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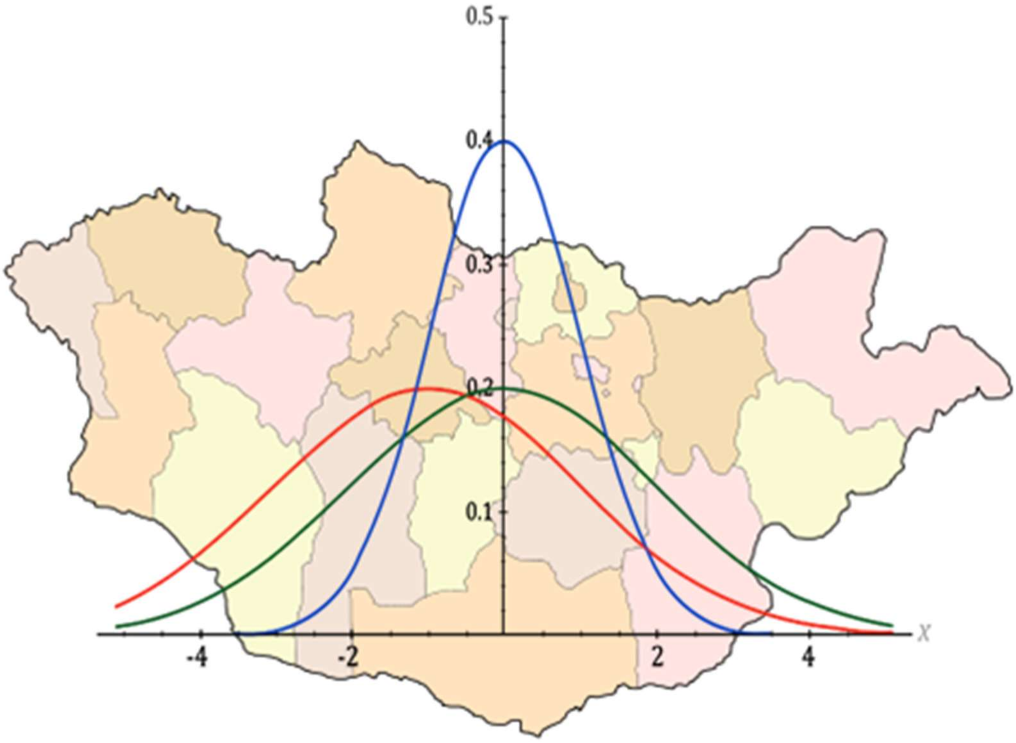
Ideas for Fiscal Equalisation Reform in Mongolia

Considering the Swiss Fiscal Equalisation System

by Stefan Pfaeffli



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Acronyms

BL	Budget Law
CC	Cost compensation
FE	Fiscal equalisation
GLDF	General Local Development Fund
LDF	Local Development Fund
RE	Resource equalisation
SNG	Sub-national government

Management Summary

Fiscal equalisation is at the heart of decentralisation, however there is a distinction between fiscal equalisation in the broader and stricter senses.

In the broader sense, fiscal equalisation includes a clear allocation of tasks and responsibilities to the central (State) and sub-national levels (aimags and soums). It also includes the management of collaboration between higher and lower governmental levels and collaboration at the same State level. When tasks are allocated to different State levels, there is a commensurate allocation of costs. Therefore, in order to complete fiscal allocation in the broader sense, there is a need to also allocate the requisite finances to cover both the tasks and the costs.

When fiscal equalisation is well designed, each State level is tasked with the correct responsibilities and receives a sufficient level of financing. However, this does not mean that each individual State entity (aimag or soum) is necessarily adequately financed. Some sub-national governments may have more own revenue per capita than others, and some may have higher costs per capita. Because of these disparities, fiscal equalisation is also needed in the stricter sense, in which the emphasis is placed on revenue equalisation and cost compensation.

This report outlines ideas for fiscal equalisation reform in Mongolia. It takes into consideration the Swiss system of fiscal equalisation, but does not simply attempt to overlay that system on Mongolia's existing inter-governmental fiscal relations. Rather, it is recommended that the existing system be simplified, further developed and improved, and, where possible and/or appropriate, that principles be adopted that have been successfully applied in Switzerland. The report is divided into three sections: (1) Analysis of the existing system of sub-national finance; (2) Technical recommendations for reforming the fiscal equalisation system in Mongolia; and (3) Considerations for the organisation of the reform project.

(1) The existing system of sub-national finance

Analysis of the system of sub-national finance starts in the year 2013 when, with the General Local Development Fund (GLDF), a substantial improvement in the financial situation at the sub-national level was achieved. Based on budget figures for 2013 and 2014, it is estimated that the share of own revenues, as part of the sub-national budget, ranged from 35-40 percent on average. The remainder was comprised of earmarked and non-earmarked transfers. The GLDF, together with financial support transfers, are non-earmarked. The volume of earmarked transfers is roughly twice the size of non-earmarked transfers. As a result of the introduction of the GLDF, the revenue share at the sub-national level is estimated to be about 28 percent of total public finance. Financial support transfers fill the basic budget deficit and have a partially equalising effect. GLDF grants are distributed according to set formulas; however, those formulas do not result in more equitable revenue distribution. Earmarked transfers are needed to finance such shared functions as education, primary health care, land relations and cadastre, child development and sports. Insufficient predictability is a major concern surrounding earmarked grants. Unfortunately, some of the own resources are neither sufficiently yielding nor buoyant.

The existing fiscal equalisation system is not based on clear goal statements. However, the fiscal autonomy of sub-national governments has improved with the introduction of the GLDF. Such fiscal autonomy is an important goal of vertical fiscal equalisation. Therefore, fiscal autonomy can be considered a de facto goal; although important aspects of vertical fiscal equalisation still need to be addressed. The same holds true for horizontal equalisation.

(2) Technical reform recommendations

The technical reform recommendations are based on consideration of good practices and discussions with members of the fiscal equalisation working group on reform priorities. Four reform packages are suggested: (i) A set of clear fiscal equalisation goals; (2) A fiscal equalisation mechanism in the stricter sense based on two key pillars (resource equalisation and cost compensation); (iii) Selected measures for improving vertical and horizontal equalisation; and (iv) Accompanying measures.

It is suggested to further develop the existing financial-support transfer system by moving towards a revenue equalisation system. When sub-national governments have higher-than-average potential revenue per capita, they should contribute proportionally to the financial support transfer fund in tandem with the central government. When sub-national governments have lower-than-average potential revenue per capita, they should accordingly receive non-earmarked grants. In addition, each sub-national government should achieve a minimum level of potential revenue per capita. This system has many advantages, including a reduction in revenue inequality between richer and poorer sub-national governments and a continued incentive to collect more taxes.

In terms of cost compensation, it is suggested to further develop and optimise the GLDF. As is currently the case, the GLDF should be financed through fixed shares of yielding taxes (VAT, mineral-resource exploitation tax). However, the criteria for the distribution of this fund should reflect relevant cost factors that make service provision more costly in different areas. Research is needed to identify and then quantify those indicators that objectively reflect those extra cost factors.

Fiscal equalisation in the broader sense is suggested as a second priority. However, in relation to vertical fiscal equalisation in the broader sense, one issue should be considered as urgent: The status of the capital city, Ulaanbaatar, meaning enhanced competencies for taxation and fees. Further suggestions are made for improved task disentanglement and more effective vertical and horizontal collaboration.

(3) Organisational recommendations of the reform project

The report recommends that fiscal equalisation reform be organised as a project. However, political consensus on broad project goals is required, as is adequate project organisation and a strong steering group and operational structure to define reform details. Headed by the Office of the President, project organisation should be anchored in all relevant ministries and should include the sub-national level.

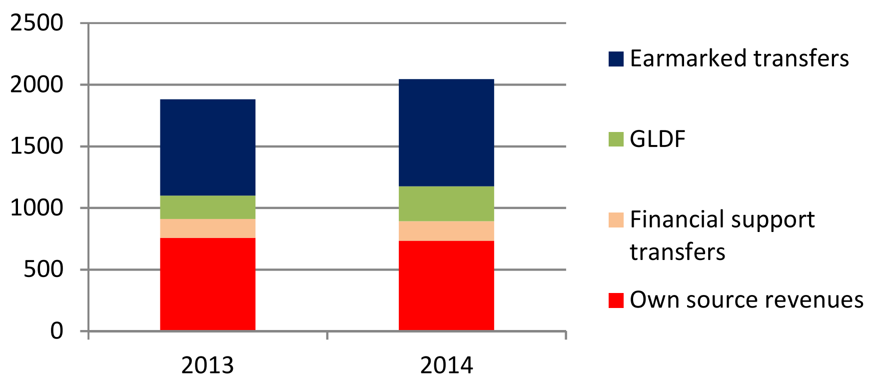
1. Short analysis of the existing system of sub-national finance

1.1. Revenue streams for the sub-national level

In Mongolia, the sub-national level is financed through own revenues and transfers. The Budget Law (BL) of 2011 delineated revenue sources for the sub-national level in Article 23.6 for own revenues and in Article 56 for transfers. The BL came into force on 1January, 2013. The breakdown of sub-national revenue for 2013 and 2014 is presented in *Figure 1*. In relative terms, the estimated share of own source revenues was 40.1 percent in 2013; it is expected to be 35.8 percent in 2014. Earmarked transfers are expected to be at least two times higher than non-earmarked transfers; in other words, financial support transfers and GLDF transfers taken together. Nevertheless, together with own revenues, the relative share of non-earmarked revenues is substantial.

In 2013, total sub-national level revenue was estimated to be close to MNT 1,882 billion. Compared with 2012, when sub-national level revenues amounted to MNT 863 billion, this is a remarkable increase. For 2013, total central government revenues were estimated to be MNT 6,178 billion. The sub-national level revenue share in the combined sub-national/central government revenue was about 28 percent (*data from the National Statistical Office of Mongolia, 2013*)[1].

Figure 1:A breakdown of estimated sub-national revenue in billion MNT



Data source: A. Lkhagvadorj, 2014, p. 13

Own taxes and fees at the sub-national level: Aimags and the capital city are empowered to levy the following taxes and fees: Capital city tax*, land payments, immovable property tax, vehicle tax,

[1] For the sub-national level, only own revenues are counted; transfers are not counted a second time to avoid doubling up.

user fees for water, wage tax, inheritance and gift tax*, and stamp duties. Soums and districts can levy the following taxes: Personal income tax, gun tax, stamp duties, user fees for hunting, user fees for natural resources other than minerals, user fees for herbs, user fees for timber, user fees for common minerals, user fees for drinking water and springs, self-employment tax, dog tax* (*NB: Those with an asterisk are not yet legislated taxes or fees*). Some of those taxes and fees are neither yielding nor buoyant. In addition, there is little incentive to improve tax collection given that the basic budget surplus must be transferred to the GLDF (*see further down, revenue-sharing/GLDF*).

Financial Support Transfer (FST): The FST, which is not earmarked and is also known as the "filling-the-gap transfer", is disbursed from upper-level budgets to lower-level budgets to cover basic budget deficits. For this purpose, the State estimates the base expenditure of each local budget taking into consideration standards of services and norm costs (BL, Article 56.4 and Resolution No. 30 of 15 September, 2012, Annex 2); it deducts base expenditure from local revenue, calculated at minimum tax rates as defined by law. According to Lkhagvadorj (2014, p. 13), the FST has a partially equalising effect when aimags are considered.

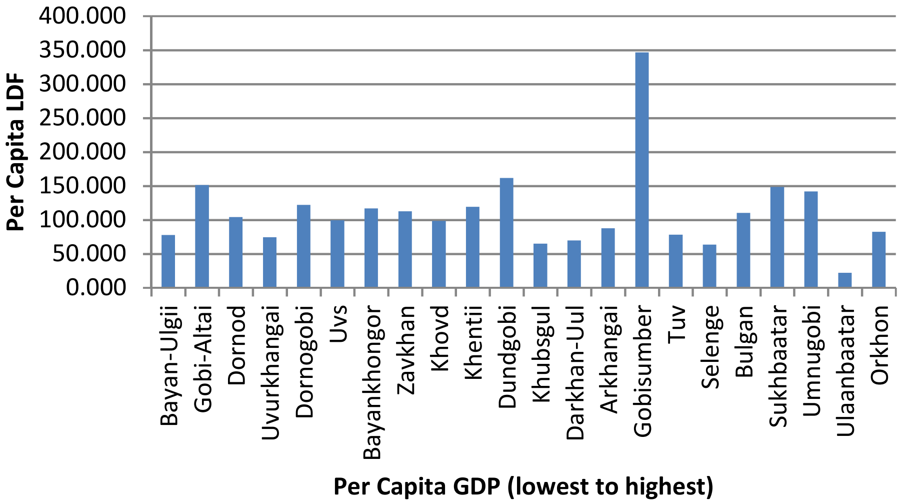
Revenue-Sharing Transfers or General Local Development Fund (GLDF): Based on Article 59 of the BL, the GLDF is, to a large extent, financed through the sharing of revenue sources which are yielding: 30 percent of the VAT on domestically produced goods and services is transferred to the GLDF, as well as 2.5 percent of mineral resource exploitation taxation. Grants and donations from domestic non-governmental organisations and foreign aid targeted at local development are also credited to the GLDF. The basic budget surplus of lower-level budgets is the fourth component of GLDF financing. The GLDF is shared between aimags (including the capital city) and soums (including districts). Based on a set formula, funds are transferred to the intermediate State level (aimags and the capital city). At least 60 percent of the GLDF transfers must then be transferred from the aimags and the capital city to soums and districts. The formula applied for the distribution of the GLDF takes into consideration four criteria: (i) Local development index; (ii) Population size; (3) Geography (population density, remoteness, territory size); and (iv) Tax initiative. Each of the four criteria has a weight of 25 percent. At the sub-national level, GLDF transfers are credited to the Local Development Fund (LDF).

The LDF gives sub-national governments more spending discretion; the spending restrictions for the LDF stipulated in Article 60.3 of the BL are minimal. However, Article 63 of the BL requires that decision-making in relation to LDF expenditure be participatory.

However, GLDF resource allocation is highly subdivided, and the resulting contributions are too minimal at the local level to generate larger, strategy-oriented capital investment projects. In addition, the formula used for the distribution of the fund is not based on in-depth economic analysis. If actual per capita LDF allocations per aimag are considered, it can be seen that the distributive effects do not adhere to a systematic pattern. Lkhagvadorj (2014, p. 17) compared the per capita GDP of each aimag, including the capital city, with per capita transfers from the LDF and found that some wealthier aimags received a higher or almost equal per capita LDF transfer as poorer aimags (*see Figure 2*). There is hence a need to further examine the distributive effects of the LDF, particularly at the soum level, and to adjust the allocation mechanism, as Lkhagvadorj (2014, p. 17) suggested.

Figure 2: Per capita LDF allocation compared with per capita GDP per aimag

(In thousand MNT, 2013)



Source: Lkhagvadorj, 2014, p. 17

Earmarked Transfers: Earmarked transfers are provided by line ministries to fund such shared functions as education (including preschool), primary health care, land relations and cadastre, child development and sports. Ministries base allocations for recurrent costs on cost calculations per service unit (Lkhagvadorj 2014, p. 13). There are two main concerns about earmarked transfers: Predictability and partial inconsistency. In relation to the former, local stakeholders are critical of the timing, with information on annual disbursements received after 15 November, which is too late for local budget preparation. The latter refers to the funding of social welfare services and possibly environmental protection through the FST, which should be considered shared functions and hence should be co-financed through earmarked transfers and not through the FST.

1.2. Goals of the existing fiscal equalisation system

Mongolia's existing fiscal equalisation system is not based on clear goal statements; therefore an assessment of the actual level of goal attainment is not possible at present.

Despite the lack of explicit goals, the current fiscal equalisation system might implicitly serve fiscal equalisation goals. The revenue-sharing system introduced on 1 January, 2013 - the GLDF - does improve sub-national governments' financial autonomy. Enhancing the fiscal autonomy of lower State levels is an important goal of vertical fiscal equalisation; however, other important aspects - such as the disentanglement of functions between higher and lower levels of government, the management of shared functions, and the city status of Ulaanbaatar - still need to be addressed. Issues also need to be addressed in terms of horizontal fiscal equalisation, including disparity equalisation taking into consideration the fiscal potential of sub-national governments; cost compensation in the event of extra burdens on sub-national governments; horizontal collaboration between sub-national governments; and territorial reform. Given that policy measures in these areas are absent, it can be assumed that policy goals do not exist in relation to these issues, neither explicitly nor implicitly.

There are many ideas circulating about how best to modify the current fiscal equalisation system; indeed, the number of reform proposals demonstrates the prevailing sentiment that reform is necessary. However, while there may be consensus on the need for reform, the issue is rarely discussed in a systematic way, with little discourse on exactly why the existing system should be reformed, where the deficiencies lie, and what the reform goals should be. Without explicit reform goals, it is not possible to assess in detail the adequacy of the reform proposals.

1.3. Reform priorities

April 8, 2014, marked the first meeting of a working group tasked with preparing the ground for the reform of the fiscal equalisation system, headed by the Presidential Advisor on Decentralisation Reform, Mr Dashdorj. The group discussed reform priorities based on presentations of options by Professor A. Lkhagvadorj and Stefan Pfaeffli, including those in the broader sense (the allocation of tasks and tax resources, the management of shared functions, the status of the capital city, horizontal collaboration, and territorial reform) and in the stricter sense (resource equalisation and cost compensation). It was agreed that the current reform priorities for Mongolia should be as follows:

1. Priority: Fiscal equalisation in the stricter sense: Resource equalisation and cost compensation.
2. Priority: Vertical equalisation: Primarily improving the status of the capital city; secondly, improving the system of vertical equalisation in the broader sense (task allocation, tax allocation, vertical collaboration).
3. Priority: Horizontal collaboration/territorial reform.

2. Technical recommendations for reforming the fiscal equalisation system

In the following section, technical recommendations are roughly sketched out as to how the fiscal equalisation system could be further developed in Mongolia. To begin with, it is recommended that the system be based on clear and explicit equalisation goals. Secondly, there is a demonstration of how the existing sub-national financing systems could be further developed to better serve equalisation purposes in the stricter sense. Thirdly, ideas are presented for vertical and horizontal equalisation in the broader sense. And finally, strategies are discussed in relation to addressing the challenges of decentralisation that extend beyond fiscal equalisation.

As stated earlier, there is a distinction between fiscal equalisation in the broader and stricter senses. Fiscal equalisation in the broader sense refers to the adequate allocation of functions (tasks) and finances (taxes and grants) to different levels of government. The management of vertical and horizontal collaboration is a part of fiscal equalisation in the broader sense. Vertical collaboration refers to collaboration between higher and lower levels of government; horizontal collaboration is organised between entities at the same State level. In the stricter sense, fiscal equalisation takes into consideration two key aspects: Equalisation on the revenue side (resource equalisation) and on the expenditure side (cost compensation).

2.1. Explicit agreement on fiscal equalisation objectives

It is recommended that the fiscal equalisation system in Mongolia be based on clearly defined goals that have a legal character. These goals should serve two purposes: Firstly, to legally enshrine the purpose of fiscal equalisation and to make it an obligatory State function; and secondly, that the defined goals serve as a yardstick for periodic system evaluation. Appropriate measures to further improve the system could subsequently be undertaken if required.

Fiscal equalisation goals could serve the following purposes:

(1) **Fiscal autonomy at the sub-national level is improved**: Sub-national governments are responsible for fulfilling their mandated functions and ensuring local economic and social development based on democratically agreed upon strategies that are nationally harmonised.

(2) **Revenue disparities between sub-national governments are reduced**: Revenue disparities refer to fiscal strength (potential per-capita revenue after equalisation).

(3) **There is compensation for above-average cost burdens of sub-national governments** provided they originate from such factors as difficult socio-demographic or geographic conditions, which cannot be changed.

(4) **The system of vertical fiscal equalisation in the broader sense is optimised**: This includes, as much as possible, the disentanglement of functions between different State levels, respect for the principles of subsidiarity[2] and fiscal equivalence[3], and the clear allocation of strategic and operative responsibilities for own and shared functions.

(5) **Horizontal collaboration between sub-national governments is optimised; territorial delineations among sub-national entities are functional**: Such a goal will help to avoid fragmentation, will help to maximise potential synergies, and will help to avoid or internalise spill-over effects[4] in which each beneficiary pays a full cost share and polluters cover external and internal costs. Such sub-national delineations are functional when they coincide with areas within which intense socio-economic collaboration is taking place.

2.2. Fiscal equalisation in the stricter sense

The recommendations presented here are dedicated to Goal 2 (reduced revenue disparities), to a certain extent to Goal 1 (fiscal autonomy) and to Goal 3 (cost compensation). For each goal, one instrument is suggested[5]. This approach enables decision-makers to properly target equalisation and helps make the streams of equalisation more transparent. However, these mechanisms should not be introduced in addition to the already existing grant system; on the contrary, the existing grant

[2] The principle of subsidiarity means that functions are allocated to the lowest possible State level. A higher State level only takes over a task when the lower level is over-burdened.

[3] The principle of fiscal equivalence means that identity is established between beneficiaries, decision-makers and financiers. This triple identity guarantees allocation efficiency, meaning that scarce resources in the public sector are used in a way that optimises social benefits.

[4] Spill-over effects are the externalities of economic activity or processes; they affect those who are not directly involved in either a beneficial or detrimental manner. In the case of beneficial spill-overs, sub-national entities (such as municipalities) can benefit from a service or a capital investment of a neighbouring entity without having to cover the entire cost share. This is the case when a service such as a theatre is subsidised by the site municipality. Cost spill-overs are such detrimental side effects as noise and smoke which also negatively affect surrounding municipalities without sharing the benefits.

[5] The Swiss fiscal equalisation approach between the Confederation and the Cantons follows this route; it serves as a role model. However, this approach needs to be adapted to the Mongolian context.

system should be further developed towards a transparent and clearly goal-oriented fiscal equalisation system.

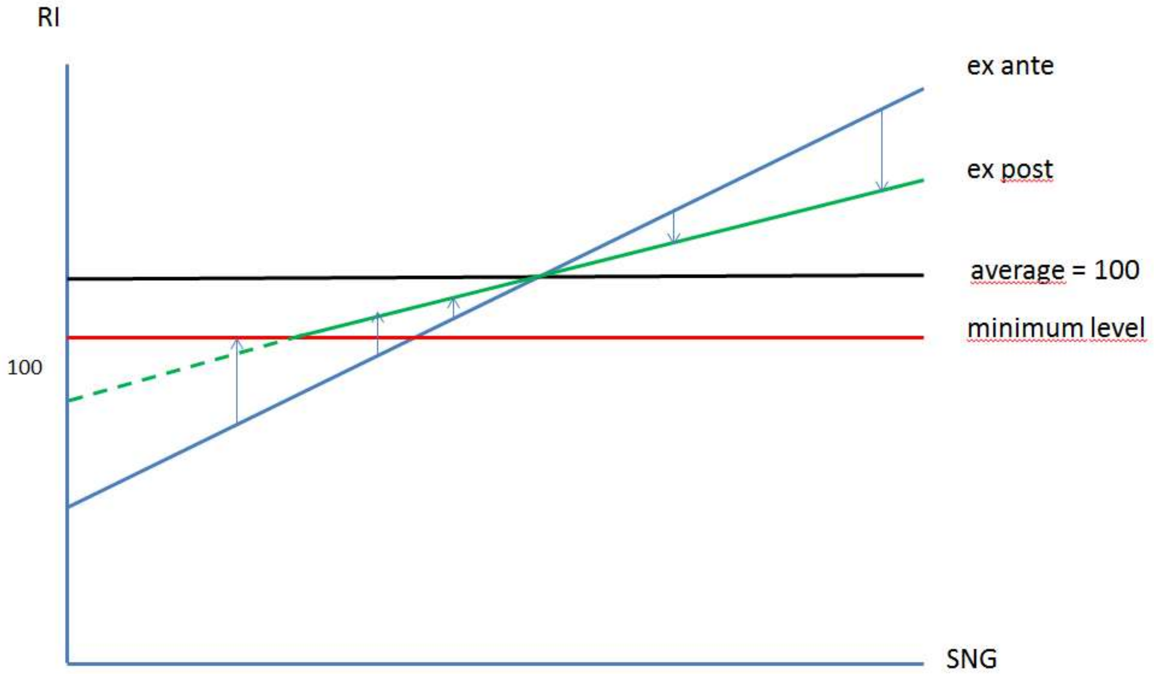
2.2.1. Resource equalisation

The suggested approach for resource equalisation is, to a certain extent, based on horizontal equalisation. This means that resource-rich sub-national governments contribute to the resource equalisation system, while resource-poor entities are supported through the system. In essence, the more resource-rich a sub-national entity is, the more it will contribute to the system; the less resource rich it is, the more financial support it will receive. The central government also contributes to the funding of resource equalisation.

The per-capita financial strength of sub-national governments does not depend on actual revenues, but on potential revenues - that is, the aggregated own revenue per capita a sub-national government *could* collect when a basic (or average) tax and fee rate is applied. For each sub-national government, this potential revenue per capita must be accurately assessed without bias each year. Based on the determined per-capita revenue potential of each sub-national government, a resource index is then calculated. The average per-capita revenue potential is considered to be index 100. Sub-national governments with an index exceeding 100 are considered to be resource-rich; those with an index below 100 are considered to be resource-poor. In order to eliminate erratic jumps, it is recommended that the actual revenue figures per capita for the past three years serve as a moving average.

The functioning of the resource equalisation system is illustrated in *Figure 3*. Sub-national governments are represented on the X axis from left to right according to their resource index in ascending order; the resource index is represented on the Y axis. Poor sub-national governments are on the left side of the X axis, the wealthier are on the right. The resource index ex ante (before redistribution) is represented by the blue line. The black horizontal line represents the national average. Resource-rich sub-national governments are required to give a certain percentage of their potential revenue per capita (whether it is collected or not). After this deduction, their position is indicated on the green ex post line. Resource-rich sub-national governments do not have to give away the entire amount of per capita revenue collected above a certain threshold. There is still an incentive to collect more revenue as only a fraction of what is collected beyond the national average must be given away.

Figure 3: Resource equalisation



Resource-poor sub-national governments will receive contributions from the resource equalisation system. This takes them from the blue to the green line. The contributions depend on the ex ante deviation of their potential per-capita revenue from the national average. A defined percentage of this deviation is compensated through the resource equalisation system. The higher the deviation, the higher the resource equalisation transfer in absolute terms. It is obvious that the revenue situation of resource-poor sub-national governments will improve through this equalisation mechanism. However, very poor sub-national governments still may not have adequate funds to fulfil their basic local government functions; therefore, a minimum resource index level is defined which each sub-national government should achieve after resource equalisation. When sub-national governments remain below this minimum level after horizontal equalisation, they will receive additional grants until they reach the minimum level. These additional grants must be vertically financed from the central government. Resource-poor sub-national governments have a strong incentive to fulfil their resource potential; if they fail to do so, they will not reach the minimum level.

Sub-national governments above the minimum level but below the national average still receive additional funds from the resource equalisation system. Their motivation to collect more revenue is not compromised by the equalisation system; they will be better off if they collect more even if they receive less in resource equalisation grants.

The minimum level must be politically defined and be based on research on the existing situation. The shift from the blue to the green line takes place through horizontal equalisation mechanisms between resource-rich and poor sub-national governments; the shift from the green to the red line is financed through vertical contributions from the central government.

It is suggested that the existing FST - the filling-the-gap system - be further developed towards a resource equalisation system. At present, it already serves to strengthen the financial autonomy of sub-national governments and enables them to fulfil their basic governmental functions. However, the existing system is not transparent and is relatively difficult to calculate. In relation to horizontal equalisation, there is overshooting when there is a transfer of the entire basic budget surplus to the GLDF. In addition, the system is not buoyant; that is, it does not progress when the economy grows and sub-national governments could be left behind. The suggested resource equalisation system can overcome these deficiencies; it is also more transparent, less complicated, more buoyant and, above all, it clearly addresses horizontal revenue disparities without negatively impacting on sub-national governments' motivation to collect taxes and fees.

The information needed for the development of the resource index should be available from the FST system; indeed, in a meeting on 9 April, 2014, the Ministry of Finance confirmed that the requisite data was available. However, it is recommended that simulations be conducted to test the functioning of a resource equalisation system in Mongolia and assessments made of the distributive results.

2.2.2. Cost compensation

As a result of unfavourable socio-demographic or geographic-topographic factors, sub-national governments may face higher-than-average recurrent and infrastructure costs. In order to ensure horizontal fairness, it is recommended that there be compensation through transfers from the central government to offset the extra costs for basic services and infrastructure.

The cost compensation system requires reliable information about the existence and influence of factors leading to the generation of extra costs. Research is needed to identify those factors and their impact on the costs of basic services and infrastructure. Specifically, there must be identification of the relevant indicators which can best explain such additional costs in a statistical model. The influence (weight) of each indicator on costs should be empirically measured using appropriate methods. Indicators which sub-national governments can influence should be excluded from the analysis.

Research on the extra cost factors for basic services and infrastructure is needed across the entire sub-national level of Mongolian government. Similar research is also needed for an assessment of the specific cost factors for the capital city.

At the 9 April meeting with the Ministry of Finance, it was learned that a World Bank project was planned to assess the weight of indicators used for the distribution of the GLDF. It is important to coordinate this planned research with the research needed to operationalise a cost-compensation scheme.[6] Duplication and potential confusion caused by the conducting of parallel research on similar issues should be avoided.

Detailed data for the analysis of costs for the provision of basic services of each sub-national government should be available from the FST. At the 9 April meeting, the Ministry of Finance confirmed the availability of the data and affirmed its readiness to facilitate the research by providing that data. According to the methodology used to estimate the base expenditure of local budgets, data should be available on fixed recurrent expenditure, variable recurrent expenditure and capital expenditure for the following sub-national government functions: Local government management, environmental and rehabilitation activities, social care and welfare, and consolidated and adjusted base expenditure.

Transfers for cost compensation should not be earmarked. The cost-saving scheme should be designed in such a way that it does not, where possible, discourage savings. If individual sub-national governments save costs, the transfers they receive should not be reduced; transfers should depend on indicators related to extra cost factors and not on the management weaknesses of sub-national governments.

It is suggested to further develop the revenue-sharing transfer mechanism (GLDF) in such a way that it serves as a cost-compensation scheme. At present, the distribution of this fund is based on

[6] At the meeting with the Ministry of Finance on 9 April, 2014, it was agreed that the project description would be shared with the project for fiscal equalisation reform. The contact persons within the Ministry of Finance are Ms. Ganchimeg and Ms. Erdemchimeg.

indicators which, to a certain extent, reflect cost-compensation criteria. However, these criteria are not yet evidence-based and their weight is not justified by empirical analysis.

The label “Local Development Fund” should not be considered an impediment to the further development of the GLDF/LDF towards a cost-compensation scheme. The current permitted use of the LDF is not purely development-oriented and the volume per sub-national government is too small to fund the larger capital investments needed to foster local economic development. A cost-compensation scheme could enable sub-national governments with cost disadvantages to implement development strategies similar to those of sub-national governments without cost disadvantages.

If the GLDF is transformed to a cost-compensation mechanism, special provisions for budgeting and participation related to the LDF should be extended to the entire sub-national budget to the extent that this is feasible.

The cost-compensation scheme should be as simple as possible; of course, such simplicity means that it is not possible to compensate each and every case to the same extent - there will be winners and losers when the system changes. However, it is advisable to cushion the negative effects with a special transition fund that can compensate those who lose out with additional grants. These grants should allow sufficient time for adjustment over a certain number of years.

2.3. Fiscal equalisation in the broader sense

The fiscal equalisation working group specified two reform directions in the broader sense at the first meeting held on 8 April, 2014: Vertical and horizontal equalisation.

2.3.1. Vertical equalisation in the broader sense

Granting city status to the capital city is likely to be the first priority that should be addressed under fiscal equalisation in the broader sense. There are three important concerns associated with capital city status: (1) Enhanced autonomy to levy fees (such as for parking, public transportation, water, electricity); (2) Increased revenue from property tax; and (3) Municipal borrowing. The division of responsibilities between the central government and the city government with respect to capital investment also needs further clarification. As Slack (2014, p. 21) points out, this is of particular importance given the fact that the capital city has double functions: Firstly, the capital city function (such as a greater need for security, parks, transportation and culture), and secondly, a local function (a place where local people live, work, use local services and are socially active).

The general issues related to vertical equalisation in the broader sense are considered to be important but less urgent. Issues that should be considered are: (1) Better disentanglement of functions; (2) Enhanced tax sharing; (3) Improved predictability of funds; and (4) Better clarification of the roles and responsibilities related to shared functions (such as on the basis of multi-year performance contracts).

2.3.2. Horizontal equalisation in the broader sense

There are two key issues to consider in relation to horizontal collaboration in the broader sense: Firstly, making use of economies of scale through better collaboration should be encouraged where possible, therefore no bonus for small size should be granted. Secondly, in order to overcome situations involving unsustainable fragmentation, it could be beneficial to test pilot cases either for horizontal collaboration (where the principle of fiscal equivalence is fully respected) or mergers.

2.4. Addressing the challenges of fiscal decentralisation beyond fiscal equalisation

Fiscal equalisation is one way of addressing the negative side effects of decentralisation. However, it is not sufficient to address the risk of a growing regional divide or unsustainable financial policymaking that has the potential to undermine the success of a decentralisation strategy.

2.4.1. Accompanying measures against the risk of a growing regional economic divide

Fiscal equalisation cannot be a substitute for the improvement of living conditions nationally; regional economic development is also needed for decentralisation and should be based on realistic strategic development plans at the aimag and soum levels. These sub-national development strategies should be elaborated in a participatory way and designed with expert knowledge. Such development should also be harmonised with national strategies and regionally coordinated. In Mongolia, regional economic development still requires improved infrastructure throughout the country, as well as improved access to quality services. Enhanced horizontal collaboration and mobile service provision in remote areas could contribute to this objective. It is also of utmost importance to stimulate private investment (both national and international) in every region of Mongolia, for which legal certainty, a low level of corruption and the client friendliness of public administrations are crucial factors.

2.4.2. Accompanying measures against the risk of unsustainable policymaking

Two measures are highly important: Firstly, capacity building in the area of public finance management is still a high priority at the sub-national level; secondly, key financial figures and a system of monitoring, reporting and auditing those figures should be elaborated and implemented to prevent sub-national governments from being financially derailed.

3. Considerations for the organisation of the reform project

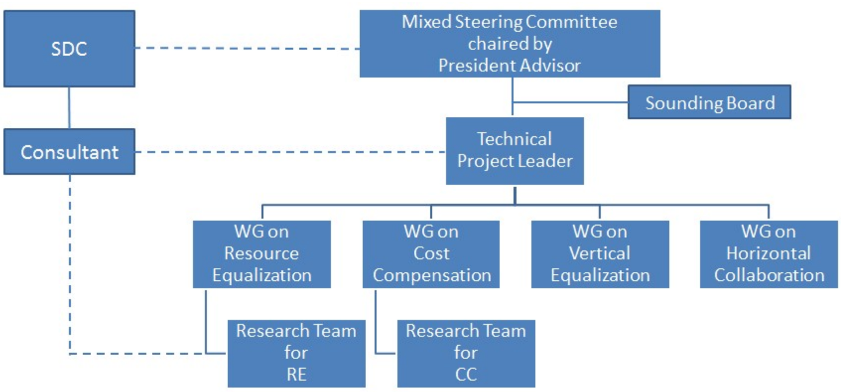
The reform of the fiscal equalisation system in Mongolia should be considered to be a project that needs proper project organisation. This form of organisation is needed all the more as it is a cross-ministry undertaking that affects both the national and sub-national levels of government. It also needs clear political guidance and technical expertise. Full country ownership of this reform project is indispensable and must be reflected in the project's organisation.

Fiscal equalisation reform is a complex process. In a complex project, no one has complete oversight of the processes involved from start to end because stakeholders' reactions are often unpredictable and important information is often not available in one place, at neither the central level nor the sub-national level. Therefore, inclusive project organisation undertaken in a spirit of partnership between national and sub-national governments is highly recommended.

In a complex project, it is also not possible to address all problems at the same time. Sequencing of the project - beginning with the fundamental aspects - is unavoidable. For this purpose and in order to promote transparency and accountability, a project description with a realistic yet still challenging time schedule and clear milestones is important. For the main positions, actors and working groups involved in the organisation of the project, terms of reference should be elaborated and agreed upon. Positions should be filled by capable and dedicated people. A project budget is also needed.

Figure 4 illustrates a possible chart for project organisation.

Figure 4: Possible project organisation



4. Annex

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4.2. List of interviews and contacts

L. Ariunaa, Sc.D.	Head of Economics and Finance Department	National Academy of Governance, Ulaanbaatar
A. Bakei	Member of the State Great Khural, Chairman of the Standing Committee on State Structure	State Palace, Ulaanbaatar
D. Baljinnyam	Senior Specialist	Cabinet Secretariat of the Government of Mongolia
G. Batkhurel	Deputy Director of Development Policy, Strategic Planning and Coordination Department,	Ministry of Economic Development, Government Building, Ulaanbaatar
D. Bertsetseg	Chair of Citizens Representative Khural	Zuunmod, Tuv Aimag
R. Burmaa	Member of the State Great Khural, Chairwoman of the Standing Committee on Petition	State Palace, Ulaanbaatar
Y. Byambatsogt	Director of State Budget and Financial Department	Zuunmod, Tuv Aimag Governors Administration Office
L. Dashdorj	Public Finance and Economic Policy Advisor to the President of Mongolia	Office of the President, State House, Ulaanbaatar
D. Davaasambuu	National Social Scientist and Policy Development Expert, Member of Working Group for the Fiscal Equalisation Reform	Former Minister of Finance of Mongolia
S. Demberel	Member of the State Great Khural, The Head of the Green Group	State Palace, Ulaanbaatar
B. Dorjsembed	Head of General Budget Policy and Planning Division	Mongolia Ministry of Finance
D. Elmer	Deputy Country Director	Swiss Cooperation Office of the Embassy of Switzerland, Ulaanbaatar
B. Enkbaigali, PhD.	Director of the Mongolian Development Institute, Member of Working Group for the Fiscal Equalisation Reform	Mongolian Academy of Sciences, Office of the President of Mongolia, Ulaanbaatar
A. Enkhbat	Lecturer and Consultant at the Office of the President, State House, Ulaanbaatar	Finance Department, School of Economic Studies, National University of Mongolia,
J. Enkhtur	Senior Specialist	Treasury Department of Ulaanbaatar City Municipality

S. Erdemchimeg	Coordinating Consultant for the World Bank Technical Assistant Project	Ministry of Finance, S. Danzan Street 571, Ulaanbaatar
L. Erdenechimeg	Member of the State Great Khural	State Palace, Ulaanbaatar
J. Ganbat	Director of Fiscal Policy and Planning Department, Ministry of Finance	Government Building, Mongolia
P. Ganchimeg	Consultant of MSTAP WB Project, Fiscal Policy Department	Ministry of Finance, S. Danzan Street 5/1, Ulaanbaatar
D. Khurelbaatar	Member of the Citizens Representative Khural, Chairman of the Finance and Budget Standing Committee	Deputy CEO of the Trade and Development Bank, Ulaanbaatar
O. Khuyagtsogt	Head of Expenditure Division of Budget Policy and Planning Department	Mongolia Ministry of Finance
A. Mandukhai	Research Assistant, Governance and Decentralisation Program	Swiss Cooperation Office of the Embassy of Switzerland, Ulaanbaatar
D. Otgontuya	Researcher and Referent at the Mongolian Development Institute	Mongolian Academy of Sciences, Office of the President of Mongolia, Ulaanbaatar
N. Selenge	Senior Program Specialist, Governance and Decentralisation Program	Swiss Cooperation Office of the Embassy of Switzerland, Ulaanbaatar
E. Temuulin	General Director of the Economic Development Department	City of Ulaanbaatar, Central Cultural Palace
J. Tsendsuren	Governor and Mayor of Zuunmod City	Government Office of Zuunmod City, Tuv Aimag
D. Tuvshinbat	Researcher at the Mongolian Development Institute	Mongolian Academy of Sciences, Office of the President of Mongolia, Ulaanbaatar
M. Waldvogel	Country Director	Swiss Cooperation Office of the Embassy of Switzerland, Ulaanbaatar