**DDLGN f2f follow up (2016)**
**Country Case Studies on Intergovernmental Transfer Schemes and SDC support: Mongolia**

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## 1. The Local Development Fund (LDF), its objectives and design elements

The important changes to intergovernmental fiscal relations introduced by the 2011 Budget Law have strengthened decentralization in Mongolia. The IBL redefines functions of subnational governments as well as local taxes, shared taxes and fiscal transfers.

SDC has been supporting the new transfer called "Local Development Fund – LDF", which shifts more financial resources to the sub-national level to finance the investments related to their functions. SDC is not contributing financially to the LDF but through different mandates, it supports execution mechanisms at the local level. The LDF is a block transfer to finance investments needs of local governments. It was created during a mining revenue boom. The legal base of the revenue sharing transfer - LDF was established in the Budget Law of 2011. The funding sources of the LDF are constituted by 25% of domestic VAT collection, 5% of the "mineral resource exploitation tax revenue" and part of the budget surplus of the richer sub-national governments. For 2013, the LDF was financed for 77% from the VAT, 11% from the mineral tax revenue and 12% from local budget surpluses respectively. The total pool of funds is a part of the state budget that is allocated to each local jurisdiction by formula.

The formula for the allocation of the LDF between local governments takes into account a local development index, population, population density, remoteness and the size of the territory as well as tax effort. Therefore, the LDF is intended to compensate for lower levels of development, higher costs for providing public services and reward fiscal responsibility. In other words, it addresses both vertical imbalances (as the expenditure needs for local governments often exceed their revenue capacity) and horizontal imbalances.

The Budget Law assigns the Ministry of Finance (MoF) the responsibility to monitor the use of the LDF as it does for any other funds executed by local governments. The MoF has also to develop the needed accounting standards and execute audits and inspections. All flows of funds move through treasury accounts at the Bank of Mongolia. Local treasurers are placed under the authority of local governors. Besides the MoF, local assemblies conduct monitoring on the LDF as well as on any other funds executed by local government. The MoF can withhold temporarily the revenue transfers if the budget legislation is breached.

Another important change introduced by the Budget Law is a provision mandating citizen participation in the budgeting process, particularity on the utilization of LDF. Citizens and their organizations have also a monitoring right regarding the local execution of the LDF. Local governments have to discuss possible citizens' findings on LDF execution during a special session and take the relevant measures. According to the same order of the MoF on LDF execution, local governments have to establish a regularly updated database on LDF execution and send it to the MoF which is in charge to make it public.

## 2. The LDF within the intergovernmental transfer system

According to the Budget Law, sub-national revenue comprises of own source tax revenue and central government transfers. There is also a transfer from sub-national governments to the central government. The amount of the latter transfer is determined as the surplus of the current budget. Part of it must be used to finance the LDF as mentioned above. The rest is used to finance the deficits of the current budgets of poorer sub-national governments.

Transfers to local governments are organized in three pillars: 1) a transfer to finance the deficits of basic, current local budgets, known as "Filling-the-gap transfer", 2) a revenue sharing transfer (LDF) to finance local investments, and 3) conditional or special purpose transfers (earmarked transfers).

Central government transfers are an important source of revenue for sub-national governments. For 2013, according to the MoF, the share of subnational governments' expenditures in total public expenditures was 28,7%, which represents 11% of GDP. Transfers represented 59,9% of local revenues in 2013.

Always for 2013 and based on MoF's data, the LDF consisted in 16,6% of total transfers, almost the same as the share of the Filling-the-gap transfer with 13,8%. The rest (69,6%) was composed of special purpose transfers. Conditional transfers for pre-school, general education and primary health care were the bulk of the special purpose transfers, followed by transfers to finance individual social welfare benefits and finally transfers to finance the delegation to local governments of land registry services. The actual allocation of special purpose transfers per-capita across jurisdictions shows that a per capita higher amount of transfer was allocated to the provinces with lower fiscal capacities, while a per capita lower amount of transfer was allocated to the two richest subnational governments. Consequently special purposes transfers have an equalizing effect.

The per capita local expenditures and revenues data prove that there is considerable variation between local governments in terms of fiscal capacities and needs—however, given the equalization impact of transfers mentioned above, this variation has been reduced over time. The min-max ratio for per capita expenditures has decreased from 21.3 fold in 2012 to 3.8 in 2013.

The dependence of local governments on the central transfers to fulfil their own functions varies greatly between jurisdictions. Three intermediate or provincial governments out of 22 manage, with all the third tier of governments below them included, to finance their basic or current budget through local and shared taxes: the capital city and two provinces where the major natural resources extraction projects are located. The other 19 provincial governments and their lower tier are heavily dependent on the support from the central government. Hence, dependence on central government transfers has risen sharply since 2013 when the assignment of expenditures and revenues together with the inter-governmental fiscal transfer system changed.

The three pillars stand globally in a coherent way even if their design still requires improvements. The "Filling-the-gap transfer", although it allows subnational governments to ensure the financing of their daily administrative and service delivery tasks, including the ordinary maintenance of local infrastructures, does not take into account "good practice": in fact, gap-filling transfers should be avoided as they undermine incentives for fiscal responsibility given budget deficits will be covered by the central government. On the other hand, the LDF is complementary to the first pillar because it provides funds for new investments as well as major rehabilitation works. Its horizontal distribution formula rewards local tax collection, which is positive but is not coherent with the contrary incentive created by the first pillar transfer. The special purpose transfers serve to finance tasks that are delegated to subnational governments; that is, these are for tasks which are not devolved. There are several conditions which are being defined by the respective line ministries and which are attached to the release of funds. Their execution is also closely monitored by line ministries.

The delineation of the three pillars has recently suffered some dispute. The special purpose transfers entail a capital investment component and the LDF was originally designed to finance investments dedicated to local, own functions, excluding health and education. However, the infrastructure dedicated to health and education is largely obsolete, energy inefficient, and its normal lifetime has often passed. Construction and rehabilitation needs are considerable and improvements of the infrastructure are demanded by the public. The MoF finally intervened to explain that the LDF can be used to invest in education and health, compensating for the too limited sector budgets.

## 3. Challenges in the implementation of the LDF

***In terms of design*****,** there are three main problems. Firstly, the formula applied to the horizontal allocation of the LDF does not seem to have been elaborated taking into consideration the allocation criteria applied to the other transfers, principally the Filling-the-gap transfer. As a consequence some jurisdictions, even if they would badly need it because they are poorer, may receive too many resources for capital investment than their administrative capacity may absorb and execute. A system needs to be designed which harmonizes better the funds for capital investment and the managerial capacities.

Second, the Filling-the gap transfers presents *the default to disincentive local fiscal effort,* which is somehow offset by the LDF formula and its fiscal effort allocation criteria. The system should be further harmonized to serve consistently the goal of increasing local fiscal efforts—a core objective which lays the ground for efficient fiscal management, service delivery and accountability.

Thirdly, the indicators used for the horizontal allocation of the LDF are numerous, at such a level that the system becomes too complex and undermine transparency. It is in particular the case of the development index, which is based on tens of indicators that are hardly available or reliable. That may result in a de facto discrete horizontal allocation and therefore little transparency behind the appearance of technical objectivity.

***In terms of execution***, there are significant capacity gaps at the community level for budgeting, planning, procurement and civic engagement in the process. The LDF has also suffered from a *weak technical capacity of the central state* to accurately estimate revenues, which has been combined with a tendency to push estimations upwards[1]. This has resulted in in-year downward amendments of the global and local LDF appropriations and disbursements, disrupting the planning and execution processes of subnational governments. Hence, the problems related to the management of the LDF at the national level have contributed to the fact that around 12% of local projects selected in 2013 were not implemented and /or were not completed.

| Local Development Fund (in billions Mongolian Tugrugs) | | | |
|---|---|---|---|
| Year | Initial allocation | Transferred | % |
| 2013 | 209.6 | 187.5 | 89 |
| 2014 | 265.7 | 195.4 | 74 |
| 2015 | 201.9 | | |

Probably more importantly, there is a whole range of *weaknesses related to the existing capacities* at the local level that affect the planning and execution stages. They are found in the local public sector but also in the private sector, concerning mainly engineering and construction firms.

Apart from the common problem of *insufficient technical skills in civil engineering and construction entrepreneurship found in both the local public as well private sector, skills in participatory planning* to fully reach the expected jump in allocative efficiency may also *lack within local governments*. Being able to establish priorities among different needs of different subsets of the population and then respond to them through a list of viable investment projects is a complex exercise. Problems range from non-representative groups of people involved in planning to a weak link between the needs expressed and a final list of feasible projects.

Weaknesses of the local civil society may also be mentioned. Local civil society is understood here as all groups and individuals pertaining to the circle of the end beneficiaries of the LDF as well as some professional organisations that may defend their interests, including the media. Individuals who are part of civil society tend to demand LDF decisions that increase their personal and private assets instead of debating around common goods and the public interest.

*Regarding its transparency requirements*, the LDF can be rated high. The regulations for its implementation do not only call for a participatory and transparent allocation but public reporting on procurement and contract execution is also required. Citizens are entitled to set up committees and request formal review sessions to be held with the executive.

While the LDF is greatly contributing to the creation of a culture of participation, there is no provision for *costing such participation* and providing the needed budget space to local

[1] More than 15% of overestimation of revenues for each of the last three years according to a Public Expenditures and Financial Accountability analysis (PEFA) carried out by the World Bank.

authorities. It is worthwhile to note that participation can be expensive in terms of time and resources: not only for the organizers, but also for the participants - a fact that is often neglected. Moreover, the *representational aspects of participation* are left out in the law and the procedures. Without clear rules that stipulate the inclusion of certain disadvantaged groups, participation can be captured by powerful groups and business interests.

## 4. Success elements of the reforms and the LDF

With the introduction of LDF, there is devolution of authority from the centre to the lowest levels of local government (soum) and to local communities over substantial local investment decisions. Discretionary spending by soums has increased by as much as one hundred times to an average of about $280,000 per soum, providing considerable development opportunity for small local communities (one third of less than 2,000 people). Moreover, requirements for citizen participation in planning and budgeting for the expenditure of LDF are institutionalised in the Law. Furthermore, different forms of social accountability on execution aspects are encouraged.

## 5. The Role of SDC

SDC supports a number of critical aspects of local governance reform, which started with the Budget Law of 2011. As mentioned above, the Law clarified and reassigned the expenditure functions. It also introduced formulas for both the global allocation to the LDF and its horizontal distribution. This ensures that the LDF transfer mechanism takes into account equity and predictability.

***The implementation of the LDF*** has been supported through various SDC projects. A number of local governments were supported to run participatory planning for the utilisation of LDF, which is required by the law. Local communities were empowered to apply social accountability tools for the improved service delivery and sound management of LDF processes. The capacity of newly created Local Procurement Units were strengthened to fulfil their task of executing local procurement processes in open, transparent, and effective fashion, i.e. by selecting the best private companies' bids to execute the projects funded by the LDF. Training sessions on the elaboration of bids were also provided to local private companies. SDC also supported the setting up and training of treasury units at the third tier level, where 60% of the LDF allocations are decided upon.

SDC continues and enhances its commitment towards decentralization through two new projects consisting in providing financial and technical support directly to subnational governments.

The aim of one intervention is to foster capable, empowered and accountable local governments to provide services responding to citizen's needs in the capital city area. Citizen participation should be ensured along the entire cycle of the budgeting process from policy planning to project identification and prioritization and further down the cycle to the monitoring of budget implementation including procurement and public scrutiny of the results achieved and resources used. In addition, the delivery of selected public services will be improved with the involvement of users through the citizen score card approach. This project of a relatively modest financial scope will be implemented by the Asia Foundation in partnership with the Municipality of Ulaanbaatar.

The second project will support the strengthening of participatory development planning, participatory budgeting, procurement, capital projects contract execution as well as treasury and accounting functions at the third tier of government, in all rural areas of the country. A major approach to complement training is the financing of performance-based grants integrated in the LDF transfer mechanism (top-up grants). This project is financed combining a loan to Mongolia with a SDC grant. It is under the direct implementation responsibility of the World Bank and the Mongolian Ministry of Finances.

***At the policy level,*** SDC supports the government in two interrelated policy issues. There is cooperation with the government in creating adequate structures in-house, which will lead to the analysis and reform processes required to establish 1) *a decentralisation strategy and policy* and 2) an adequate *legal framework for civic engagement and participation*. Although connected with the LDF these policy frameworks have a broader scope.

The involvement in policy support and dialogue is substantial. Until 2018, it is hoped that the government will take advantage of SDC's support to clarify the allocation of functions across the three levels of governments and adapt accordingly both the tax assignment and the transfer system, with an attention put on the horizontal equalization of resources. The Government will also receive support to strengthen citizens' rights to participation through the establishment of a right to oppose decisions of local governments' assemblies through referendum. The support will also be provided to the Government to conduct broad information campaigns on the rights of citizens to participation in decisions and to be informed on the use of public funds.

**The exit strategy** relies on (i) government ownership, where the objective is that country authorities will be able to take over all responsibilities; and (ii), cooperation with multilateral agencies. The projects supporting policy development are carried out by the Government itself, so that reforms are generated from inside and face less risks to be reversed. The cooperation with multilateral agencies shall ensure the continuation of technical and financial support beyond SDC's involvement.

**Reference Documents and Further Information:**

Website link of the LDF

http://tusuv-oronnutag.mn/

Financial Reports from the Ministry of Finances

LDF funding sources

Research Paper

Analysis of Budget Law of Mongolia of 2011

Project Documents

GDP-SDC Decentralisation Policy Support Project

GDP-SDC Urban Governance Project

World Bank Sustainable Livelihood Project – SLP3