such as training programs; for investment projects, or for specific public services that

¹⁰ For reasons of space, we leave out here the category of revenues derived from borrowing. For the standard classification of types of local government revenues see, OECD Revenue Statistics, OECD, 2007

local governments are expected to perform on a permanent basis. In all cases however, local governments can only use the money for the purposes that are specified in the design of the grant.

If local governments are given categorical grants to perform a public service on regular, multi-year basis, these services should be considered as delegated functions and not own functions of local governments. This means that ultimate responsibility for the service still rests with the national government, and that the national government can tell local governments how the service should be delivered and even take it back if it feels that local governments are failing to meet their responsibilities.

Categorical grants for delegated functions obviously restrict the autonomy of local governments and are generally disliked for this reason by both local government officials and advocates. Nonetheless, they can be useful instruments in a reform process, particularly if the intention is eventually to transform delegate functions into own functions and categorical grants into general purpose revenues.

- General Grants are grants given by the national government to local governments and which can be used in any way local governments see fit. General grants are sometimes given to all local governments because the costs of the services they have been assigned exceeds the amount of money that they can be expected to raise from own revenues and shared taxes. And sometimes general grants are only given to local governments whose weak tax bases makes it impossible for them to raise the revenues needed to the services they have been assigned. In this case, general grants are called equalization grants. In many post communist countries, all local governments receive some general grant money from the national government, while poorer ones receive more through the same mechanism.

In designing general grant systems, there are three fundamental questions. First, how big should the size of the total grant pool be? Second, how should the size of the grant pool be defined in law to ensure that it doesn't change radically from year to year? And third, on the basis of what kind of formula should the pool be allocated to individual local governments every year¹¹.

There is a huge amount of variation across countries in the proportion of total local government revenues that comes from each of these revenue types, though most countries make use of all of them. There is also a clear preference in the literature on public finance for making sure that as much local government revenue comes from own sources as possible. And the reason for this, as we have already suggested, is to strengthen the virtuous circle between democratic accountability and the efficient and effective (raising and spending) of public money.

At the same time, we have also suggested that there are often problems with doing this in developing and transitional countries for two reasons. First, the tax bases of most developing countries are skewed to capital cities, meaning that most

¹¹ For more on the design of grant systems see Ehtishan Ahmad and Jon Craig, *Intergovernmental Transfers*, in T. Ter Minassian, **Fiscal Federalism in Theory and Practice**, (IMF Washington D.C. 1997) pp. 73-107.

jurisdictions are poor. And second, there are very few high yield taxes that can reasonably be made into true local government taxes because most taxes are better administered and controlled by the national government. Worse, the “high yield” tax that public finance theorists think is most appropriate to give to local governments – the market based property tax—has proved notoriously difficult to implement in the developing world.

As a result the share of local government revenues that comes from own-sources is relatively low in most of post-communist Europe –between 15 and 35 percent depending on the country. Indeed, it is lower than public finance theorists would consider optimal in most OECD countries. But this is another story. What matters here, is that post-communist countries have had to rely on the other mechanisms we have described above when designing their intergovernmental finance systems.

In and of itself, this is not particularly problematic. What has been problematic, however, is that reformers in post-communist countries have generally been allergic to the idea of grants, seeing them as being both inherently political and as a distasteful form of dependency. Indeed, this is not surprising given the way grants were used under communism and the way they continue to be used in many countries today.

But the effort to avoid or minimize the use of grants, led many post-communist countries –particularly in the initial years of reform—to build their intergovernmental finance systems around shared taxes, particularly shares of the wage tax¹². In many cases however, this proved disastrous. To understand why consider for a moment what would happen if a country decided that the main source of local government revenue should be a 100 percent share of the wage tax. In poor rural jurisdictions this share will yield very little money because 100 percent of nothing is still nothing. Meanwhile, in the capital city and this share will not only yield too much money, but it will simultaneously deprive the national government of precisely the revenues that need to be redistributed to poorer jurisdictions if they are to have viable local governments.

As a result, it is extremely important when designing intergovernmental finance systems in post communist and developing countries to think realistically about how much money local governments (of different types) can be expected to derive from own revenues and shared taxes on the one hand, and from various types of grants on the other.

Moreover, it must be understood that the writing of Local Government Finance Laws –laws which define the types of revenues local governments are entitled to, including the definition of grant pools and the formulas used to allocate them— is not just a

¹² Indeed, in many countries, shared taxes were, or still are, referred to as own revenues or local taxes because the shares are stated in law, and the revenues seem to local government official like a stable entitlement. But this is a serious mistake for at least two reasons. First, shared taxes do not enhance the link between local governments and their citizens because it is not local governments who are responsible for setting the rate or the base of the tax. And second, while the shares may be stated in law, the value of these shares are still subject to national government tax policy, something local government officials painfully discovered when national governments started lowering the rate of the wage tax and changing its base.

legal exercise. On the contrary, these laws must grow out of serious empirical efforts to model the financial effects of different mixes of revenues and grant structures on local governments with different tax bases and different expenditure needs. And this in turn requires both political will and the active cooperation of the Ministry of Finance.

In summary then, what are the major lessons that can be learned from local government reform in post-communist Europe?

The first lesson is simply that the functions and finance that local governments should be assigned will differ from country to country and overtime. As such there is no single or indeed permanent model of what local governments should do, or how they should be financed. Indeed, in most post-communist countries reform has been process, and often one that is still continuing today.

The second lesson is that while local government reform throughout post communist Europe has generally been a process, the countries in which this process has been most successful have been those where there was a clearly stated goal of creating politically, juridically and financially independent local governments. In these countries, the first step was to create democratically elected local governments and to endow them with legal identities, property rights, independent budgets and at least a few important service responsibilities.

Then, overtime, further functions were devolved to them increasing their financial and managerial responsibilities. Moreover in many countries, responsibilities were devolved asymmetrically, meaning some functions and finances were devolved first to larger more capable jurisdictions and only later, if at all, given to smaller entities. Or put another way the lesson is to treat local governments as young adults with clear, if limited rights and responsibilities, and not as children whose every decision has to be subject to prior parental approval.

The third lesson is that the rules governing what local governments are responsible for, and how they should be financed not only should be worked out together, but clearly stated in framework legislation, meaning usually in a Law on Local Governments and a Law on Local Government Finance. For all the reasons described in this section, the development of these laws is never easy, particularly because legal and financial work has to be conducted more or less simultaneously. Nonetheless, not only is this work necessary if local governments are to fulfill their democratic, socio-economic and developmental promise, but it can and has been done.

IV. The Situation of Local Governments in Mongolia Today

The current debate over the direction of local government reform in Mongolia today is both chaotic and perhaps at something of a crossroads. At the moment, what is driving the debate are the effects of the Public Sector Management and Finance Law (PSMF Law), a law that was itself long and hotly contested beginning in the late 1990s, and ultimately passed in 2002. This Law was a response to

Mongolia's chronic fiscal problems in the decade after 1992, and has three basic elements.

- First, it recentralized control over the public sector by requiring that **all** expenditures be specified in the national budget, and by reasserting line ministerial control over most public spending. This has resulted in a radical decline in the amount of money spent by Mongolia's territorial and administrative units, which prior to the implementation of the law were responsible for about 30% of all public expenditures (c.13% of GDP) and are now responsible for about 10% of all public expenditures (c. 3.0% of GDP).¹³
- Second, the Law attempted to improve the effectiveness of public spending by requiring that all public expenditures be based on performance contracts signed between line ministries (Portfolio managers) and the subordinate public entities (General Managers) responsible for the actual delivery of a public service. These performance contracts are supposed to clearly define the unit costs of providing a given service as well as the timing, quantity and quality of all outputs.
- And third the Law put in place a unified, electronic Treasury system for the management of all public monies. This system requires that all public revenues and expenditure be coded by economic type, functional purpose and by the organization spending the funds and allows for the control and monitoring of all public monies.

It is not the purpose of this paper to assess the PSFM Law. Nonetheless a few general observations are in order because reactions to the Law are clearly influencing current discussions of state-local relations in Mongolia today.

At the most general level, the Law has clearly fulfilled its primary purpose and Mongolia is no longer running serious budget deficits. On the contrary, for the third year in a row it is running a budget surplus¹⁴. This is an important achievement which cannot be taken lightly.

Similarly, the new Treasury System –which is still being extended to the Soum level-- has radically improved public sector financial accountability and the quality of the data available on where public revenues are coming from, and how they are being spent. This means that for probably the first time Mongolian analysts have the data necessary to conduct the kinds of analyses necessary to rationally think through how public sector service responsibilities might be reapportioned between levels of government and as well as how these levels of government might be financed. So again, the Law has produced very tangible as well as very promising gains.

¹³ Ariunaa Lkhagvadorj, *Status Quo on Fiscal Decentralisation in Mongolia*, Finanzwissenschaftliche Diskussionsbeiträge Potsdam 2007. For a slightly different calculation of the share of GDP currently spent by territorial units see, Open Society Forum, *Local Budget Review*, May 29, 2007 pp. 1-47. It should be noted that most of this decline is due to the fact that aimag level governments are no longer responsible for paying the wages of teachers and health care workers.

¹⁴ Mongolia Quarterly, World Bank, February 2008, p. 5

It is much less clear, however, whether the system of performance contracting is really working. At a minimum, Portfolio Managers and General Managers are obviously having difficulties defining the unit costs of public sector services and specifying the output of these services in terms of quantity, quality, and timing. At a maximum, these difficulties are rendering the contracts time consuming exercises that result in pro forma agreements that bear little resemblance to reality¹⁵.

More importantly for our purposes, is the growing feeling that the law has led to an over-centralization of public finances and has deprived Mongolia's territorial governments of any meaningful role in the development of the country. This discontent expresses itself along at least three dimensions. The first is simply that territorial governments have too little revenues to improve the lives of their citizens. The second is that they have lost control over the behavior of line ministries in their jurisdictions. And the third is that the budget process, by requiring that all territorial budgets be included in the national budget, and that all investment spending and investment contracting be approved centrally, has become both incredibly cumbersome and so restrictive that it is impossible for territorial governments to address their infrastructure investment needs¹⁶.

At the time of my mission to Mongolia, this discontent was generating a number of different reform initiatives. For example, Aimag Governors had recently been given back control over the hiring of 9 out of the 13 department heads whose appointment had been shifted to line ministries under the PSMF Law. Similarly, some parliamentarians were pushing for increasing the share of mineral taxes retained in the budgets of territorial units. And others were looking to create territorial development funds that would restore at least some control over investments to the local level.

All of these responses to the PSMF Law are understandable, and in some way justifiable. At the same time however, they are all fragmentary responses that fail to address what I think is still the fundamental problem in state local relations in Mongolia today. Put simply and perhaps a little brutally, the problem is that Mongolia has yet to decide whether it wants to have a system based on a deconcentrated state administration in which the real function of democratically elected local hurals is to serve as advisors to the state officials who preside over them; or whether it wants to have truly independent local governments –no matter how limited or expansive their service responsibilities might be¹⁷.

¹⁵ Get cites,

¹⁶ It is worth adding that at least two members of parliament complained to me that under the new system they have to spend considerable time trying to ensure that items like school toilets and hospital roofs for their jurisdictions make it into the national budget.

¹⁷ For a similar conclusion, see Keith Mclean, "An Assessment of Decentralization in Mongolia" World Bank, mimeo c. 2000. For a less generous one, see Gita Steiner-Khamsi, Ines Slope, "Decentralization and Recentralization Reform in Mongolia: Tracing the swing of the pendulum" Journal of Comparative Education, Vol. 40 no. 1, February 2004

And the uncertainty about how to answer this question continues to compromise efforts to really think through how service responsibilities should be divided between levels of government. Or put another way, if territorial governments are really just deconcentrated units of the national government with advisory councils, then it is much less important to figure out what the division of responsibilities between levels of government should be because in the last instance all responsibilities belong to the state.

In this context, my basic reading of the PSFM Law is that it has radically reshuffled responsibilities for public service sector responsibilities from lower levels of the state back towards the center. In doing so, it has reopened the question of what local governments should be in Mongolia, without however answering it.

At the same time, and perhaps paradoxically, I think the very success of the PSFML has created conditions in which it is now both possible and necessary to finally face the question of whether Mongolia really wants to have independent local governments: Possible because by stabilizing Mongolia's public finances the law has helped overcome the fiscal distress that always works against decentralization. Necessary, because the fact that the national government has failed to meet its own investment targets for the last two years¹⁸ despite running budget surpluses suggests that over-centralization may now be creating its own developmental bottlenecks¹⁹.

For the moment, however, it is important to ask the question why Mongolia has had so much difficulty over the last 15 years in determining whether it really wants to have independent local governments at all. Here, I think the basic answer lies in the peculiar way Mongolian politicians have chosen to understand the meaning of a "unitary state." Worse, this understanding is deeply embedded in the constitution and will thus be difficult to change.

Nonetheless, I think it is necessary to concentrate on this peculiar understanding for at least two reasons: First, even within the existing constitutional arrangements meaningful reform is possible if national government policy makers understand where the confusions and tensions lie. And second, because in the best of all possible worlds I believe that efforts to create truly independent local governments – even ones with limited public sector service responsibilities-- would be accompanied by constitutional reform.

In any case in the rest of this section, I briefly identify what are the central misunderstanding, while trying to illustrate how at least some of the express themselves in practice. In the next and final section, I outline how I would go about addressing them.

Like most countries, Mongolia is a unitary state, meaning the national parliament is the sole, sovereign legislative body in the country. As in other unitary state's, the

¹⁸ Mongolia Quarterly, World Bank, February 2008, p. 5

¹⁹ It is perhaps worth adding that the rapid growth of the mining industry –upon which Mongolia's GDP growth is largely based—will be producing new and unprecedented developmental challenges at the local level, challenges that it will be increasingly hard to meet without real local governments.

national parliament can assign legal powers to other levels of government, including democratically elected ones. In many unitary states, national parliaments have devolved very significant amounts of authority to regional and local councils or legislatures. Indeed there are some unitary states –like Australia and Sweden— where so much power has been assigned to lower levels of government that in many respects they have begun to resemble federations. In most, however, the responsibilities assigned to lower level governments are much more limited, as is the case in Mongolia today.

In this there is nothing unusual. What is unusual is that the Mongolian Constitution requires that the *“Governance of administrative and territorial units of Mongolia be organized on the basis of a combination of the principles of both self-government and central government.”* What this means is that while each territorial or administrative unit has a democratically elected hural, and a hural chairperson the hural only nominates the local governor, who then must be appointed by higher level state officials. Thus, the Governors of Aimags and the Capital city are appointed by the Prime Minister, while the governors of Soums, Baghs and Horoos are appointed by the Governors above them (Article 60).

Article 60 also states that *“State power shall be exercised on the territories of Aimags, the Capital City, Soums, districts, Baghs and Horoos by the Governors of these territories.”* And Article 61 underlines the point by declaring that *“While working for the implementation of the decisions of a respective Hural, a governor as a representative of state power shall be responsible to the government and the governor of the higher instance for proper observance of national laws and the fulfillment of the decisions of the government and the respective superior body in his/her territory.”*

In other words, despite serving as the heads of local governments, Governors at all levels of the system are not only appointed by the national government, but their primary responsibility is to serve it, and not the Hurals who in theory they represent. Indeed, point 2 of Article 61 states *“Governors shall have the right to veto decisions of respective Aimag, Capital City Soum, District, Bagh and Horoo hurals.”*

To be sure, point 3 of the same Article provides for the possibility of local hurals over-turning the veto decisions of governors and indeed forcing their resignations. And point 2 of Article 62 states that *“Authorities of higher instance shall not take decisions on matters coming under the jurisdiction of local self-governing bodies.”* Both of these points are obviously intended to ensure that local governments have some real power.

On the one hand, however, it is hard to see how they can really use these powers when they know that the Governor’s primary responsibility is to represent the interests of the national government, and that even if they force the current governor to resign, the next one must also be approved by higher-level state representatives. Similarly, it is hard to see why local hurals would risk entering into serious conflicts with their governors when they are the state representatives with the greatest chance of improving the overall circumstances of the jurisdiction.

On the other hand, the constitution does not specify in any way the “matters coming under the jurisdiction of local self governing bodies.” Instead, this is left to the Law on Administrative and Territorial Units of Mongolia and their Governance. Article 14 of this law lists 32 specific competencies and at first glance seems quite detailed. On closer examination, however, this is not the case. Many of the competencies concern the right of Hurals to make decisions about how to organize themselves while others simply state that Hurals can discuss certain matters, approve programs developed elsewhere, or provide the governor with information.

Indeed, with the exception of a half-dozen relatively clear provisions regarding the rights of hurals to dispose of locally owned property the list does not describe any public sector service responsibilities to speak of. In other words, there is no mention of any of the basic functions that one might associate with local governments, such as the maintenance and improvement of local roads, parks, cemeteries, streetlights, water supply and sewage treatment systems or solid waste services.

Similarly, there is no mention of any competencies in the delivery of social services that are also often assigned to local governments, such as responsibilities in pre-university education, primary health care, or the maintenance and operation of cultural institutions. As such, while the Constitution and the Law Administrative and Territorial Units purport to define a specific set of competencies for local hurals, the definitions of these competencies are too general to be of much real practical use.

In short, it seems that while the constitution creates democratically elected hurals at all levels of governance, it defines Mongolia’s unitary state in a way that ensures that the national government retains operational control over virtually all hural decisions. Obviously, this means that it is impossible to speak in any meaningful way about juridically, politically or administratively independent local governments. Indeed, it is in contradiction with everything we have learned about creating viable local governments in post-communist Europe²⁰.

Moreover --and not surprisingly given the circumstances-- the real powers of hurals are not only very poorly specified but there is a huge amount of confusion about what is a local government and what isn’t, and about which levels of government are supposed to do what. In fact, there is so much confusion that it is often hard to know exactly what people mean when they talk about local governments, or for that matter the difference between Aimags and Soums²¹.

²⁰ Many of the “lessons” were actually put in proscriptive form by the Council of Europe in the 1985 European Charter of Local Self-Governments (http://www.doeni.gov.uk/lgrt_gov_appendix_2.pdf). Most post-communist countries signed the Charter well before meeting its conditions, and used it to “leverage-up” their own practices. Equally importantly, the Council of Europe continues to issue directives and instructions which have over the years clarified the principles enumerated in the Charter and in fact made them more robust. See, (<http://www.search.coe.int/taxis/search>)

²¹ This confusion is reflected in Article 58.1 of the Constitution which defines aimags, the capital city, soums and districts as “administrative, territorial, economic and social *complexes*” (italic added). The question, of course, is what the word “complexes” means here. Or put another way, it means at once everything and nothing.

Consider this perhaps trivial example of the kind of confusion I am talking about: In some Aimags, the government buildings have signs on them that identify them as the offices of the national government. In others, however, the same buildings are identified as the headquarters of local governments.

Similarly, when parliamentarians talk about efforts to strengthen local governments, many of them mentioned the recent decision to allow governors to hire and fire the representatives of sectoral ministries that work out of the Aimag Offices. This decision undoubtedly restored some of the power that Governors lost under the PSFM Law. But the decision really only shifted power from one agency of the national government –line ministries-- to another –governors—and properly speaking was not really about local governments at all.

Finally, consider the situation in Aimag Centers. Here the Aimag Governor simultaneously fulfills three distinct functions. First, he is an important state official responsible for coordinating the work of line ministries in his region. Second, he is the supervisor of the governors of all Soums in the Aimags. And third, he is the de facto head of the largest “local government” in the Aimag because in practice Aimag Governors have taken over the most important powers of Soums in the Aimag Center²².

Or put another way, the Soums of the country’s 21 (out of 22) largest settlements look more like Baghs and Horoos in terms of their rights and responsibilities than they do other Soums. We will return to this point in the next section because it has critically important implications for thinking about which level of territorial administration –if any-- Mongolia might want to transform into truly independent local governments.

For the moment, however, it is important to understand how the same problematic conception of the unitary state has been extended to intergovernmental financial relations. What I mean by this, is that legislators seem to have decided that in a unitary state there can be only one sovereign budget, and that the budgets of all other public bodies –including those of local hurals—must be included in the national budget, and voted on by the national legislature.

This understanding of intergovernmental financial relations is not specified in the Mongolian constitution. Nonetheless, it is very different from how intergovernmental financial relations are understood in the vast majority unitary states, including those of post-communist Europe. Here over the last 15 years, lower level governments have been given independent budgets. These budgets are not included in the national budget, nor are they pre-approved by the Ministry of Finance.

Instead, framework legislation –usually a Local Government Finance Law—defines the shared taxes, general grants, categorical grants, and own-revenues that local

²² For example, in most Soums, governors and hurals are responsible for supervising or controlling the budget entities or companies that provide water, clean streets and maintain basic urban infrastructure. In Aimag centers, however, it is the Aimag governor who performs these functions. The same was true with control over the disposition of publicly owned property. As a result, about the only thing the Soum government did in these jurisdictions was to perform civil registry and other notary functions.

governments are entitled to. Local Governments have Budget and Finance departments that are responsible for collecting their own revenues and for projecting the yields of shared taxes and grants that will be transferred to them by the national government

Every year, the executive body of the local government proposes to the council a budget in which revenues and expenditures are legally required to be in balance, and in which every revenue and expenditure must be identified in accordance with the Chart of Accounts. And every year, the Council must approve a year-end final statement that confirms (or rejects) that money has been spent in accordance with the budget it approved earlier and which it may have amended during the course of the year. The rejection of a year-end financial statement is usually considered grounds for the Council to dismiss the executive. At the same time, if these year-end statements --or data from the Treasury System--reveal that a local government has overspent its revenues, than the national government has the right to at least temporarily revoke the jurisdiction's financial independence until the debts are paid off.

In Mongolia, however, local governments have neither independent budgets nor stable revenues. Instead, lower level governments propose their revenues and expenditures to higher level governments and ultimately to the Ministry of Finance for approval. Because they know that their revenues are ultimately dependent on the decisions of the Ministry of Finance, they ask for as much as they think they can get, or as the Deputy Governor of one Soum put it, "We ask for four wheels, in the hope of getting two"²³.

This kind of bargaining obviously opens the system up to a lot of potentially unfair politics. It also undermines any rational planning because while the Ministry of Finance probably bases most of its final decisions on last years numbers, perhaps adjusted upward for an inflation and perhaps GDP growth, nobody can be sure of this outcome going into the process.

This kind of "top down", bargaining-based budgeting is possible because the revenues of local governments are not fully defined. In particular, the grants or transfers that the National Government provides to the vast majority of lower level governments are not defined in any law or by any formula. Instead, the Ministry is pretty much free to take as much as it thinks is necessary from "surplus" jurisdictions to give as much as necessary to deficit ones²⁴.

At the Aimag level, these transfers do in fact significantly reduce the difference in per capita' revenues between Mongolia's richest and poorest regions --from about 25 to 1 before transfers, to about 3.5 to 1 after them²⁵. This is a good thing because it

²³ Actually, this is a version of a joke that I used to hear throughout Eastern Europe in the 1990s. Strangely, the Romanian version of the joke would do very well in Mongolia: "We ask for a horse in the hope of getting a goat."

²⁴ I say "pretty much free" because it is always possible that the Great Hural adjusts some of these allocations when ratifying the national budget.

²⁵ Aimag Budget data from the Ministry of Finance; Own calculations for the years 2006, 2007, 2008.

means that the national government is aware that public revenues have to be redistributed in Mongolia if all parts of the country are to have a chance to provide reasonable public services. Nonetheless, not only is the system extremely unpredictable --with different Aimags doing substantially better or worse from year to year-- it is not clear what the rationale behind it is, or how rational it is²⁶. Moreover, we have no data about how these transfers work at the Soum level.

The ability of the national government to arbitrarily take revenues away from some jurisdictions and give them to others means that in some fundamental way the existing definitions of “local taxes” are legal fictions. But even as fictions, they are poorly defined and problematic terminologically. First, every thing that is being labeled as a local tax really is a shared tax because local governments have no political responsibility for setting rates. Second, the rates at which these taxes are shared with lower level government are defined in many different pieces of tax legislation. And third both what is being called a local tax and the rates at which these taxes are shared seem to be constantly changing²⁷.

Finally, and in the last instance, not only do lower level governments have very limited true own revenues, but even less reason to try to collect them: After all, why bother to try to increase your revenues if it means that next year the Ministry of Finance will have grounds for giving you less, or taking more.

In short, the Mongolian understanding of what unitary state is –an understanding that unfortunately has both been defined in the constitution and extended beyond it—has made it very difficult to talk about independent local governments in Mongolia today for at least three reasons.

First, the system of state-appointed governors at all levels of territorial administration has embedded “local governments” within the structure of the state. Second, by embedding local governments within the structure of the state, Mongolia has avoided trying to determine which levels of government should really be responsible for which functions. As a result, everybody is unsure about who is responsible for what, and the real meaning of the terms like Soum in fact depends on whether we are talking about rural Soums, or the Soums of Aimag centers. And third, by assuming that in a unitary state there can be only one national budget, legislators have had no reason to think about creating an intergovernmental finance regime that would endow local governments with independent budgets and adequate, predictable and transparent revenues.

²⁶ For example, after transfers –or rather take backs—Ulaanbaatar’s per capita revenues are about average for the country as a whole. Given the fact that Ulaanbaatar must maintain much more urban infrastructure than other jurisdictions, and that in fact much of its infrastructure serves people from elsewhere in the country, it appears, at least at first glance, that too much money may be being taken away from the capital.

²⁷ It should be added that for the purposes of tax collection, the Ministry of Finance and Economy considers all taxes collected by its Aimag based tax officials as “local” taxes, while taxes paid directly to the Ministry in Ulaanbaatar by certain large companies are considered national taxes. This inconsistency distorts the picture of how wealth is distributed across the country and makes the design of better revenue sharing arrangements more difficult than it should be..

V. Possible Directions for Local Government Reform in Mongolia

Mongolia is one of the largest countries in the world and one the most sparsely populated. There are only 63 Soums in the country with more than 5000 inhabitants and in many of these the largest settlement is significantly smaller. Moreover, there are 265 jurisdictions with less than 5000 inhabitants, most of which contain multiple settlements separated from each other by vast distances. At the same time however, about 40% of the population lives in Ulaanbaatar and the capital is a major city by any standard.

Mongolia's size, sparse population, and nomadic traditions have historically complicated the efforts to build a modern nation state and are no doubt at least partially responsible for why national and local institutions are so deeply entwined with one another today. Indeed, depending on how one looks at it, Mongolia currently has either two basic levels of local government --Aimags and Soums-- or no local governments at all because their functions, powers, and finances are too embedded in central government structures to really call them local governments at all.

In any case, the demography and topography of Mongolia are so unique that thinking through what local government reform might look like is particularly difficult. After all it may simply be impossible for the vast majority of Mongolia's small and isolated Soums to rationally administer themselves. Or more exactly, without the active and direct engagement of the national government in the development of many of these jurisdictions there will remain very little in the way of local public services for them to administer, and very little in the way of local skills with which to do it.

Nonetheless, most Mongolians do live in jurisdictions that in other countries have proved large enough to successfully administer many public services on their own, and to generate some of the democratic, developmental, and financial gains that we outlined earlier. And my guess is that Mongolia is too small a country for three levels of self-government, and too big for just one. Or put another way, I think the vastness of Mongolia, and the infrastructure and other challenges that come with it, require a strong state at both the national and regional levels. At the same time, however, the citizens of Mongolia's cities and towns need truly independent local governments to improve public services, to sustain and enrich the country's democracy, and to increase their control over their economic futures.

What this suggests is that Mongolia should set itself the clear goal of creating independent local governments at the Soum level, but move towards this goal in a measured and asymmetrical way: On the one hand, only the country's larger Soums should be initially be endowed with the rights and responsibilities of local governments. On the other hand, these rights and responsibilities should be carefully considered and only expanded as the new local governments prove their mettle.

The first step in such in a reform effort would be to clearly separate state functions from local government functions at the Aimag level. This requires clearly defining Aimag Governors as state officials and Soum Governors as the chief executives of

their local governments. In practice, this means Aimag governors would have to be removed from the day to day business of running the country's 21 aimag centers. They would also have to be relieved of the responsibility for supervising the work of the 30 to 40 other Soums that might also be given the status of local governments in the in the first iteration of reform.

It should be added here, that this separation of state and local government functions at the Aimag level might also make it easier to consolidate Aimags. As I understand it, this idea has been widely discussed over the last 10 years but so far hasn't gotten very far politically²⁸. If however, state and Soum functions were clearly separated, then aimag governors would no-longer be responsible for one of the functions they currently perform –running Aimag centers.

At the same time, the burden of another of their current functions –setting the budgets and supervising the work of other Soums—would also be reduced because at least some of these (non-Aimag center) Soums would become independent local governments. Finally, the job of running the Soums that are currently Aimag centers would become a much important role than it is today, a fact which might well reduce at least some of the inevitable resistance to the idea of consolidating Aimags

But let us return to the main line of argument. As we have suggested throughout this exercise, the most important and difficult part of any local government reform effort lies in determining what functions these governments should have, and how they should be funded. And to figure this out, each sector and the budget of its respective ministry has to be carefully reviewed to determine which functions in which sectors might reasonably be assigned to local governments, as well as how much money the national government is currently spending on these functions.

Consider for a moment education. Since the passage of PSFM Law, the Ministry of Education, through its representatives at the Aimag level is directly responsible for all spending on pre-schools and general education schools. Money, however, flows to schools in two streams, one that is based on the number of pupils attending a given school and which can only be used for paying teachers wages, and another significantly smaller steamer that goes to schools to pay their operating costs, including the wages on non-pedagogical personnel²⁹.

Making local governments responsible for teachers pay is probably not a good idea for at least two fundamental reasons. First, and most importantly the national government still controls wage rates and probably should do so for the foreseeable future. Second, the national government is currently involved in the inevitably messy and politically painful business of rationalizing employment in Mongolia's schools, and dumping this problem on newly established local governments is not a good way to start a successful reform process.

²⁸World Bank Policy Note, *Mongolia's Regional Development Selected Issues*, August 2005, pg 1-25. Get other cites.

²⁹ World Bank, *Public Financing of Education in Mongolia: Equity and Efficiency Implications*, September 2006, pp. 1-77

On the other hand, it would probably make sense to make local governments the owners of school buildings, and to assign to them the responsibility for maintaining and improving school facilities, including the responsibility for paying the wages on non-pedagogical personnel. In this case the stream of funding that currently goes to individual schools for operations and maintenance would be “sent” to local governments, either as a categorical grant for pre-university education, or as part of their general revenues.

If local governments received the money through categorical grants they would only be able to spend it on education. If they received it as part of their general revenues, they would be able to spend it on whatever they prefer, but they would still be the legal owners of school facilities and responsible for maintaining and improving them. In both cases, however, local governments would be responsible for determining how to allocate their education resources –education budgets-- between schools located in their jurisdictions. And because of this they would have a direct interest in ensuring that this money was used efficiently by, for example, improving heating systems, making sure that water and electricity was not wasted, and by both reducing and reallocating non-pedagogical labor across schools.

Moreover, the experience from post-communist Europe is that one of the things that local governments take most seriously –if provided at least some of the funds necessary to do so—is investment into school facilities. This makes perfect sense given how seriously citizens (read: voters) take the education of their children. Indeed, where ever local governments have been assigned responsibilities in the education sector and have been provided with reasonable revenues, they have quickly increased the total amount of public money spent on schooling³⁰.

Under such a reform, the education departments of the regional (Aimag) governments would continue to pay the salaries of all teachers according to the formula set by the Ministry of Education. They would also continue to ensure that all schools met the standards set by the Ministry. Finally, they would remain responsible for allocating money for operating and investment costs to schools in Soums that had not been transformed into local governments during the initial phase of the reform.

But those Soums that had been granted local government status would receive --at least at the beginning of the process-- a categorical grant for school maintenance and improvement that they could spend across schools as they see fit. Moreover they would be free to contribute to school budgets or school investment projects whatever money they wanted to from their general revenues.

Similar arrangements are conceivable in the health and social welfare sectors. In health, however, I would propose to limit local government involvement in the sector only to primary health care clinics and not general purpose hospitals. The most

³⁰ See Ken Davey, **Balancing National and Local Responsibilities: Education Management and Finance in Four Central European Countries**, Open Society Institute, Local Government Initiative, Budapest, 2002. For the Polish experience see the essay in the same volume by Tony Levitas and Jan Herczynski *Decentralization, Local Governments and Education Reform and Finance in Poland: 1990-1999*, p. 113-191.

important reason for this is that the general purpose hospitals that are located in Aimag Centers serve the citizens of many Soums. As a result, assigning ownership and responsibility for maintaining them to the Soum in which they are located means that this Soum de facto becomes responsible for providing services to people who live elsewhere. And because these services cost money to provide, there is a risk that the Soum will eventually try to reduce access to the hospital for non-residents in effort to control its costs³¹..

On the other hand, local governments should have wider powers in areas like culture and sports. In other words, I would not only recommend giving them ownership over local cultural institutions, but I would assign them full responsibility for the service. This means that they would assume full control over the existing institutions, including responsibility for hiring, firing and paying personnel. Indeed, local governments should have the freedom to decide how they want to provide cultural services to their citizens, including even the right to close existing institutions, and to develop new or alternative programs³². And to reflect the status of these responsibilities as true local government own-functions, I would recommend providing them with the funds for these responsibilities not through a categorical grant, but through their general revenues.

But again, the first step in determining how much general revenue they would need for providing “cultural services” would be to analyze the spending on local cultural institutions that is currently paid for through the Ministry of Education’s budget. Here, however, we are likely to encounter the problem of “uneven institutional endowments” that we discussed earlier (see pages 11-12). As a result, decisions would have to be made about how to resolve the inevitable financial tensions that occur when we decentralize a service and not just the institutions presently delivering that service.

Most fundamentally, local governments would have to be assigned clear responsibility for managing and improving “basal metabolic” urban functions, meaning those functions without which complex human settlement is impossible: In other words, water supply; sewage treatment; solid waste collection and disposal; central heating; local roads³³; street-lighting; parks; cemeteries; and public markets.

The most challenging problem in this area probably concerns determining what exact powers should be given to local governments with respect to water supply and sewage treatment. This is a particular challenge in Mongolia today because water is a scarce resource that has to be carefully husbanded, and because the current

³¹ The literature on public finance calls this problem, the free rider problem because people from outside the jurisdiction are getting to use or “ride” the service without paying for it.

³² The right to close existing institutions might initially be limited by requiring higher level approval.

³³ Given the vast distance between settlements within Soums, responsibility for local roads might have to be defined in terms of the roads within and immediately around settlement areas. This would continue to leave the national government responsible for maintaining and improving the roads between settlements within Soums.

division of responsibilities in the sector is very unclear and very fragmented³⁴. As a result, considerable effort will have to be devoted to mapping where existing responsibilities for water supply and treatment lie before determining which of these responsibilities should be transferred to the new local governments.

And as with the other sectors that we have discussed, the budgets of the relevant line Ministries will have to be examined in order to determine how much money the national government is currently spending on these services. Unlike with Education and Culture, spending on these services will be harder to identify for at least three reasons.

First, much of the spending will come from different Ministries and information will have to be pieced together to get a reasonable picture of what is going on in reality. Second, it will be harder to identify how much spending is of a purely local character and how much of it is really for the regional or national “parts” of the same function. Third, in many cases it will be hard to distinguish operating and maintenance costs from investment expenditures. And fourth, and perhaps most importantly, the national government is probably under spending on these functions now.

As a result, it is especially important in estimating the revenue needs of local governments for these “basal metabolic purposes” that an effort be made to ensure that the revenue they receive for them is truly adequate. Or put more simply, that more money go to the local level for these services than is currently being spent on them now. At the same time, the current restrictions on the maximum size of local investments would have to be lifted or relaxed, as would the rules requiring that all investments be procured through the Ministry of Construction and Urban Development.

As we have indicated earlier however, we think there are very good reasons for putting more money at the local level, though how much money is always debatable and certainly awaits greater empirical analysis. First, Mongolia’s GDP is growing at a nice pace and will probably continue to expand rapidly with the development of the mining industry. Second, Mongolia spends too little of its GDP on investment --4.7% as opposed to c.10% internationally.

And third, Mongolia is currently under spending its own investment targets, at least in part because the central government agencies responsible for preparing and tendering investments appear to be overloaded³⁵. In short, by putting more money for the maintenance and improvement of these “basal metabolic functions” in the hands of truly independent local governments, Mongolia would not only ensure that people took their local governments very seriously, but would probably be improving the overall effectiveness of its investment spending as well.

None of this is meant as an argument for allocating large amounts of funds on newly created local governments. Nor is it an argument for relaxing standards on financial

³⁴ See D. Basandorj and Satyajit Singh, (DRAFT) *Restoring the Image of Blue Mongolia: Rural Water Supply and Sanitation*, UNICEF & UNDP, Ulaanbaatar, 2008.

³⁵ See again, World Bank, *Mongolia Quarterly*, February 2008, pp. 1-24, especially pgs. 4-7; interviews with officials at the Ministry of Urban Construction and Development.

reporting, investment preparation, or procurement. On the contrary, local government budgets should be expanded modestly and –like other public sector entities—they should be held to rigorous standards. Moreover, and obviously the great gains in public sector accountability made possible by the Treasury System should continue to be protected and extended.

What it is an argument for, however, is treating Mongolia’s local governments –and by extension-- the citizens of a new and still developing democracy as young adults and not children. In other words, and again, the basic idea is to grow people into taking responsibility for managing the public circumstances of their everyday lives, and to do so by clearly defining what the expectations are, and by giving them the resources necessary to meet these expectations.

As a legal, or more exactly a constitutional matter, how this should be done is an open question. Ideally, the constitution would be amended so as to clearly define Soums as the basic institution of local government in Mongolia with both democratically elected Hurals and democratically elected Governors³⁶. At the same time, Aimags would be defined as territorial units of the National government with state appointed Governors, though here I see no reason why Aimag councils could not be retained as consultative bodies.

The meaning of these changes would then be extended downward in the legal system through a new Law on Local Governments, and amendments to the existing Law on the Administrative and Territorial Units of Mongolia and their Governance. Together this legislation would clearly specify the new division of responsibilities between state and local governments. The Law on Local Governments would also contain clear transitional provisions that defined which Soums were to become local governments immediately, and on what basis other Soums would be granted this status over time. Similarly, transitional rules governing the relation of Aimags governments to those Soums that had not yet been given local government status would have to be defined.

A less desirable option would be to maintain the existing system of vertically appointed governors at all levels of the system, and only amend the Law on the Administrative and Territorial Units to more clearly specify the service responsibilities of Aimags and Soums. Indeed, given how difficult it is to change a country’s constitution, this option may be the only politically realistic one at the moment.

Nonetheless, by not eliminating the language in the Constitution that requires the dual subordination of governors at all levels of the system, this option continues to blur the line between local and national institutions. Moreover, it does not send a clear signal to either politicians or citizens that the rules of the game are changing and that there are new expectations for local governments and local citizens. Finally, and perhaps most importantly in practice, by leaving in place the system of state appointed (Soum) governors this option means that Mongolia’s local governments will always be at risk of political manipulation from above.

³⁶ Soum governors could obviously be elected indirectly by their Hurals, or directly elected by citizens.

For all of these reasons, constitutional reform would be extremely desirable. Nonetheless, I think significant gains can be made if, as I have suggested, state and local government functions are more clearly defined. In all circumstances, however, the real litmus test of any new system will be whether this separation of public sector service responsibilities is accompanied by the development of new Law on Local Government Finance.

As we have indicated, the purpose of this law is to give local governments independent budgets, and adequate, predictable and transparent revenues. As such it would require abandoning the current idea that in a unitary state there can only be one real budget. Luckily, however, this idea is not enshrined in the constitution and thus the development of such a law would not require constitutional amendments. It would however, require amendments to the PSFM Law and the General Law on Budgets. Here, the basic idea is to ensure that the same basic principles and procedures applied to the construction, execution, and reporting of local government budgets as they do to the national budget, but that these budgets are conceived of as separate constructs that are ultimately controlled by Soum Hurals.

Most importantly, the Law on Local Government Finance has to specify precisely define the own revenue powers of local governments; the shared taxes that they will be entitled to; and the nature of all categorical and general grants, including the size of the grant pools, and the formulas by which they should be allocated. And as we have indicated the development of the specific features of this law cannot be separated from the effort to define which responsibilities should be assigned to local governments for the simple reason that the total amount of revenues that the law should “give” them, must be directly connected to estimations of the costs that they are likely to incur in providing these same responsibilities.

As a result, both legal and financial work must be carried out more or less simultaneously. Equally importantly, there is no one right answer to how the law should define how much of which types of revenues local governments should be entitled to. On the contrary, there are many different ways this can be done. What is important to understand however, is that the proportion of revenues that local governments are expected to receive from different sources will have different distributional effects on their per capita revenues, and that under all circumstances there will be a need for both categorical and equalizing general grants.

And here the central problem is how to define the size of grant pools, and the formulas that are used to allocate them, in such a way as to make them reasonably predictable from year to year. Or put another way, the key problem is how to prevent the need for grants becoming an excuse for the national government to determine every year which local governments receive them and which don't, and how much each should get.

There are a number of different ways this critical problem can be resolved. But the simplest and most effective one in my experience is to define the size of the general or equalizing grant pool as some percentage of the national yield of a few buoyant taxes that will grow with the overall economy. In Mongolia, the obvious candidates for these taxes would be the VAT and the Mineral Tax. As the economy grows the

share of these taxes that would go to local governments through the grant system would automatically increase as well.

At the same time the law would contain the formula by which this pool would be allocated to all local governments every year, less desirably, lay out its basic principles, leaving the actual formula to be specified by government ordinance every few years, and only after consultation with the representative institutions of local governments themselves. In all cases, however, the law should create an institutional framework for the permanent discussion of local government issues, particularly those that effect local government finances because the issues here never go away³⁷.

But again, and in conclusion, the most important task facing Mongolia today is to more clearly define the rights and responsibilities of local governments and to provide them with independent budgets and the adequate, predictable and transparent revenues that will allow them to rationally execute their responsibilities. For all the reasons we have discussed, this is not any easy task anywhere. Moreover, the unique demographic, topographic and historical circumstances of Mongolia will make it perhaps harder here than elsewhere.

At the same time, creating viable and dynamic local governments is not rocket science either. Indeed, I firmly believe that if the new Parliament of Mongolia decided to take local government reform seriously, a complete reform package could be developed before the middle of next year and prepared for implementation for fiscal year 2010.

³⁷ Typically this is done by creating a Commission for Intergovernmental Affairs that include representatives of the national government and representatives drawn from the membership of local government associations, and requiring it to meet on a regular basis.

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Annex

Next Steps in Preparing a Comprehensive Reform of State-Local Relations in Mongolia

Step I: The Creation of a Working Group on the Reform of State-Local Relations

The preparation and execution of a comprehensive reform of State-Local relations will require a Working Group that ideally has the support of the Government and which contains leading figures from the most important political parties and representatives of key Ministries. The Group should have between 7 and 12 members should be officially charged with supervising the research and policy necessary to prepare such a reform, and ultimately for drafting and/or vetting the new legislation that will be necessary to implement it. This Working Group should be constituted as quickly as possible.

Step II. Determination of Possible Reform Paths

The most important decision facing the Working Group is whether the reform of state-local government relations should take place within the existing constitutional arrangements –arrangements which we have argued, make it difficult to create truly independent local governments-- or whether reform should proceed on the assumption that the Constitution can and should be changed.

Ideally, this decision would take place immediately, because it would make the framework for the entire effort much clear. And obviously my own personal feeling is that the best decision would be one that accepts that the Constitution can and should be changed. But as I have indicated, the fundamental work of determining what local governments should do, and how they receive the revenues they need to do it, will be very similar under all reform scenarios. Indeed, because of this, it is possible to postpone this fundamental decision until some of the basic work on local government functions and finances is gets done.

Step III. Preparing the grounds for determining which functions should be assigned to Local Governments and how they should be financed.

The foundation of any real reform will lie first in clearly separating national government functions from local governments by defining what local governments should do, and then in determining how local governments should be financed. The final decisions about which functions local governments should have and how they should be financed are political decisions. But these political decisions must be based on strong empirical analysis and –ultimately—on financial simulations of the consequences of different possible functional assignments.

Conducting this empirical research should not be the work of the Working Group. But the Working Group must coordinate its execution and be its recipient. Moreover, because the work will require considerable research into the organization and finances of particular Ministries the work must have the strong political support of the Working Group.

In the rest of this section I briefly outline the types of research and analyses that must be conducted both with respect to determining local government functions and with respect to the design and simulation of new revenue mechanisms. The two strands of the research –functions and finances— should be carried out in parallel with each other and if aggressively pursued can be completed in six to eight months.

A. Sectoral Analyses of Functions, Institutions, and Regulatory powers that should/might be transferred to Local Governments

The precondition of any local government reform strategy in Mongolia is a much clearer division of the precise functions (and their costs) that will or should be assigned to local governments. In theory, all sectors should be analyzed to figure out which particular functions within them should be transferred to local governments and with what sorts of funding. In practice, however, it is best to start with the most important sectors first because each sector will have different characteristics and will require somewhat different methodologies.

Virtually all public functions involve some combination of institutionalized service delivery, regulatory power, and the practical power to make investments. But some involve more of one thing than the other, and it is useful to distinguish between functions that are primarily about delivering –usually through existing institutions (with existing budgets and costs)-- public services such as preschool education, primary education; functions that are primarily about decision making power and regulatory authority, such as Urban Planning; and functions that are primarily about both investment money and regulatory power, such as water supply.

Work should be conducted in a couple of sectors where we know we are talking primarily about the devolution of managerial and financial responsibility to local governments for the running of existing institutions; and in a couple of sectors where we are talking primarily about regulatory and investment powers. With regards to the former, I would suggest looking at culture and education first. With regards to the latter, I would suggest looking at Urban Planning and Construction and Water supply and waste water treatment examples of the other. Once the research teams become familiar with doing this type of work it should be extended to other sectors like health, agriculture, solid waste, and social welfare.

To do this work, research teams should be formed that contain individuals with: Knowledge of particular sectors; Excel skills and the ability to read budgets; Legal skills and the ability to determine where decision make power lies; Sociological skills and the ability to analyze what existing institution do or don't do, and which actors in the “system” have the capacity to assume existing or new responsibilities. Below, I briefly describe how each sector might be approached.

A.1. Culture

At the moment the national government basically runs all cultural institutions and policies through the Ministry of Education and its aimag officers, though at the Aimag and Soum levels, policies and practice may be influenced by “local government” governors, and hurals. In particular, the national government maintains and pays for museums, libraries, theatres, theatre troops, and cultural centers.

The first step is thus to figure out which of these institutions should be transferred to local governments. For example, the national museum or national library should not –by definition-- be transferred to local governments; local theatres, cultural centers, libraries and museums probably should. The second step is to map the distribution of these institutions across Soums and Aimags to determine whether the “function” is currently being provided everywhere, or more exactly, how uneven the existing distribution of cultural institutions is.

The third step is to enrich this map by determining how much money is currently being spent by the national government to operate and maintain these institutions (wages and other operating costs) in different jurisdictions. In other words, it is necessary to current expenditures in the sector in order to think about the scale of revenues that should accompany the devolved responsibilities and to determine how difficult it will be to:

- *decentralize the function* (providing local governments with money on the basis of the number of citizens that the function should serve)
- *decentralize the institutions* (providing local governments with money on the basis of the historical costs of the –unevenly distributed—institutions associated with delivering function)
- some combination of the two.

The fourth step is to figure out how much the national government has been investing in “local” cultural institutions, and to determine how much of this current (or enlarged) investment budget should be put into the local government revenue system “for”, but not necessarily earmarked directly, to culture.

In the area of culture, I would argue that local governments should have full control over the relevant institutions, meaning that they should not only be made the owners and operators of the concerned institutions, but they should also be responsible for opening and closing them, and for hiring and firing personnel. This means that the analysis of the sector should include an analysis of the actual ability of local governments to hire and fire people, as well as the possible difficulties –legal and practical—with assigning them property rights over these institutions.

A.2 Education

The situation in education is both similar to and different from that in they area of culture. Given the current system of funding education, and the greater visibility and universality of the function, it should be relatively easy to map the distribution of kindergartens, general education schools, and dormitories, as well as to distinguish between funding for teachers wages, and funding for the wages of all other staff as well as for all other operating costs. Similarly, it should be relatively easy to figure out how much the national government has been spending on investments in the school facilities over the past few years as well as to make some assumptions about how much investment could and should be made over the coming years.

On the other hand, because teachers wages are such a large share of total public spending, and because for the foreseeable future the national government is going

to set teachers wages, it is probably imprudent to think about making local governments entirely responsible for the finance and management of kindergartens and schools. In other words, I would not try to make them responsible for teachers wages (and the allocation of the pedagogical labor force across schools) because they probably lack the capacity to manage this task now; because it will prompt fierce resistance from both MoF and the Ministry of Education; and because so long as the national government sets teachers wages splitting the responsibility for setting teachers wages and paying them can be dangerous.

Local governments however could be made the owners of schools and kindergartens and responsible for the maintenance, operation, and improvement (read new investment) of school facilities. In this division, they could also be responsible for the hiring, firing and payment of the wages on non-pedagogical personnel. As such, they would be responsible for allocating (determining school budgets for) material costs, media (water, electricity, heating fuel), repairs, investments, and non-pedagogical staff.

So a study designed to help us concretize such a proposal would have to:

- Map the geographical distribution of these expenditures now, and their relation to enrollment, school (size), dormitories and dormitory students.
- The size and use of investment funds in the sector
- The legal and practical obstacles to making local governments the owners of school facilities
- The legal and practical obstacles to making them responsible for hiring and firing non-pedagogical personnel (are these persons covered by the civil service law, for example, and if so what does it mean)
- What the budget process between schools and local governments should look like with respect to operating costs and investments.
- Should the right to open or close a school facility or part of it (e.g. a dormitory) should be subject to Min of Ed approval.
- And perhaps above all, should these responsibilities (including property rights) be assigned to Aimags or Souns, and why.

As with culture, once ideas about which functions should be transferred to local governments, and how much these functions should cost, decisions would have to be made about how this funding should be provided to local governments. Here the first question is should local governments receive these funds as part of their general revenues –in which case they could spend it on anything—or should they receive them as a categorical which could only be spent on education. My guess is that in the initial years of reform it is probably more prudent to require that it be a categorical grant.

The second question that needs to be answered is how to ensure that the size of this categorical grant grows with the overall economy so that local governments can make improvements in their education facilities at least as rapidly as the overall growth in the economy. The best way to do this is to “anchor” the size of the categorical grant by expressing it in law as either a percentage of the overall GDP, or percentage of the national government tax revenues. These provisions should be put into the new Law on Local Government Finance under the chapter concerning grants and transfers.

The third question that needs to be answered is what formula should be used to allocate this categorical grant pool across local governments, a whether the formula should be stated in law, or just the procedures governing its determination. The basis for answering this question requires reviewing the formula that the Ministry of Education is currently using to allocate non-pedagogical education costs to schools. Here, it should be relatively easy to modify the formula so that funds are allocated to local governments. But the provisions in the new local on government finance law should either contain the formula itself, or define the procedures by which its set, periodically reviewed, and amended.

A.3 Water and Sewage Management and Water Infrastructure Improvement

The existing system for the management and financing of wells, water supply and sewage systems in Mongolia today is both very centralized and very fragmented in the sense that responsibilities are dispersed across a wide number of ministries. At the same time, it is an absolutely critical “local” function and the one about which citizens are probably most concerned because in many places they spend huge amounts of time, energy and probably money trying to get clean, safe drinking water.

So this is a sector that is both hard to figure out and necessary to figure out. A recent report (still in draft form) conducted for the UNDP gives a reasonable picture of the problems, but does not contain clear proposal for solutions³⁸. More importantly, while it “sees” the problem of local governments in the system, it is very unclear about what their future role should be.

This role must however, be defined. My basic assumption is that local governments should probably be assigned primary responsibility for at least water supply, meaning digging wells; building pumping stations, laying pipes, and organizing the sale and delivery of water to citizens. They should be allowed to run public companies for this purpose, as well as to contract some or all of these services through private companies.

The money needed to maintain and improve these services should come through a combination of local government “general revenues” and the fees and charges that citizens pay for water. In as much as some of the money for future investment will come from local government budgets, the revenue system must give them at least some of the money currently spent by the national government on investments in the sector. In other words, while some money for making improvements in these systems will come from user fees and charges, and other money will continue to come from grants from the central government (and donors), the general revenue system must be designed to give local government enough disposable income to make some of these investments on their own.

³⁸ D. Basandorj and Satyajit Singh, (DRAFT) *Restoring the Image of Blue Mongolia: Rural Water Supply and Sanitation*, UNICEF & UNDP, Ulaanbaatar, 2008. pp. 1-57

Equally, importantly, the analysis of the sector must contain a serious examination of the regulatory authorities that are currently dispersed across sectors, and which ones must be given to local governments to give them effective control over the responsibility they have been assigned, and which ones should be retained by the national government, and where. In other words the research in the sector must be designed to answer the following sorts of questions:

- Who is responsible for maintaining water systems now?
- Who owns which assets?
- Who set prices?
- Who makes investment decisions concerning the digging of new wells and the extension or improvement of existing systems?
- What sectoral laws would have to be amended to assign local governments primary responsibility for water supply?
- What regulatory authority should remain in the hands of which state agencies?
- How much money is being spent on investments in the sector now, and how much of this investment could be reasonably assigned to local governments?

A.4 Urban Planning and Construction

This is also a difficult sector because the right to determine how land is used and developed has both local and national implications and is usually shared between national and local governments. Indeed, this is true in Mongolia today but many of the rules governing who does what are unclear, and there seem to be many different national government agencies involved in making land use and planning decisions, as well as funding different types of urban infrastructure such as local roads, solid waste facilities, and again water.

Thus, and as with the water sector, the first step necessary for making policy decisions about who should do what, and with what money requires mapping the existing division of competencies in the sector across local and national government institutions. It also requires determining how much national government investment money is currently being spent on basic urban infrastructure, and how much of this money should eventually be given to local governments through the intergovernmental finance system.

The research team assigned to investigate these issues should answer the following sorts of questions.

- Who owns the property rights to what kinds of “unused” public property?
- What are the procedures for privatization?
- What are the current procedures for determining general and detailed urban plans and for issuing building permits?
- How much control over these procedures do local governments currently have, and which ones should be assigned to them in the future?
- What sectoral laws would have to be amended to assign these powers to local governments?

- How much of the national investment budget is currently being spent on general urban infrastructure that can be considered local and which should be included in the general revenues of local governments?

B1. Data Base on the Origin of Public Revenues and the Relative Wealth of Soums and Aimags

Parallel to the work that must be conducted to determine which functions should be assigned to which level of governments, data bases must be built that will eventually make possible the design of a new revenue system for the independent budgets of local governments. The first data is on the origins of all public revenues and it is necessary to be able:

- See and eventually simulate, the amount of money each local government would receive if they were assigned X% share of tax A; Y% share of tax B; and given control of taxes, fees and charges C, D, and E.
- To determine the relative wealth (tax bases) of different local governments in order to design a general grant and/or equalization system that would provide all or some local governments with additional moneys because the yield of shared taxes and/or own fees, charges and taxes that can be assigned to them will remain insufficient to allow them to adequately fund their (new) expenditure responsibilities (public sector functions).

Creating such a data base will be a challenge because:

- The existing definitions of what constitutes state and local taxes is inconsistent and is technically incorrect (there are no real local taxes, only shared taxes in the current system).
- In part because of these bad definitions the origin and flow of revenue from different taxes are not consistently recorded. The wage tax, for example, of at least large firms is transferred directly to Ulaanbataar and is not recorded (at least in the budgets of Aimags or soums) by its point of origin. To determine the relative wealth of local governments in Mongolia (for grant design) and how much a potential share of the wage tax would yield in each local government (as a general revenue) we need information on the yield of this tax by point of origin.
- Information on tax rates, as well as the rates that particular taxes are being shared with local governments is dispersed over many pieces of legislation. For example, according to the Law on the Personal income tax the rate of the livestock tax is being charged differently in different Aimags. This means that the interpretation of the data on the yield of the tax that should be gotten from MoF will have to be “standardized” (set at a uniform rate) to do simulations. Meanwhile, it remains unclear to whether this tax is being given entirely to Aimags, or some of it is being shared with Soums, and if so according to what rules. As such, the creation of the data base must be accompanied by legal research on:
 - The base of all taxes, fees and charges
 - The rates of all taxes, fees and charges
 - The rates at which these fees charges are being “shared” or assigned to local governments.

- At the moment, Soum budgets are virtually invisible so seeing their revenue sources –and separating them out from the revenues and transfers they “receive” from the Aimags is very difficult, and perhaps even impossible. Hopefully, however, MoF and/or the treasury system codes the origin of every revenue by Soum. If so, we ought to be able to build a data base, based on the “relative wealth of Soums” and then aggregate it up to create a data base on the relative wealth of Aimags. If not, we have to build the data base on the basis of information at the aimag level and impute (guesstimate) downwards. For many reasons this is much less desirable.
- The relative wealth of jurisdictions in Mongolia will be changing rapidly with the development of the extractive industries. As a result, the data base would ideally contain information on where new mining revenues are likely to come on line in the foreseeable future.

The data base should be built on actual and not planned numbers, and we should build it on data *from the same source*. The data must be official data, and therefore the key institutional requirement for creating the data base is the cooperation of MoF. Ideally the data base would be for 2006, 2007 and eventually 2008. Since data collection is improving it is probably best to start with 2007 and then work forwards and backwards from there. The data should be organized in excel work sheets with Aimags and Soums in rows, and revenue sources in columns. Each year should be separate.

B.2 Data base on Demographic and Institutional Characteristics of Soums and Aimags

Parallel to, but distinct from the data base on the “relative wealth of local governments and the origins of public revenues”, a data base will need to be created on demographic and institutional characteristics of Soums and Aimags. The information needed for this data base will come from a variety of different sources, but most importantly from the State Statistical Office and from the sectoral studies we have discussed earlier.

As with revenue data, demographic and institutional data should be entered into Excel sheets with Soums and Aimags and rows, and demographic and institutional data in columns. The purpose of this data base is to be able to map, where people live, under what conditions, and what public service institutions serve them in each jurisdiction.

Some of this data will be important for thinking about the revenue and expenditure needs of local governments and some will be important for mapping the uneven distribution of important local public service institutions across the country so as to better understand local investment needs.

The data base should contain information on: Population, area in Km², number of bags and khoros; Percent of herders; percent living in gers; Poverty rates; Number of families receiving different types of state aid; Percent of population with electricity, piped water, trucked water, dug wells; Number and type of public utilities with employment, and or privatized public service companies; Employment and Unemployment (rates, absolute numbers), Livestock; Veterinary Stations (number,

employment); Schools (types, enrollment and employment); Hospitals (beds, employment); Health clinics and doctors, nurses; Number of registered companies, legal entities; Number of registered NGO, civil society institution; Mortality, fertility – Human Development Indexes; Number of libraries, cultural centers, theatres, museums, sports facilities (with employment); Km of paved and unpaid roads; Distance from Aimag center; Distance from nearest Soum; Water treatment plant, year of construction; Solid waste dumps; Existence and nature of any public transport systems; Existing mines, by type, employment, (tax) revenue; Mineral Exploration licenses,

Step IV. Developing concrete proposals for the definition of new local government functions their situation in law

The research and policy agenda sketch out above should allow the Working Group to develop concrete proposals for the definition of a new division of state and local government functions, as well as new the development of a new law on local government finance.

As we have indicated before, the key political question is whether or not the constitution can or should be amended. At a minimum an amended constitution would do away with the requirement that the governors (or mayors) be approved by higher level officials. It would also contain new provisions defining Aimags as deconcentrated administrative units of the national government and Soums and the Capital City as Mongolia's basic units of local government. The constitution should also contain provisions that state that the process by which Soums are granted full status as local governments is to be defined in a (new) Law on Local Government. This will allow policy makers to design a progressive strategy for transforming existing Soums into truly independent government

If such constitutional amendments are considered possible, then the Working Group would begin drafting a new Law on Local Government and a new Law on State Territorial Administration. Taken together these two laws would clearly define which functions and responsibilities were to remain with the national government at the Aimag level and which functions were to be transferred (over time) to Soums and the Capital City.

At a minimum, the Law on Local Government would contain chapters on the relation between the executive and legislative components of local governments; the local government budget process; local government financial reporting; the relationship between Soums, Bags and Horoos; and above all the rights and responsibilities (functions) of Soums as independent local governments. It would also contain transitional provisions governing the criteria and procedures for progressively granting Soums the status of local governments.

Because of the importance of Ulaanbaatar, and because the size of the city undoubtedly allows for the possibility of assigning it more functions than other jurisdictions, a special law on the Capital City should be drafted in parallel with the new Law on Local Governments. At a minimum, this law should define the additional functions that the City might be assigned; the rules governing the special relationship

between the City and the national government as the capital city; and the relationship between the City and its districts, bags and hooros.

A new Law on State and Territorial Administration would, in turn, define the organizational structure of Aimags; the power of the Governor and his authority with respect to the different line ministries operating at the Aimag level; the basic functions and responsibilities of both the governor and the line ministry representatives; the authority and responsibilities of any directly or indirectly advisory council created (or maintained) at the Aimag level, and the powers of oversight that Aimags would have with respect to independent local governments . It would also contain provision about the oversight role Aimags would perform with respect to Soums that had been granted the status of local governments as well as transitional provision concerning their powers vis-à-vis Soums that had not yet been given that status.

If however, policy makers decide that the constitution cannot or should not be changed than the existing law on State and Territorial Administration would have to amended in such a way as to as define as clearly as possible the division of function between Aimag and Soum levels. This will be more difficult than drafting new legislation because it will be in many ways like sew in cloth on to old. Nonetheless it is certain possible to do this.

Under either scenario, however, the PSMFL would also have to be amended. Here the crucial amendments concern less the procedures governing how public expenditures are made, than with making a clear distinction between local and national government institutions. In other words, the law has to be amended to make possible the creation of independent local government budgets, and to define local governments as managers of these budgets. But many if not all of the rules governing how and on what basis public expenditures can be made, can be retained.

Moreover, and under either scenario, a new Law on Local Government Finance must be drafted.

Step V. The Development of a New Law on Local Government Finance

Once the functions which local governments will be assigned have been determined, and the costs associated with each estimated, it becomes possible to draft a new Law on Local Government Finances. The fundamental purpose of this law is to provide local governments with adequate, predictable and transparent revenues and to separate the determination of local government budgets from the determination of the national budget.

As we have already indicated, the specific provisions of the law governing how much revenue local governments are expected to raise on from own-sources and how much they can expect to get from various grants and shared taxes have to be designed so that together they yield funds equal to the total costs of the expenditure responsibilities that will be assigned to them.

There are many possible ways this can be achieved, and the share of funds local governments receive through grants, shared taxes and own sources have different

policy implications, particularly with respect to how much inequality in local government revenues policy makers consider acceptable. For these and other reasons, the drafting of the Law must be accompanied by the conduct of financial simulations that show what the consequences financial consequences of different rules are for different types of local governments. Under all circumstances, however, the Law on Local Government Finance should define:

- The nature and type of all local government own fees, charges and taxes and the nature of their rate setting powers.
- All shared taxes and the rates at which they will be shared with local governments
- The nature of all categorical grants for (permanent) delegated functions (like primary education). The rules governing such categorical grants should specify the following:
 - How the size of the grant pool should be determined every year. This should be done by defining (“anchoring”) the size of the grant pool in some easily calculable way such as;
 - the grant pool should be no less than the size of last years grant pool adjusted upwards for inflation and GDP growth;
 - no less than X% of the central government revenues for A,B,C (or all) taxes for the previous fiscal year ;
 - no less than Y% of the GDP from the previous fiscal year.
 - The specific formula used for allocating the grant, or the basic principles behind the formula that will be used to allocate the grant. In the latter case the law should specify when and between whom the formula will be discussed and ultimately approved.
- The nature of all general grants, including especially equalization grants. As with categorical grants for delegated purposes the rules should make the size and the allocation of these funds more or less automatic by specifying how the grant pool should be determined, and by defining at least the basis on which the formula is to be allocated.
- The nature and procedures by which all categorical grants for specific (one time) purposes will be determined and allocated.
- Rules governing local government borrowing including the nature of any limitations on the right to incur debt or issue guarantees.
- Rules requiring the establishment, role and powers of an intergovernmental finance commission. This commission should be composed of representatives of the national government and representatives of local governments and it should be required to meet on a regular basis to review all legislation that can affect local government revenues or expenditures.

Step VI Preparing for a New Local Government Regime

In the best of all possible worlds, a more or less complete package of reform legislation could be prepared by the Working Group by the beginning of second quarter of 2009. Ideally, the legislation would be prepared in close cooperation with the government, and could be passed by the beginning of the third quarter for implementation in 2010. This however, is a very ambitious schedule.

Under all circumstances however, the passage of the new legislation must be accompanied by a public relations campaign designed to inform citizens of the new rights and responsibilities of local governments, as well as training programs designed to prepare local government officials for their new duties. Both of these endeavors will require significant donor support and donor coordination.